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KPMG report: Final regulations, amount determined under section 956 for corporate U.S. shareholders

Final regulations from the U.S. Treasury Department and IRS, published in the Federal Register on May 23, 2019, are designed to coordinate the application of section 956 with the new participation exemption system introduced by the 2017 tax law (Pub. L. No. 115-97).

These **final regulations** [PDF 312 KB] (referred to in this report as the "Section 956 Final Regulations") finalize November 2018 proposed regulations (the "Section 956 Proposed Regulations") addressing the determination of the section 956 amount for certain domestic corporations that own (or are treated as owning) stock in controlled foreign corporations (CFCs). Read a KPMG report (November 2018) about the proposed regulations: ***TaxNewsFlash***.

Background—2017 tax law and Section 956 Proposed Regulations

For distributions made after December 31, 2017, a domestic corporate shareholder that is a 10% owner of a foreign corporation—including a CFC—is generally eligible for a 100% deduction with respect to the foreign-source portion of a dividend received from the foreign corporation (a "section 245A dividend").

The 2017 Tax Act[1] preserved the deemed section 956 inclusion regime which generally treated investments in U.S. property by a CFC in the same manner as a distribution by the CFC. And, the pre-existing U.S. CFC anti-deferral rules subjected the deemed repatriation of undistributed foreign earnings to different tax treatment than a "section 245A dividend."

As a result of these concurrent regimes, corporate section 951(b) U.S. shareholders ("U.S. Shareholders") faced potential disparities between the taxation of actual repatriations of undistributed foreign earnings under section 245A and the taxation of deemed dividend distributions under section

[1] Pub. L. No. 115-97, § 14401 (Dec. 22, 2017) (the "2017 Tax Act") that is also at times referred to as the "Tax Cuts and Jobs Act."

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956. The Section 956 Proposed Regulations were designed to address and alleviate this potential disparate treatment.

Broadly speaking, the Section 956 Proposed Regulations reduced the amount of the deemed inclusion that a corporate U.S. Shareholder would otherwise take into account ("the tentative section 956 amount") by the amount of the section 245A deduction that the shareholder would otherwise be allowed if the shareholder had received a distribution from the CFC in an amount equal to the "tentative section 956 amount" (the hypothetical distribution). The Section 956 Proposed Regulations applied to lower-tier CFCs by treating each CFC as if it were directly owned by the U.S. Shareholder and as if the CFC had made a hypothetical distribution to the U.S. Shareholder (through each entity by reason of which the U.S. Shareholder indirectly owned the shares and pro rata with respect to the equity that gave rise to the indirect ownership) equal to the "tentative section 956 amount." These rules generally restored section 956 / section 245A parity because the U.S. Shareholder could no longer receive better (or worse) treatment by making a section 956 investment in U.S. property.

The Section 956 Proposed Regulations did not address whether a foreign tax credit would be available for the taxes attributable to the amount of the section 956 inclusion not fully offset by the hypothetical distribution amount; this issue was addressed separately in section 960 proposed regulations (also released by the IRS and Treasury in November 2018). In relevant part, those proposed rules would eliminate the ability to claim deemed paid credits for section 956 inclusions (generally applicable to CFC tax years beginning after December 31, 2017, once the regulations under section 960 are finalized).

Section 956 Final Regulations

The IRS and Treasury did not receive comments on the Section 956 Proposed Regulations, and the Section 956 Final Regulations generally retain the proposed rules, subject to a few discrete changes and clarifications.

Specifically, as described in the preamble, the Section 956 Final Regulations make changes relating to (1) the allocation of hypothetical distributions and (2) U.S. partnerships and their partners.

The Section 956 Final Regulations also add two new examples to illustrate the operation of these rules.

Allocation of hypothetical distributions

Ordinarily, the section 959 earnings and profits (E&P) ordering rules provide that a distribution by a CFC is allocated to the CFC's prior-year section 959(c)(1) E&P (the "Section 956 PTEP") prior to being allocated to the CFC's prior-year section 959(c)(2) E&P (e.g., Subpart F and GILTI PTEP) and current-year section 959(c)(3) E&P (i.e., residual non-previously taxed E&P).

Published comments raised concerns about how the proposed rules would apply in the case of a CFC that has prior-year E&P described in section 959(c)(1) and current-year E&P described in section 959(c)(3) that does not result in a section 951 or section 951A inclusion. In response, the Section 956 Final Regulations include a taxpayer-favorable E&P ordering rule under which the hypothetical distribution is treated as attributable first to E&P described in section 959(c)(2) and then to E&P described in section 959(c)(3). No amount of the hypothetical distribution is treated as attributable to the Section 956 PTEP. This rule, which applies solely for purposes of the hypothetical distribution, is illustrated in a new example in the Section 956 Final Regulations (Example 3).

KPMG observation

This special E&P allocation ordering rule mitigates an unintended consequence of the mechanical operation of the hypothetical distribution rule. As noted in published commentary, the interaction of

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the pre-existing rules for determining a section 956 amount and the "regular" E&P ordering rules under section 959 could result in section 956 tax leakage for certain taxpayers that have CFCs with undistributed prior-year Section 956 PTEP.

Example

To illustrate the adverse treatment that could result in the absence of the special E&P allocation rule, assume:

- US Co wholly-owns CFC1, that CFC1 has $200x of undistributed foreign-source earnings ($100x Section 956 PTEP and $100x 959(c)(3) E&P) and zero undistributed U.S.-source earnings, that CFC1 has USD functional currency, and that US Co would be allowed a section 245A deduction with respect to any actual dividend paid from CFC1.

- Also, assume that US Co's aggregate tentative section 956 amount with respect to CFC1 is $20x.

- In accordance with the hypothetical distribution fiction, US Co is deemed to reduce such amount by the amount of the section 245A deduction to which US Co would be allowed if CFC1 distributed to US Co an amount equal to the tentative section 956 amount (e.g., $20x). Under the "regular" E&P ordering rules, the entire $20x amount would be attributed to CFC1's Section 956 PTEP—none of which would provide for a section 245A deduction.

- Thus, US Co would have a section 956 deemed inclusion equal to $20x even though any actual distributions received by US Co that would be attributable to CFC1's E&P would not have resulted in US federal income tax (assuming sufficient tax basis in CFC1 stock).

The new rule fully eliminates the section 956 tax leakage illustrated in the above example. Because no amount of the hypothetical distribution is treated as attributable to Section 956 PTEP (and instead is attributable to CFC1's section 959(c)(3) E&P), the entire amount would provide for a section 245A deduction and would fully reduce US Co's aggregate tentative section 956 amount.

U.S. partnerships and their partners

Pursuant to their grant of regulatory authority under section 245A(g), the IRS and Treasury prescribe a rule for the treatment of corporate U.S. Shareholders owning stock of a specified 10% foreign-owned corporation through a partnership.

Consistent with the first alternative method described in the preamble to the Section 956 Proposed Regulations, the final regulations provide that the tentative section 956 amount with respect to a U.S. partnership is reduced to the extent that one or more corporate U.S. partners would be entitled to a section 245A deduction if the partnership received such amount as a distribution. Any remaining amount of the U.S. partnership's inclusion under section 956 is then allocated to partners in the same proportion as net income would have been allocated to the partners if the CFC made an actual distribution to the U.S. partnership. This rule is illustrated in a new example in the section 956 Regulations (Example 4).

KPMG observation

The determination of the section 956 amount at the partnership level is clearly intended as a taxpayer-favorable result. It is worth noting, however, that the formulaic allocation of any resulting section 956 inclusion in a manner which may be inconsistent with the partnership agreement and section 704(b) allocations, has the potential to create much uncertainty and complexity in the application of these rules.

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Applicability date

The Section 956 Final Regulations apply to tax years of a CFC beginning 60 days on or after date of publication in the Federal Register (i.e., since published on May 23, 2019, the rules are effective for CFC tax years beginning on or after July 22, 2019), and to tax years of a U.S. Shareholder in which or with which such CFC's tax years end.

At the U.S. Shareholder's discretion, however, the Section 956 Final Regulations may be applied to tax years of CFCs beginning after December 31, 2017, and to tax years of the U.S. Shareholder in which or with which such CFC's tax years end (subject to a consistency requirement for related U.S. persons).

KPMG observation

Because the section 960 proposed regulations disallow foreign tax credits relating to section 956 inclusions, taxpayers are likely to elect to apply the Section 956 Final Regulations retroactively.

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