Final Section 956 regulations facilitate foreign credit support for certain US corporate borrowers

DENTONS

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On May 22, the Treasury Department and the Internal Revenue Service (IRS) finalized regulations under Section[1] 956 that allow certain US corporate borrowers to obtain increased credit support from certain controlled foreign corporations (CFCs) without incurring US tax, so long as certain conditions are satisfied. The final regulations do not apply to individuals, regulated investment companies (RICs) or real estate investment trust (REITs). They generally adopt the proposed regulations with certain modifications or additions, and they apply to taxable years of CFCs beginning on or after July 22, 2019. However, taxpayers may apply the final regulations to taxable years beginning after December 31, 2017, if all US-related parties apply them consistently to all CFCs in which they are US shareholders.

In most cases, US corporate borrowers will now be able to pledge 100 percent of the stock of their CFCs, and those CFCs will be able to guarantee the debt and pledge their assets without triggering a deemed dividend under Section 956. This is because the final regulations generally exempt corporate US shareholders of CFCs from the application of Section 956 by providing that the amount otherwise determined under Section 956 with respect to such US shareholder for a CFC's taxable year is reduced to the extent that the shareholder would be allowed a deduction under Section 245A if such shareholder had actually received a distribution from the CFC in an amount equal to the tentative Section 956 amount.

There remain a few circumstances, however, where a US corporate borrower will generally not be able to provide the additional credit support of its CFCs without potentially creating a deemed dividend under Section 956.

- **New CFCs**. In order to benefit from the deduction allowable under Section 245A, the US corporate borrower must satisfy a one-year holding period requirement with respect to the CFC (which could be met retroactively). Therefore, in most cases, US corporate borrowers should insist that they should pledge only 65 percent of the stock of such new CFCs, consistent with market practice prior to the new regulations.
- **Certain hybrid instruments**. Generally, a dividend for which the CFC is allowed a deduction or other tax benefit under the tax regime of any foreign country (or US possession) had the CFC paid an actual dividend.
- **Certain US-source earnings**. The deduction under Section 245A does not apply to income effectively connected with a US trade or business that is subject to US tax or dividends from at least 80 percent–owned US subsidiaries (including RICs and REITs). Therefore, to the extent that the CFC owns a US business or assets, it may generate US-source dividends that would not be subject to the deduction under Section 245A, and thus may be subject to Section 956.

Main differences from proposed regulations

The final regulations include two main differences, both of which are favorable to taxpayers. First, they provide that the

Section 956 deemed dividend to a US partnership borrower owned directly (or indirectly through other partnerships) by one or more US corporations is reduced to the extent of the aggregate amount of Section 245A dividends received deductions that would be available to the US corporations with respect to their distributive shares of the deemed dividend received by the partnership.

The final regulations also, solely for purposes of determining the amount of the deduction allowed under Section 245A for purposes of these regulations, modify a rule on technical earnings and profit ordering. This rule is intended to preclude technical issues that could arise with respect to CFCs that have "previously taxed income" attributable to prior Section 956 inclusions, as well as current-year earnings and profits that would be eligible for the Section 245A dividends received deduction if distributed.

Interaction with recent guidance under Section 245A

On June 18, the IRS issued temporary regulations that limit the Section 245A deduction available for certain dividends received from CFCs after December 31, 2017. The provision of credit support by a CFC that is subject to these rules may give rise to a deemed dividend to the US corporate borrower under Section 956.

In general, the temporary regulations may apply in two situations. First, the rules limit the Section 245A deduction to 50 percent of dividends attributable to earnings resulting from certain related-party dispositions of property by a fiscal year CFC during 2018 prior to the application of the global intangible low-taxed income (GILTI) provision to the CFC. Second, the rules limit the Section 245A deduction for dividends paid out of certain earnings generated by a CFC during any taxable year ending after December 31, 2017, in which a controlling US corporate shareholder reduces its ownership of the CFC by more than 10 percent, or transfers more than 10 percent of the CFC stock, to the extent that such earnings (i) would have been included in the shareholder's income under the GILTI or Subpart F rules had the ownership reduction transaction not occurred, and (ii) are not taken into account by any US person.

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1. "Section" references are to the Internal Revenue Code of 1986, as amended. ↩

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