GLOBAL TAX & CORPORATE LAW

IRC Section 956 Overview

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IRC Section 956 Overview

- Generally, a domestic corporation is not subject to current U.S. tax on earnings generated from the active businesses of its offshore corporate subsidiaries (each a "Controlled Foreign Corporation" or "CFC").

- CFCs may have a significant amount of accumulated earnings that have been taxed in foreign jurisdictions at relatively low marginal rates (and that have not yet been subject to US federal or state income tax).

- The distribution of accumulated earnings by a CFC to a US affiliate would generally cause such earnings to be taxed in the United States at a rate of approximately 40% (combined federal and state), subject to possible reduction for foreign tax credits relating to the foreign income taxes paid by the CFCs. Foreign tax credits will be insufficient in most cases given the earnings of the CFCs that have been taxed at low rates.

- The amount of any investment by a CFC in "United States property" would be treated as a deemed distribution to IHR to the extent of the CFC's accumulated earnings, pursuant to Internal Revenue Code Section 956 ("Section 956"). For this purpose, a loan from a CFC to its US affiliate would be treated as an investment in "United States property."

IRC Section 956 – Cash Pooling

- When the Treasury Functions of US based multinational companies begin to look at cash management initiatives, it is imperative that they work closely with their counterparts within the Tax Department to mitigate any issues related to Section 956.

- When determining whether a cash pooling arrangement (the "Pool") will create issues under Section 956, two points should be evaluated:

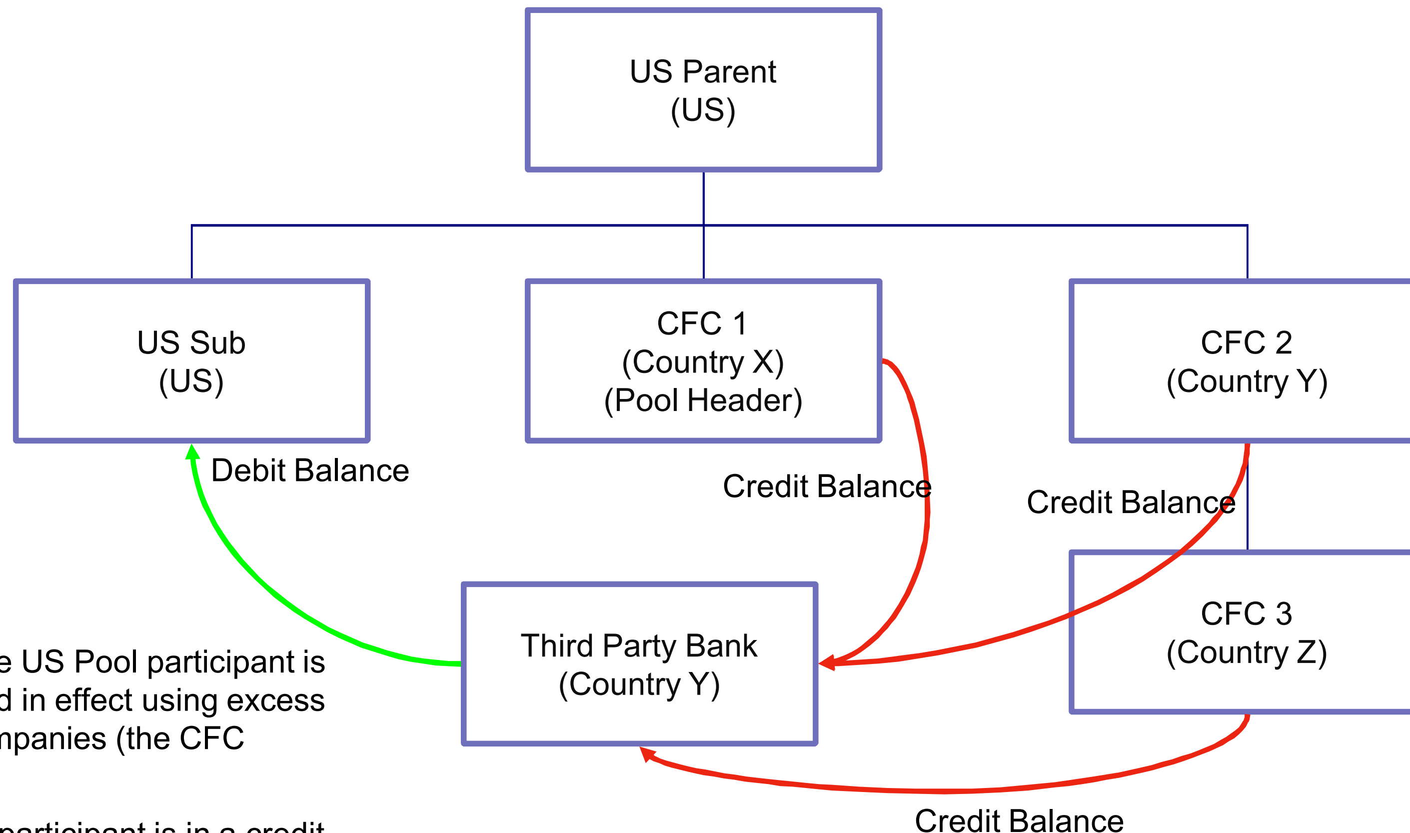
  - Whether the US participant in the Pool is long cash in the Pool or short cash in the Pool; and

  - Whether the assets of any CFC participant in the Pool are pledged or used to guarantee (or as security for) the debt of the US participant.

- With respect to the position of the US participant in the Pool, there is a risk if the US participant is short in the Pool, that the IRS could take the position the CFC participants in the Pool have made a loan of their excess cash to the US participant and thus have an investment in US property subject to 956.

- With respect to the pledge of CFC's assets, it is important to make sure that any cross-collateralization built into the Pool meets the expectations of the parties and takes into consideration the risk of a 956 inclusion.

Potential 956 Dividend – Cash Pooling Example



• In this example, the US Pool participant is short in the pool, and in effect using excess cash of its sister companies (the CFC participants).

• As long as the US participant is in a credit position within a certain time frame dictated by Section 956, there will be no deemed dividend.

• Certain provisions may be built into the Accession Agreement to avoid a 956 Inclusion.

*All ownership is 100% unless otherwise noted

IRC Section 956 - Background

Section 956 Background

Section 956 was enacted by the Revenue Act of 1962 as part of the legislation that introduced the "Subpart F" and "CFC" concepts into the federal income tax law. The Subpart F legislation was intended to combat perceived abuses by US persons in control of certain foreign corporations who were taking advantage of the so-called "deferral" privilege, which, until the legislation's enactment, permitted the earnings of most such CFCs to escape US income tax until actually distributed to their US shareholders as dividends.

In enacting the rules contained in IRC, Sections 951-971, Congress declared that CFCs in effect could be taxed on certain types of profits on a current basis before the actual distribution of those profits to their shareholders as dividends. This was accomplished by requiring the inclusion of these profits in the gross income of the CFC's US shareholders in the same manner as if an actual dividend had been paid to them.

There are a number of circumstances that can result in the taxation of a CFC's undistributed earnings to its US shareholders. One such circumstance is under the rules governing a CFC's investment of its earnings in certain, defined "United States property". These rules require a CFC's US shareholder to currently recognize as taxable income its CFC's current or accumulated earnings to the extent that it invests such earnings in certain types of property located (or deemed to be located) in the US. These rules are prescribed by IRC, Sections 956 and 951(a)(1)(B).

IRC Section 956 – Some Technical Aspects

IRC, Section 956 Code and Regulations

IRC Section 951(a)(1) provides, in part, that if a foreign corporation is a controlled foreign corporation for an uninterrupted period of 30 days or more during any taxable year, every person who is a United States shareholder of such corporation and who owns stock in such corporation shall include in his gross income for his taxable year in which or with which such taxable year of the corporation ends his pro rata share of the corporation's increase in earnings invested in United States property for such year.

Section 956 provides a two part test to determine whether certain earnings of a CFC are deemed to be remitted to its US shareholder. First, the CFC must have invested in certainly defined and identified “United States property.” IRC Sections 956(a)(1)(A) & (c). Section 956(c)(1) provides that for purposes of Section 956(a), the term 'United States property' means any property acquired after December 31, 1962, which is (A) tangible property located in the US, (B) stock of a domestic corporation, (C) an obligation of a US person, and (D) any right to the use in the US of a patent or copyright, an invention, model or design (whether or not patented), a secret formula or process, or any other similar property right which is acquired or developed by the controlled foreign corporation for use in the US.

Treas. Reg. § 1.956—2T(d)(2) provides, in part, that the term 'obligation' includes any bond, note, debenture, certificate, bill receivable, open account, or other indebtedness, whether or not issued at a discount and whether or not bearing interest.

IRC Section 956 – Some Technical Aspects

IRC, Section 956 Code and Regulations

The second part of the Section 956 test is a measurement of the CFC's earnings as compared to it's investment in US property to determine the amount of deemed repatriation of the CFC's earnings to its US shareholder.

Section 956(a) provides that the amount the US shareholder of the CFC will include in its income as a deemed dividend from the CFC will be the lesser of : 1) the excess (if any) of the US shareholder's pro rata share of the quarterly average amount of US property of the CFC, over the amount of earnings and profits treated as having been previously included in income on account of investment in earnings in US property in IRC Section 959(c)(1)(A) with respect to the US shareholder or 2) the US shareholder's pro rata share of the applicable earnings of the CFC.

When applying the first prong of the measurement test, the adjusted basis of the US property held by the CFC will be used as the property's "amount" reduced by any liability to which the property is subject. IRC Section 956(a) (flush language) (emphasis added). Thus, Congress has specifically provided that it is the CFC's net investment in US property that is to be measured under Section 956.