Chapman and Cutler LLP

Chapman Client Alert

February 13, 2018 Current Issues Relevant to Our Clients

Deemed Dividends After the Tax Cuts and Jobs Act

Although recent legislation commonly referred to as the Tax Cuts and Jobs Act (the “TCJA”) retained Section 956 of the Internal Revenue Code (and its notorious deemed dividend issue), the enactment of other changes may reduce the impact of Section 956 on U.S. taxpayers. U.S. borrowers still affected by Section 956 now will need to compare the benefits and costs of, on the one hand, receiving actual dividends excluded from U.S. tax but without a foreign tax credit, with the alternative of incurring taxable deemed dividends which may make potential foreign tax credits available.

In the process of negotiating the TCJA, Congress considered eliminating Section 956, but ultimately decided to preserve it. This summary discusses the continued impact of Section 956 and its relationship to other Code sections that will impact lending transactions to multi-national groups.

Background

Controlled foreign corporations (“CFCs”) are non-U.S. corporations of which more than 50% of the vote or value is owned by U.S. shareholders. A U.S. shareholder is a U.S. person that owns 10% or more of a foreign corporation. The Code requires a U.S. shareholder to include in income certain types of passive and related-party income, whether or not such income is actually distributed. However, active income of a CFC has historically not been subject to U.S. tax until the income is repatriated to the United States.

Section 956 attempts to prevent taxpayers from bringing (directly or indirectly) the income of a CFC that has escaped U.S. taxation back to the United States without triggering tax. Specifically, Section 956 requires a U.S. shareholder to include in income (as a deemed dividend) its pro rata share of a CFC’s investment in U.S. property. Without Section 956, a CFC generally could build an international corporate headquarters for its U.S. parent or make loans to its parent without triggering U.S. tax.

Historically, Section 956 has impacted lending transactions because the regulations thereunder interpret both a guarantee by a CFC and a pledge of a CFC’s assets, if in respect of an obligation of a U.S. person, as an investment in U.S. property subject to tax. In addition, the regulations treat a pledge of more than two-thirds of a CFC’s voting stock in respect of a U.S. person’s debt as a pledge of the CFC’s assets.

The combination of Section 956 and the broad approach of the regulations has caused U.S. borrowers to insist not only that CFCs not guarantee or pledge their assets in respect of obligations of the U.S. borrower, but also that the U.S. borrower pledge no more than two-thirds of the CFC’s voting stock. Accordingly, lenders typically have to forego desired security on loans in order to prevent adverse tax consequences to their borrowers.

Although Section 956’s “deemed dividend” issue generates much concern, it is not always problematic. The deemed dividend amount required to be included is the lesser of (i) the excess of (a) the U.S. shareholder’s share of the average amount of U.S. property held by the CFC at the close of each quarter over (b) the amount of previously taxed CFC income or (ii) the shareholder’s share of the CFC’s earnings.

Thus, for a CFC with no (or negative) current or accumulated earnings and profits, the amount included under Section 956 would be zero. The test is an annual test, however, so a U.S. shareholder that avoids inclusion one year may be required to have an inclusion in future years. Consequently, U.S. borrowers historically have been reluctant to give lenders additional security with respect to their CFCs even if they have no current or accumulated earnings and profits, and anticipate nominal CFC earnings in ensuing years.

New Tax on Deferred Foreign Income

Separately, as part of the TCJA, Congress required U.S. shareholders to include in income in the last taxable year that started before 2018 the accumulated post-1986 earnings and profits of a CFC. This inclusion is required without regard to any investment in U.S. property.

The one-time inclusion of deferred foreign income generally will be taxed (for U.S. corporations) at a rate of 15.5% on accumulated cash and 8% on tangible assets. The U.S. shareholder's cash position is the sum of the cash, currency, net accounts receivable, publicly traded property, commercial paper, CDs, federal, state or local government securities, and short-term obligations held by the CFC.

Notice 2018-13 indicates that the IRS intends to issue regulations that will treat such inclusions as "previously taxed income" for the purposes of the CFC rules. This means that, in many cases, the earnings and profits taken into consideration under Section 956's deemed dividend rule generally will be limited to earnings and profits accumulating after 2017.

New Deduction for Dividends from Non-U.S. Sources

The TCJA allows a U.S. corporation that is a U.S. shareholder of a 10% owned non-U.S. corporation (other than a passive foreign investment company that is not also a CFC) to take a deduction for the foreign source portion of any dividend received from such corporation. A 10% owned non-U.S. corporation is any foreign corporation with respect to which the taxpayer is a corporate U.S. shareholder with respect to such corporation. The foreign source portion of the dividends are dividends other than dividends either attributable to a U.S. trade or business or received from an 80% owned U.S. corporation. However, the basis of the stock is reduced by the amount of the deduction allowed.

The new tax deduction for dividends means that U.S. corporations are not taxed on dividends from non-U.S. subsidiaries, although they may have to recognize more gain (due to the reduction in basis) at some point in the future. The deduction only applies to actual dividends, however, so many U.S. corporations may prefer to receive an actual dividend rather than have to include income with respect to a deemed inclusion under the CFC rules.

On the other hand, no foreign tax credit is allowed in respect of the dividend if the foreign source dividend deduction is taken. This means the relative benefit of the foreign source dividend deduction may depend upon the non-U.S. taxes imposed on the foreign corporation, since deemed inclusions from CFCs, which are not eligible for the foreign source dividend deduction, do not preclude the utilization of the foreign tax credit. Thus, the U.S. tax cost of CFC inclusions is reduced by the amount of any foreign tax credits otherwise available.

No deduction for a foreign source dividend is allowed if the CFC was entitled to a deduction for the payment of the dividend. This rule prevents CFCs from creating hybrid instruments that would be treated as equity from a U.S. perspective (to obtain the foreign source dividend deduction) but as debt from a non-U.S. perspective (to obtain a deduction for the distributions made).

"Springing" CFCs

The TCJA expanded the scope of Section 956 and the potential for a deemed dividend issue as it relates to pledges and guarantees through several changes that broaden the definitions of both U.S. shareholder and CFC. First, the rules attributing share ownership for purposes of determining CFC status were broadened, so that a non-CFC foreign parent corporation could – counterintuitively – become a CFC simply by forming or acquiring a U.S. subsidiary, with attendant potential consequences under Section 956 to existing U.S. shareholders if the foreign parent (or any of its foreign subsidiaries, which would also become CFCs) had any investment in U.S. property (including by reason of a guarantee or pledge in respect of an obligation of a U.S. person). This "springing" CFC status of the foreign parent could be all the more consequential to a U.S. shareholder to the extent the foreign parent's earnings had not been previously taxed by reason of the tax on deferred foreign income discussed above. While legislative history suggests that Congress intended (and that the IRS may pursue) a narrower notion of share attribution for CFC purposes than that reflected in the Code as modified by the TCJA, the precise scope of the attribution rule is presently uncertain, and it is impossible to predict the range of fact patterns and circumstances in which expanded and unexpected CFC status might raise Section 956 issues – so it seems likely that lenders will continue to encounter sensitivity to those issues among multinational group borrowers, including perhaps even groups which historically have not regarded themselves as having any CFCs.

The second area of expansion was a change in the definition of U.S. shareholder. Prior to the TCJA, U.S. shareholders were defined only in terms of the percentage of the vote they held in the non-U.S. corporation. A shareholder who held 10% or more of the vote was a U.S. shareholder. The TCJA expanded the definition so that shareholders who hold 10% or more of the value of the equity in a non-US corporation will also be U.S. shareholders. This means that some persons who historically have not treated themselves as U.S. shareholders may now be U.S. shareholders and non-U.S. corporations that have not been CFCs will now be CFCs.

The definitions contained in loan documents relating to borrower group entities excluded from the requirement to provide guarantees and pledges may need to be reviewed to take into consideration the expansion of the definition of CFC under the TCJA.

Conclusion

The changes discussed above do not eliminate the deemed dividend issue created by CFC guarantees and pledges. However, the going-forward elimination of pre-2018 earnings and profits from the Section 956 calculation, coupled with the potential for an associated foreign tax credit, may make borrowers less averse to having such deemed CFC inclusions from investments in U.S. property, depending upon the specific factual situation. Certainly, lenders can be expected to assert that argument, while also contending (in the alternative) for the possibility that borrowers instead consider actually distributing and repatriating post-2017 earnings (hence eliminating earnings that might support a potential Section 956 inclusion) at a tax cost limited to local (*i.e.*, non-U.S.) withholding tax. U.S. borrowers willing to entertain either lender argument, however, will need to consider the relative advantages and costs of incurring CFC inclusions with foreign tax credits or, instead, repatriating earnings without any relief afforded by such a credit.

For More Information

If you would like further information concerning the matters discussed in this article, please contact any of the following attorneys or the Chapman attorney with whom you regularly work:

Colman J. Burke
San Francisco
415.278.9033
cburke@chapman.com

Paul D. Carman
Chicago
312.845.3443
carman@chapman.com

Craig M. Cohen
New York
212.655.2552
ccohen@chapman.com

Steven L Kopp
New York
212.655.2505
steven.kopp@chapman.com

Christie R. Galinski
Chicago
312.845.3431
galinski@chapman.com

Chapman and Cutler LLP

Attorneys at Law · Focused on Finance®

This document has been prepared by Chapman and Cutler LLP attorneys for informational purposes only. It is general in nature and based on authorities that are subject to change. It is not intended as legal advice. Accordingly, readers should consult with, and seek the advice of, their own counsel with respect to any individual situation that involves the material contained in this document, the application of such material to their specific circumstances, or any questions relating to their own affairs that may be raised by such material.

To the extent that any part of this summary is interpreted to provide tax advice, (i) no taxpayer may rely upon this summary for the purposes of avoiding penalties, (ii) this summary may be interpreted for tax purposes as being prepared in connection with the promotion of the transactions described, and (iii) taxpayers should consult independent tax advisors.

© 2018 Chapman and Cutler LLP. All rights reserved. Attorney Advertising Material.