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by Libin Zhang

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In this report, Zhang discusses some uncertainties and planning opportunities concerning dividends paid by foreign corporations to domestic corporate shareholders.

Table of Contents



## Introduction

The headline international tax reform of the Tax Cuts and Jobs Act (P.L. 115-97) was to switch the United States to a territorial taxation system. If a domestic corporation is a 10 percent or more shareholder of a foreign corporation, new section 245A generally provides the domestic corporation with a 100 percent dividends received deduction (DRD) for dividends from the foreign corporation. The DRD effectively renders the foreign corporation's foreign earnings tax-free for a domestic corporate shareholder.

This report discusses some considerations in determining the section 245A DRD and its interactions with other code provisions. It completes a trilogy of articles that began with section 965 deemed repatriation income,[1] and continued with the two towering regimes of subpart F income and global intangible low-taxed income (GILTI).[2]

## Foreign Earnings

The 100 percent section 245A DRD generally applies to the foreign-source portion of dividends paid by a "specified 10 percent owned corporation" to a domestic corporate shareholder. Such a specified corporation is a foreign corporation in which the domestic corporation is a U.S. shareholder under section 951(b) — that is, a U.S. person that has a 10 percent interest, by vote or value, in the foreign corporation.

The foreign-source portion of any dividend eligible for the section 245A DRD is the portion attributable to undistributed foreign earnings, which are defined in section 245A(c)(3) as all undistributed earnings other than:

- income effectively connected with the conduct of a U.S. trade or business and subject to U.S. income tax; and
- any dividends received from a domestic corporation (including a regulated investment company or a real estate investment trust) at least 80 percent of the

[1] Libin Zhang and Joshua A. Rabinovits, "The End of Eternity: Anomalies in Transition to Territoriality," *Tax Notes*, Apr. 30, 2018, p. 621.

[2] Zhang, "To the Frying Pan: New Virtues of Subpart F Over GILTI," *Tax Notes*, July 2, 2018, p. 73.

stock of which is owned by the foreign corporation.

The two U.S.-related exclusions from undistributed foreign earnings are generally eligible for the preexisting 50 percent or 65 percent DRD under section 245, which applies to the U.S.-source portion of dividends paid by some qualified 10 percent owned foreign corporations to domestic corporate shareholders.

However, the two U.S.-related exclusions do not cover all U.S. earnings. Undistributed foreign earnings eligible for the section 245A DRD include, in addition to all foreign earnings after February 28, 1913, under section 316(a)(1):

- income that is effectively connected with a U.S. trade or business but not subject to U.S. income tax, such as because of a U.S. income tax treaty; and
- U.S.-source investment income other than dividends from an 80 percent owned foreign corporation, such as U.S.-source interest income.

For a controlled foreign corporation, some of the earnings since 1963 may have been subject to current U.S. tax as subpart F income. The section 965 deemed repatriation income rules may also have applied to some, but not all, of the above amounts earned from 1987 to 2017. For instance, section 965 does not apply to some individual shareholders of a non-CFC foreign corporation; the individuals can contribute their foreign corporation stock to a domestic corporation in 2018 and have the foreign corporation pay its accumulated earnings as tax-free dividends to the domestic corporation.

Some dividends may have portions eligible for one DRD but not the other DRD, such as if the domestic corporation owns only nonvoting stock of the foreign corporation:

**Comparison of Section 245 DRD and Section 245A DRD**

| | Section 245 DRD for U.S.-Source Portion Of Dividends | Section 245A DRD For Foreign-Source Portion of Dividends |
|---|---|---|
| Shareholder ownership requirement | "Qualified 10 percent owned foreign corporation" requires at least 10 percent ownership by vote *and* value under section 245(a)(2), generally without any constructive ownership rules. | "Specified 10 percent owned foreign corporation" requires 10 percent or more ownership by vote *or* value under section 245A(b)(1), with section 958(b) constructive ownership rules. |
| Holding period | Over 45 days during the 91-day period beginning on the date that is 45 days before the ex-dividend date, under section 246(c)(1). | Over 365 days during the 731-day period beginning on the date that is 365 days before the ex-dividend date, during which the taxpayer is a U.S. shareholder of the specified 10 percent owned foreign corporation, under section 246(c)(5). |
| DRD amount | 50 percent or 65 percent DRD (if 20 percent owned foreign corporation), which reduces the 21 percent corporate tax rate to 10.5 percent or 7.35 percent. | 100 percent DRD reduces the 21 percent corporate tax rate to 0 percent. |
| Section 1248 deemed dividend | Does not apply to a section 1248 deemed dividend, under section 245(a)(11). | Can apply to a section 1248 deemed dividend, under section 1248(j), described below. |
| Earnings | Applies only to earnings earned when the foreign corporation is a qualified 10 percent owned foreign corporation for the shareholder under section 245(a)(6). | No requirement that the earnings must be earned while the domestic shareholder is a U.S. shareholder of the specified 10 percent owned foreign corporation. |
| Source of income | Dividend is U.S.-source income, or foreign-source income because of treaty-based resourcing in a separate category, under section 245(a)(10). | Dividend is foreign-source income under section 861(a)(2). |

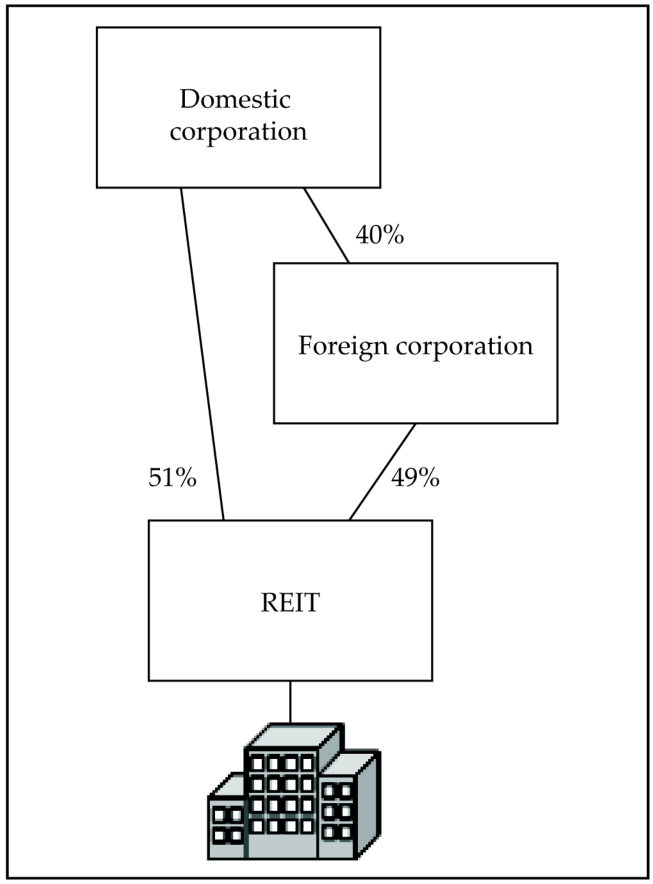
### RIC or REIT Dividend

After the enactment of section 245(a)(12) by the Protecting Americans From Tax Hikes Act of 2015 (P.L. 114-113), a domestic corporation cannot claim the section 245 DRD for a foreign corporation's distributions attributable to dividends received on or after December 18, 2015, from a RIC or REIT owned at least 80 percent by vote or value by the foreign corporation.[3] These RIC or REIT dividends are also ineligible for the section 245A DRD.

Section 245(a)(12) applies only to dividends from 80 percent owned corporations. A lower amount of stock ownership in the REIT, RIC, or other domestic corporation can cause the dividends to be "foreign earnings," eligible for the section 245A DRD.

**Example 1:** A domestic C corporation owns 40 percent of the stock of a foreign corporation that is not a CFC. The foreign corporation owns 49 percent of a REIT, which pays a $100 ordinary REIT dividend to the foreign corporation. Under the applicable income tax treaty, the U.S. dividend withholding tax may be as low as 5 percent. The foreign corporation's $95 of after-tax REIT dividend income is not from an 80 percent owned corporation and therefore is not excluded from being considered foreign earnings by section 245A(c)(3)(B). The foreign corporation may pay its $95 of those foreign earnings as a $95 dividend to the domestic C corporation and result in a $95 section 245A DRD. The end result is that the domestic corporation indirectly earns $100 of REIT income and pays $5 of U.S. tax, plus any foreign taxes.

If the remaining 51 percent of the REIT's stock is owned by U.S. persons, such as the domestic corporate shareholder, the foreign corporation can generally sell its domestically controlled REIT's stock without any U.S. income tax under section 897(h)(2). It could distribute the gain to the domestic corporation as additional foreign earnings eligible for a section 245A DRD.




### Foreign Tax Credit and Section 904

Section 245A(d) disallows any direct or indirect foreign tax credit for any foreign taxes paid or accrued (or treated as paid or accrued) on any dividend that is allowed the section 245A DRD. If the dividend is not allowed the section 245A DRD because of a failure to meet the holding period or other requirements, the shareholder should be able to claim direct FTCs, although indirect FTCs are generally not available given the TCJA's repeal of section 902.

Section 904(a) generally provides that a taxpayer may use FTCs only to the extent of its section 904 FTC limitation, which is computed separately for four categories (passive, general, GILTI, and foreign branch). The section 904 FTC limitation is roughly equal to the pre-FTC U.S. tax imposed on the foreign-source taxable income in each category.

The TCJA enacted new section 904(b)(4) for a corporate U.S. shareholder of a specified 10 percent owned foreign corporation. The

[3] Such RIC and REIT dividends received by the foreign corporation after 1986 and before December 18, 2015, may be eligible for the section 245 DRD. *See* P.L. 114-113, section 326(c).

shareholder's foreign-source taxable income (and entire taxable income) for section 904 purposes is determined without regard to:

- the foreign-source portion of any dividend received from a specified 10 percent owned foreign corporation;
- any deduction properly allocable or apportioned to income (that is not subpart F income or GILTI) on stock of the foreign corporation; and
- any deduction properly allocable or apportioned to that stock, to the extent income on the stock is not subpart F income or GILTI.

If a corporate U.S. shareholder has a taxable dividend from a specified 10 percent owned foreign corporation that does not result in a section 245A DRD, the taxable dividend is still excluded from foreign-source taxable income (and entire taxable income) for section 904 purposes.[4] For instance, the TCJA House bill would have allowed the section 245A DRD for a taxable "nimble dividend" under section 316(a)(2) — that is, to the extent of current earnings and profits even if the corporation had a deficit in accumulated E&P. The provision is not in the final TCJA, which therefore does not allow the section 245A DRD for a taxable nimble dividend. The taxable nimble dividend does not increase the section 904 limitations to allow more FTCs.

For a corporate U.S. shareholder that has (non-dividend) capital gain from the sale of stock of a specified 10 percent owned foreign corporation, the gain is not a dividend and is generally added to U.S.-source taxable income (and entire taxable income).

Before the TCJA, a domestic C corporation that was accumulating unused FTCs could periodically receive a dividend distribution from a foreign subsidiary, which would give rise to foreign-source taxable income and tentative U.S. tax that could use up the FTCs. After the TCJA's enactment of section 245A, the same dividend distributions generally are free of U.S. tax, do not generate new FTCs, and do not use up any FTC carryovers. In either case, the domestic corporation receives distributions, pays no U.S. taxes, and pays taxes to a foreign government. However, there is a greater incentive to reduce the foreign taxes after the TCJA, because they do not offset any U.S. taxes and do not free up any undistributed earnings. Further, financial accounting treatment is likely less favorable after the TCJA, by treating the foreign taxes as an immediate economic expense instead of creating a deferred tax asset.

### Hybrid Dividends

The section 245A DRD is not allowed for a hybrid dividend paid by a CFC. The shareholder is also not allowed any direct or indirect FTCs for the hybrid dividend under section 245A(e)(3). In contrast, the section 245A DRD and FTCs are available for a hybrid dividend from a non-CFC foreign corporation.

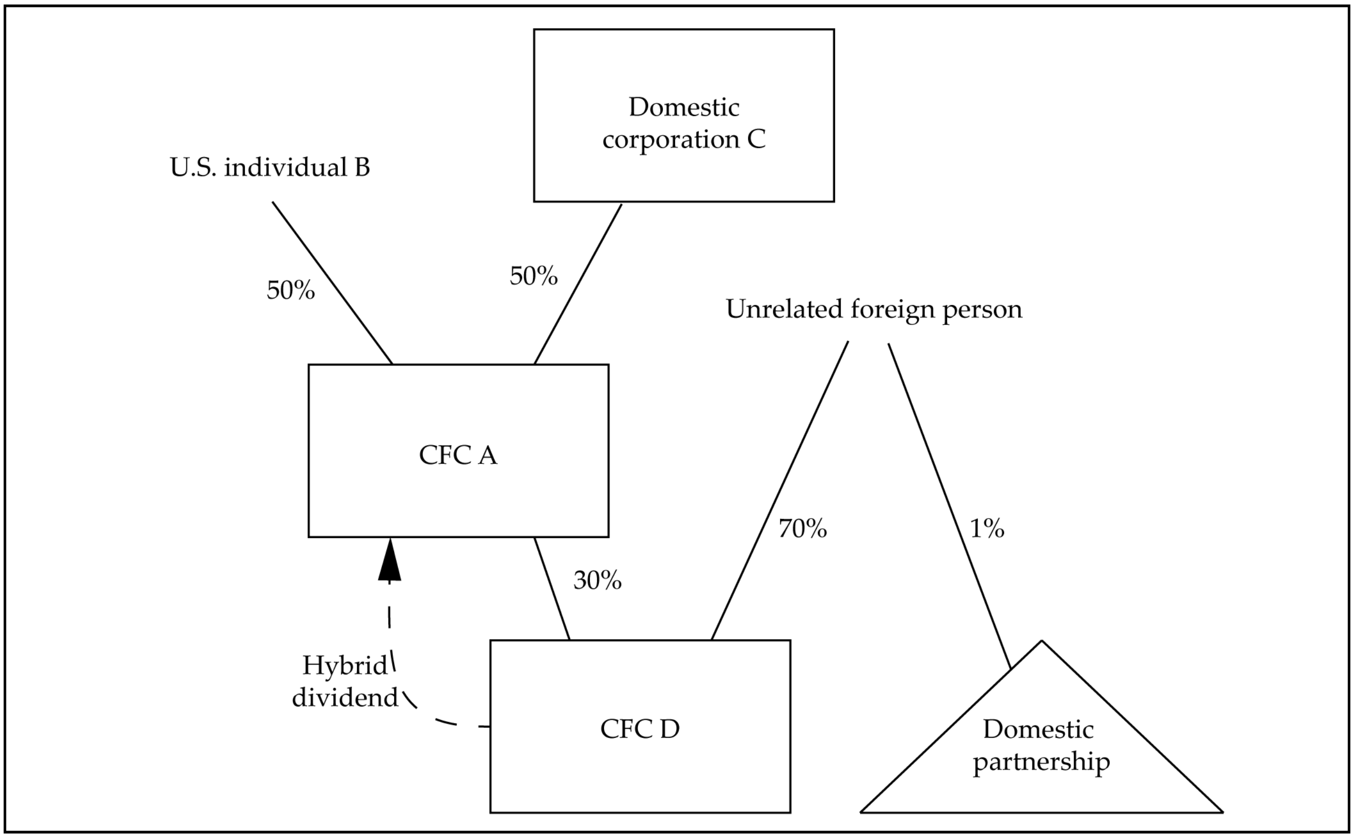
A hybrid dividend is defined in section 245A(e)(4) as a dividend for which the CFC receives a deduction or other tax benefit for any foreign income taxes.[5] The disallowance of the section 245A DRD and indirect FTCs is understandable in that there should not be a double benefit of a CFC deduction and tax-free shareholder income. It is less apparent why direct FTCs are disallowed, while they are allowed for a taxpayer who receives interest, rent, or royalty payments that are deductible by the payer and subject to foreign withholding tax.

If a CFC has a U.S. shareholder that is a domestic corporation, and the CFC receives a hybrid dividend from any other CFC for which the same domestic corporation is also a U.S. shareholder, section 245A(e)(2)(A) provides that the hybrid dividend is treated as subpart F income of the receiving CFC. Section 245A(e)(2)(B) provides that the U.S. shareholder will include in gross income its pro rata share of that subpart F income, with no FTCs allowed under section 245A(e)(3).

It is clear from section 245A(e)(2)(B) that the domestic corporation U.S. shareholder of the two CFCs should include its share of the hybrid

[4] Although the heading of section 904(b)(4) is "Treatment of dividends for which deduction is allowed under section 245A," the statutory text doesn't depend on the section 245A DRD being allowed.

[5] For a discussion of what tax benefits can give rise to a hybrid dividend, see New York State Bar Association Tax Section, "Report on Section 245A," Report No. 1404, at 45-47 (Oct. 25, 2018).




dividend as subpart F income. The scope of section 245A(e)(2)(A) is less clear as to whether the increase in the CFC's subpart F income affects all U.S. shareholders, such as individuals and other domestic corporations.[6]

**Example 2:** CFC A is owned 50 percent by individual U.S. shareholder B and 50 percent by corporate U.S. shareholder C. CFC A owns 30 percent of the stock of CFC D, which is owned 70 percent by an unrelated foreign person. The unrelated foreign person owns 1 percent of a domestic partnership, which causes CFC D to be a CFC as a result of section 318(a)(3)(A) downward attribution. Corporation C is indirectly a U.S. shareholder of CFC D.

CFC D pays a $100 hybrid dividend to CFC A. CFC A might recognize the entire $100 hybrid dividend as subpart F income, even though most of CFC D's hybrid dividend deduction was not allocated to U.S. persons. Shareholder C has $50 (50 percent) of subpart F income from CFC A, with no allowed FTCs. It appears that individual B may also have $50 (50 percent) of subpart F income from CFC A, also with no allowed FTCs.

## Gain as Dividend

When a U.S. person sells stock of a foreign corporation, section 1248 generally recharacterizes the gain as a dividend to the extent of the foreign corporation's post-1962 E&P accumulated while it was a CFC and owned by the U.S. person. Section 1248 applies to any U.S. person who owned 10 percent or more of the foreign corporation's voting stock at any time during the five years before the sale when the foreign corporation was a CFC.

The TCJA enacted new section 1248(j) to provide that if a domestic corporation disposes of stock in a foreign corporation that was held for at least one year, any amount treated as a dividend under section 1248 is also treated as a dividend for

[6]If the section 245A(e)(2)(A) increase in the CFC's subpart F income affects all U.S. shareholders, section 245A(e)(2)(B) would be superfluous, which suggests a congressional intent to increase only the subpart F income of the domestic corporation that is a U.S. shareholder of both CFCs. For a duplicative ambiguity in another TCJA provision that was clarified to the taxpayer's benefit, see section 3.05(d) of Notice 2018-26, 2018-16 IRB 480, and its analysis of section 965(n)(1).

section 245A purposes.[7] However, not all section 1248 deemed dividends are allowed the section 245A DRD.

**Example 3:** A corporate U.S. shareholder owns 12 percent of a CFC's stock. On January 1, 2018, the CFC issues new stock that dilutes the corporate U.S. shareholder to owning 6 percent. If the shareholder sells its CFC stock in 2018, some of the gain is recharacterized as a dividend under section 1248(a), which is likely ineligible for the section 245A DRD because of the lack of 10 percent ownership at the time of sale. Further, the taxable dividend does not increase the shareholder's FTCs allowed under section 904.

Conversely, a U.S. person may have stock gain that is not a dividend under section 1248, while a distribution would be a dividend eligible for the section 245A DRD.

**Example 4:** A corporate U.S. shareholder owns 40 percent of the stock of a foreign corporation that has never been a CFC. The shareholder's dividends from the foreign corporation are eligible for the section 245A DRD. In contrast, section 1248(a) does not apply to the shareholder's gain from the sale of the foreign corporation's stock because it has no earnings from when it was a CFC. It may be desirable for the shareholder to first receive a dividend distribution before the sale, although the dividend may be recharacterized as part of the sales proceeds depending on the source of the dividend cash and other facts.[8]

On the other hand, when section 1248 does apply to a sale of CFC stock, it may interact with section 245A to eliminate all subpart F income or GILTI for the year of sale.

**Example 5:** A domestic corporation owns 100 percent of a foreign corporation that is a CFC. The corporate shareholder has a tax basis of $100 in its $1,000 of foreign corporation stock, which has a tax basis of $100 in $1,000 of assets. The foreign corporation engages in internal and external asset sales and generates $900 of income that will give rise to $900 of subpart F or GILTI inclusions at the end of its tax year. Before the end of the foreign corporation's tax year, the shareholder sells the stock of the foreign corporation to a new owner that maintains the foreign corporation's CFC status. The selling shareholder has $900 of section 1248 deemed dividends and a $900 section 245A DRD, or zero net income. The buying shareholder's subpart F income or GILTI inclusion is zero under sections 951(a)(2) and 951A(e)(1), because its $900 subpart F income or GILTI inclusion is reduced by the selling shareholder's $900 of dividend income from the sale. Absent any technical corrections or regulatory guidance to the contrary, both selling and buying shareholders have zero income.

When a foreign corporation liquidates into a domestic parent corporation in an otherwise tax-free section 332 liquidation, the parent corporation generally recognizes taxable income equal to its foreign corporation stock's "all E&P amount." The amount is determined under reg. section 1.367(b)-2(d) using section 1248 principles, but without regard to the section 1248 requirements regarding 10 percent ownership during the prior five years, CFC status, and exclusion of pre-1963 foreign earnings. Given the disparate definitions, regulatory relief may be necessary for the section 367(b) all E&P amount to be allowed a section 245A DRD, although separate dividend distributions before the liquidation can be eligible for the DRD.

## Stock Tax Basis Adjustments

Section 961(d) provides that solely in determining a domestic corporate shareholder's loss on any disposition of stock of a specified 10 percent owned foreign corporation, the tax basis of the disposed stock is reduced (but not below zero) by the amount of any previously allowed section 245A DRD. The stock basis reduction does not apply if the stock tax basis was already reduced as a result of the same DRD under section 1059.

Section 1059 was amended to sometimes reduce stock tax basis after a section 245A DRD, as well as after a section 243 DRD or section 245 DRD for U.S. earnings. Section 1059 applies to a more limited extent than section 961(d), generally only

[7] The section 1248(j) one-year holding period is similar to the 365-day holding period in section 246(c)(5). There is a small discrepancy if a shareholder holds the stock for 365 days in a non-leap year, which is one year or more for section 1248(j) purposes but not more than 365 days for section 245A purposes.

[8] *See Waterman Steamship Corp. v. Commissioner*, 430 F.2d 1185 (5th Cir. 1970). A taxable stock dividend under section 305 may be an alternative. When there are other shareholders and different classes of stock, the fast pay stock rules in reg. section 1.7701(l)-3 may apply.

if the shareholder has held the stock for two years or less before the announcement date of an "extraordinary dividend," which is a dividend that equals or exceeds 10 percent of its stock tax basis (or stock fair market value). Special rules apply to preferred dividends and redemption transactions treated as dividends for U.S. tax purposes.

Section 961(d) was presumably intended to discourage a corporate shareholder from acquiring 10 percent or more of a foreign corporation, receiving a tax-free non-extraordinary dividend from the foreign corporation by claiming the section 245A DRD, holding the stock for a year or more, and selling the stock to recognize a taxable loss. Section 961(d) can affect domestic corporate shareholders that have held the foreign corporation stock for any period and may be recognizing the loss on stock disposition for economic reasons, although it does not affect a shareholder that sells the stock shortly after the dividend at a (lower) gain.

**Example 6:** A domestic corporation owns 100 percent of a CFC with a value of $500 and a tax basis of $600 as of the end of 2017. The CFC earns $100 in 2018, which it distributes to the shareholder as a $100 dividend with a $100 section 245A DRD. The shareholder later sells the CFC stock for $500. Section 961(d) disallows the $100 of losses.

### Sections 1248 and 1059

The interaction between section 1248 and section 1059 is somewhat unclear.

**Example 7:** A domestic corporation pays $100 to acquire 100 percent of a CFC. After one year but within two years, the CFC distributes $160 to the domestic corporation shareholder. The CFC has a total of $280 of foreign earnings at the time of the distribution, all earned while it was a CFC.

The shareholder has a $160 dividend and a $160 DRD, or $0 net income. The $160 dividend is an extraordinary dividend under section 1059. The shareholder must reduce its stock tax basis by the nontaxed portion of the dividend, which is the entire $160 section 245A DRD. The stock tax basis is reduced from $100 to zero, and the remaining $60 is treated as gain from the sale or exchange of the CFC stock under section 1059(a)(2).

Under section 1248(a), gain from the sale or exchange of the CFC stock is treated as a dividend to the extent of the remaining $120 of foreign earnings. Accordingly, the $60 gain is treated as a dividend that may give rise to a $60 section 245A DRD under section 1248(j), which results in $0 net income.

The $60 dividend is also an extraordinary dividend. The shareholder must reduce its stock tax basis by $60, which results in $60 of gain under section 1059(a)(2), and so on.

### Foreign Corporations

Section 245A by its terms applies only to domestic corporations. If a foreign corporation is a CFC, reg. section 1.952-2 generally provides that the CFC's gross income and taxable income for subpart F purposes are determined by treating the CFC as a domestic corporation. The TCJA's conference report indicated that the CFC can claim the section 245A DRD for a dividend received from a specified 10 percent owned foreign corporation.[9]

Before the TCJA, a CFC could exclude a smaller set of foreign dividends from subpart F income under section 954(c)(6) (dividends from a related CFC generally before 2020) or section 954(c)(3)(A)(i) (dividends from a related foreign corporation generally organized in the same country as the CFC). After the TCJA, section 245A may apply before those exclusions, because the CFC must first compute its taxable income before determining which net income items are excluded from subpart F income. Section 245A may be worse than prior law in some cases.

**Example 8:** A CFC owns preferred stock of a related CFC and receives a $100 extraordinary dividend in 2018. The dividend-receiving CFC has a $100 taxable dividend, a $100 section 245A DRD, and zero net income. The dividend-receiving CFC must reduce its stock tax basis in the payer CFC by $100 under section 1059. Before the TCJA, the dividend-receiving CFC could have

[9] H.R. Rep. No. 115-466, at 599 n.1486 ("A CFC receiving a dividend from a 10-percent owned foreign corporation that constitutes subpart F income may be eligible for the DRD with respect to such income."). However, the preamble to the recently proposed GILTI regulations implementing section 951A, REG-104390-18, requested comments on whether reg. section 1.952-2 should allow the section 245A DRD for a CFC.

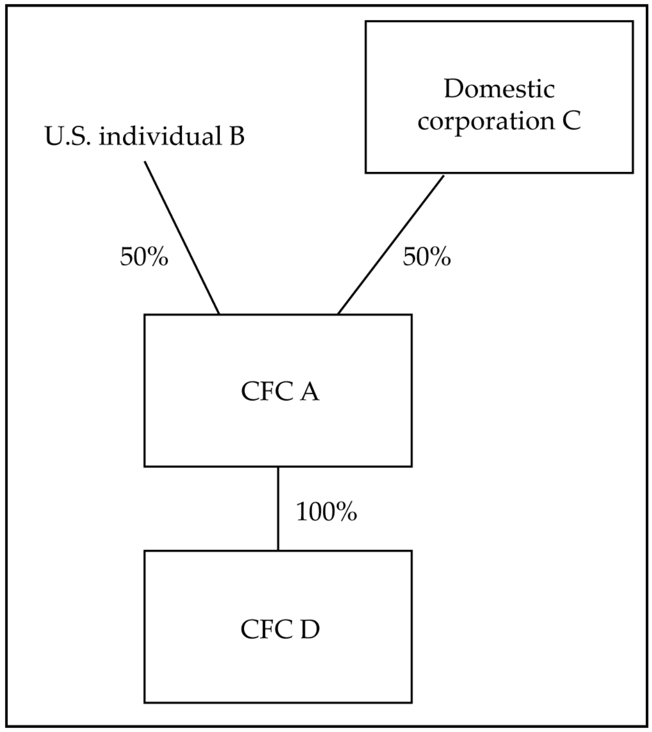
applied section 954(c)(6) to exclude the entire $100 dividend from subpart F income, with no reduction to its tax basis in the payer CFC's stock.

If a CFC disposes of stock in another foreign corporation, section 964(e)(1) provides that the gain is included in the CFC's gross income as a dividend to the same extent as under section 1248(a), as if the selling CFC were a U.S. person. New section 964(e)(4) provides that if a CFC disposes of stock in another foreign corporation that was held for at least one year, the foreign-source portion of the section 964(e)(1) deemed dividend will be treated as subpart F income of the selling CFC, of which a pro rata share is subpart F income of a U.S. shareholder of the selling CFC. The U.S. shareholder is allowed a section 245A DRD for the imputed subpart F income, as if the subpart F income were a dividend.

As noted, when a domestic corporation sells stock of a foreign corporation, the section 1248 deemed dividend is sometimes not allowed the section 245A DRD. Section 964(e)(4) can create a better result by always allowing the section 245A DRD for corporate U.S. shareholders when a CFC sells a lower-tier foreign corporation's stock. However, it may penalize the CFC's noncorporate U.S. shareholders, who could have deemed subpart F income with no section 245A DRD.

**Example 9:** CFC A is owned 50 percent by individual U.S. shareholder B and 50 percent by corporate U.S. shareholder C. CFC A has owned, for at least one year, 100 percent of the stock of lower-tier CFC D. CFC D has $100 of foreign earnings accumulated while it was owned by CFC A. CFC A can receive a $100 dividend from CFC D and claim a $100 section 245A DRD, which results in no taxable income and no subpart F income.

If instead CFC A sells its CFC D stock, $100 of the gain is dividend income under section 964(e)(1). Section 964(e)(4) treats the dividend as $100 of CFC A's subpart F income. Shareholder C has $50 of subpart F income and a $50 section 245A DRD, while individual shareholder B may have $50 of subpart F income with no DRD.




## GILTI

The TCJA's new section 951A generally requires a CFC's U.S. shareholders to recognize GILTI equal to the CFC's earnings in 2018 and later, reduced by a 10 percent net deemed tangible return on certain depreciable assets and some other exclusions. For corporate U.S. shareholders, GILTI is generally eligible for a 50 percent section 250 deduction, which reduces the U.S. tax rate on GILTI from 21 percent to 10.5 percent.[10]

GILTI does not apply to a non-CFC foreign corporation. However, the TCJA has expanded the universe of CFCs with the repeal of section 958(b)(4), which previously prohibited foreign-to-domestic downward attribution as in Example 2.

For a corporate U.S. shareholder of a CFC, the section 245A DRD is limited to dividends paid out of the CFC's earnings that are not already subject to subpart F or GILTI, such as:

- some pre-2017 foreign earnings, such as foreign earnings from 1913 through 1986

[10]The section 250 deduction is lowered to 37.5 percent in 2026 and later, which reduces the 21 percent U.S. tax rate to 13.125 percent.

that were not subject to section 965 deemed repatriation;
- the 10 percent net deemed tangible income return;
- subpart F income subject to the section 954(b)(4) high-taxed exception (that is, a foreign tax rate of more than 18.9 percent);
- some dividends received from a related person as defined under section 954(d)(3);
- foreign oil and gas extraction income under section 907(c)(1); and
- GILTI tested income to the extent offset by a GILTI tested loss from another CFC.

When a U.S. shareholder has GILTI or subpart F income with an allowed 80 percent or 100 percent of indirect FTCs, respectively, section 78 provides a gross-up that treats 100 percent of the indirect FTCs as a taxable dividend. The gross-up dividend is generally ineligible for any DRD.

### Section 956 Investment in U.S. Property

Section 956 provides that a CFC's U.S. shareholder has gross income generally to the extent that the CFC invests its earnings in specified U.S. property, which includes tangible property in the United States, stock and debt obligations of related parties, and intangibles used in the United States. Section 956 was enacted by the Revenue Act of 1962, with the general goal that "bringing earnings back to the United States is disallowed unless the shareholders have paid tax on these earnings."[11] The section 956 income does not qualify for any tax preferences for dividends.[12]

After the TCJA enactment of section 245A, an actual CFC distribution of foreign earnings to a corporate U.S. shareholder is free from U.S. tax in 2018 and later. Because the 100 percent DRD means that there is no U.S. tax being avoided by an investment in U.S. property instead of a dividend, both the House bill and the Senate amendment of the TCJA repealed section 956 for corporate U.S. shareholders of a CFC. However, the conference bill and the TCJA left section 956 intact.

The complicated rules of section 956 continue to apply in 2018 and later, although with less impact as a result of the GILTI provisions. If a CFC has previously taxed E&P attributable to subpart F income or GILTI, section 959(a)(2) provides that the CFC can make investments in U.S. property up to that previously taxed E&P without giving rise to section 956 income. Section 959(c) requires a CFC to keep track of three categories of E&P: section 959(c)(1) E&P that consists of E&P previously taxed under section 956 or excluded under section 959(a)(2); section 959(c)(2) E&P that consists of E&P previously taxed under subpart F or GILTI (unless moved to section 959(c)(1) E&P because of section 959(a)(2)); and section 959(c)(3) E&P that consists of all other earnings or deficits. A CFC's distributions come first from the previously taxed section 959(c)(1) E&P, then the previously taxed section 959(c)(2) E&P, and lastly from section 959(c)(3) E&P.[13]

An actual dividend may reduce CFC stock tax basis under section 1059. Section 956 may discourage U.S. shareholders from avoiding section 1059 by having the CFC make investments in U.S. property.

Before the TCJA, domestic corporate shareholders may have been relatively indifferent to foreign dividend withholding taxes, which give rise to direct FTCs that can reduce the dividend's U.S. tax. Similarly, dividend distributions through chains of foreign corporations may result in foreign income taxes, which give rise to indirect FTCs. Because the section 245A DRD reduces the U.S. tax to zero and disallows the appurtenant FTCs, the foreign taxes have become real economic costs that may be avoided with a U.S. investment in the absence of section 956.

The continuing existence of section 956 may provide some tax planning opportunities. For instance, a CFC may have investment income subject to high foreign taxes that is neither

[11]H.R. Rep. 87-1447, at 65 (1962). *See also* S. Rep. 87-1881, at 88 (1962).

[12]*See Rodriguez v. Commissioner*, 722 F.3d 306 (5th Cir. 2013), *aff'g* 137 T.C. 174 (2011); and *SIH Partners LLLP v. Commissioner*, 150 T.C. No. 3 (2018).

[13]It is unclear why section 959(c)(1) E&P is tracked separately from section 959(c)(2) E&P. If a CFC prefers more section 959(c)(1) E&P instead of section 959(c)(2) E&P — for example, for FTC purposes — the CFC can receive a somewhat gratuitous loan guarantee from a U.S. shareholder or make some investments in U.S. property, which are tax-free under section 959(a)(2), and change the section 959(c)(2) E&P to section 959(c)(1) E&P.

subpart F income nor GILTI. A CFC dividend to a domestic corporate shareholder would result in a full section 245A DRD, zero U.S. taxable income, and zero indirect FTCs. A section 956 investment of those accumulated earnings in U.S. property could instead result in positive U.S. taxable income and excess indirect FTCs for the domestic corporate shareholder.[14]

On October 31, 2018, Treasury issued proposed regulations (REG-114540-18) that generally repeal section 956 for corporate U.S. shareholders, to the extent that they would be entitled hypothetically to a section 245A DRD for an actual dividend. The proposed regulations are intended to reduce complexity, costs, and compliance burdens and rely on the original purpose of section 956 from its 1962 legislative history, with less focus on the TCJA's legislative history and the anticipated $2 billion decrease in federal revenues over 10 years that may result from the repeal of section 956 for corporate U.S. shareholders.[15]

## Conclusion

Section 245A contains substantial complexity and traps for the unwary, especially when compared with the different requirements for the section 1248 deemed dividend for gain from the sale of foreign corporation stock. Some provisions — such as foreign earnings including some U.S. dividends and other income — might not have been thoroughly considered by Congress and may lead to technical corrections.

The effect of the DRD is lessened by GILTI, which imposes current U.S. taxation on some CFC foreign earnings and thereby allow tax-free distributions of previously taxed income. Nevertheless, section 245A and related provisions are anticipated to reduce federal revenue by $223.6 billion in 2018 through 2027,[16] which suggests that hundreds of billions of dollars will be distributed from foreign corporations to their domestic corporate shareholders in tax-free dividends. ■

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[14] A section 956 investment may have collateral consequences: A loan to a U.S. shareholder may have exchange rate risk and consequent subpart F income exposure for the CFC; U.S. withholding taxes can apply to the interest payments; the interest income can be taxed by the CFC's home country or in the United States for its U.S. shareholders; and the borrower's section 904 limitations may be worsened by interest expense apportionment.

[15] *See* Joint Committee on Taxation, "Estimated Revenue Effects of the 'Tax Cuts and Jobs Act,' as Passed by the Senate on December 2, 2017," JCX-63-17, at 7 (Dec. 6, 2017).

[16] JCT, "Estimated Budget Effects of the Conference Agreement for H.R. 1, the 'Tax Cuts and Jobs Act,'" JCX-67-17, at 6 (Dec. 15, 2017).