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Newly Proposed Regulations Limit Section 956 Inclusions for U.S. Corporate Shareholders of CFCs

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Hughes Hubbard & Reed LLP • A New York Limited Liability Partnership
One Battery Park Plaza • New York, New York 10004-1482 • +1 (212) 837-6000

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November 6, 2018 - On October 31, 2018, the United States Treasury Department issued proposed regulations that would exempt certain U.S. corporate shareholders of controlled foreign corporations (“CFCs”) that invest in United States property from taxation under Section 956 of the Internal Revenue Code (the “Code”). The proposed regulations would scale back the existing rules to the extent a U.S. corporate shareholder is eligible for the Participation Exemption, which was enacted as part of the Tax Cuts and Jobs Act in late 2017 and is discussed in further detail below. While not effective until tax years beginning on or after the date that the regulations are finalized, the proposed regulations may be relied upon by a taxpayer for CFCs’ tax years beginning on or after January 1, 2018, provided that the taxpayer consistently applies the proposed regulations with respect to all of its CFCs.

Section 956 of the Code

Under Section 956 of the Code, U.S. Shareholders (generally, U.S. persons that own 10% or more, directly, indirectly or constructively) of a CFC that invests in certain “United States property” are required to include in income an amount of earnings (the “Tentative Section 956 Amount”) up to the value of that property. United States property includes tangible property located in the U.S., stock of a related domestic corporation, loans or other obligations of a related U.S. person, and the right to use certain intellectual property in the U.S. In addition, certain guarantees and pledges of assets by a CFC that secure debt obligations of U.S. Shareholders, as well as pledges of two-third or more of the voting stock of the CFC to secure such obligations, are also treated as investments in United States property.

The Participation Exemption and the Proposed Regulations

The Tax Cuts and Jobs Act provided certain corporate U.S. Shareholders with a 100% dividends-received deduction for foreign-source dividends received from a CFC, subject to holding period requirements and other

restrictions (the "Participation Exemption"). At the time the statute was enacted, commentators questioned why the same deduction was not also available with respect to the investments in U.S. property subject to Section 956. The proposed regulations reduce the Section 956 inclusion by the amount of the dividends-received deduction to which a corporate U.S. Shareholder would have been entitled had the Tentative Section 956 Amount been distributed as a dividend, effectively putting the U.S. Shareholder in the same position as if it had actually received a dividend.

Practical Considerations

The proposed regulations have a number of practical ramifications. First, repatriating cash back to the U.S. by means of a loan from a CFC to a U.S. Shareholder in situations where, for example, a dividend might be prohibited as a matter of foreign corporate law or result in foreign withholding tax, generally will not result in adverse U.S. tax consequences as compared to an actual dividend. Second, in many cases, it will no longer be necessary to exclude CFCs from acting as guarantors of loans to U.S. borrowers, contrary to what has been typical practice in drafting credit agreements.

Some caution, however, is in order. It would be advisable for borrowers to maintain flexibility to remove CFCs as guarantors of debt obligations if the proposed regulations are not finalized in their current form. In addition, the proposed regulations do not change the application of Section 956 to U.S. Shareholders that are individuals, regulated investment companies, or real estate investment trusts, and the government has asked for comments regarding whether and how the proposed regulations should apply to U.S. Shareholders that are partnerships. Finally, the proposed regulations, if adopted as final regulations, or if taxpayers choose to apply them prior to finalization, will in many cases prevent corporate taxpayers from affirmatively using Section 956 to increase foreign tax credits.

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