LEGAL UPDATES

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Final IRS Regulations Modify the Deemed Dividend Rule

Industry

Financial Services & Capital Markets

Key Points

Controlled foreign corporations may now provide credit support for U.S. corporate parents without adverse U.S. income tax consequences.

Market practice will likely shift toward more controlled foreign corporations credit support.

On May 23, 2019, the Internal Revenue Service issued Final Regulations under Section 956 of the Internal Revenue Code of 1986. The purpose of the Final Regulations is to eliminate a disparity caused by the Tax Cuts and Jobs Act (TCJA) in the tax treatment of actual dividends and deemed dividends, in each case, made or deemed made, by controlled foreign corporations (CFC) to U.S. corporate shareholders meeting certain ownership and holding period requirements. The Final Regulations align the tax treatment of deemed dividends with that of actual dividends and allow U.S. corporate shareholders to better avoid certain adverse tax impacts triggered when a CFC provides credit support.

Section 956 was based on the notion that U.S. corporate shareholders were implicitly receiving the benefit of CFC earnings by having their CFCs provide credit support for their debt obligations. To prevent this, Section 956 was enacted. Under Section 956, if a CFC provides certain credit support for a U.S. parent company's debt obligations, the U.S. parent is deemed to have received a dividend from the CFC (referred to as a "deemed dividend").

In December of 2017, Congress enacted the TCJA, which created a mismatch in the treatment of actual dividends and deemed dividends. The TCJA enacted Code Section 245A to establish a "participation exemption" that entitles a U.S. corporate shareholder to a "dividends received" deduction equal to the amount of the dividend actually received from a CFC, assuming certain ownership and holding requirements are met. The participation exemption only applied to actual dividends, not to deemed dividends. The result was that a CFC could make an actual dividend to a U.S. corporate shareholder without tax, but a deemed dividend to the same U.S. corporate shareholder from the same CFC would be taxable.

What this means to you

The Final Regulations align the tax treatment of deemed dividends with the participation exemption under Code Section 245A. The Final Regulations provide, generally, that a U.S. corporation can reduce the amount of a deemed dividend from a CFC under Section 956 to the same extent it would if it were an actual dividend. As a result, CFCs may now provide credit support to U.S. corporations without triggering a taxable dividend, assuming certain ownership and holding requirements are met.

Now that the Final Regulations have been released, market practice will likely shift toward more CFC credit support. For a more detailed analysis of the Final Regulations, please seethis supplemental document.

Contact us

If you have questions about the Final Regulations and how it impacts your business, contact William Gardner or your Husch Blackwell attorney.