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In this report, Cunningham explores situations in which U.S. multinational borrowers might incur a section 956 inclusion as a result of using controlled foreign corporation stock or assets as collateral, and he describes the factors that must be evaluated when providing such collateral as well as the strategies that can be undertaken to avoid the inclusion.

This report represents the views of the author only and does not necessarily represent the views or the professional advice of KPMG LLP.

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In general, many lenders prefer lending to an entity established under the laws of the United States, as they are typically more acquainted with the corporate and bankruptcy laws there. If a multinational group has a U.S. parent, the parent will provide a single point of contact through which creditors' remedies can be exercised against the assets of the entire group. Also, before the Tax Cuts and Jobs Act, the federal income tax rate on corporations was generally 35 percent, a very high rate relative to other jurisdictions, so many U.S. multinational borrowings were incurred by a U.S. entity to maximize the after-tax benefits of the borrowing, and these borrowings continue to be refinanced with that U.S. entity post-TCJA. Not surprisingly, then, substantial amounts of post-TCJA U.S. multinational borrowings from third-party lenders are incurred by the U.S. entities within the group.

Although a U.S. entity is frequently the borrower, many multinational groups own one or more subsidiaries that are controlled foreign corporations for U.S. tax purposes and often comprise a substantial portion of the credit of the group. Thus, lenders usually require that a CFC provide credit support for loans to a U.S. parent entity.

In these cases, lenders prefer that the CFC itself guarantee the U.S. shareholder's debt and pledge all its assets in support of its loan to the U.S. shareholder. Absent that guarantee or a pledge, the lender would be able to seek repayment only by exercising its creditor's rights against the U.S. owner of the CFC. Although the assets of the U.S. shareholder would include the stock of the CFC, a pledge of the stock of a CFC is a much less valuable claim to the lender than if the CFC were to guarantee the debt or pledge its assets in support of the U.S. shareholder's debt. If the lender were to seize the stock of the CFC, it would still be structurally subordinated to other

creditors who have direct claims against the assets of a CFC. That is, if the lender were to foreclose on the stock of the CFC, it would receive only whatever assets remain after the CFC satisfies its obligations to its direct creditors. Thus, from a lender's perspective, it is far preferable for a CFC to directly pledge its assets or guarantee a U.S. parent's debt than if the U.S. parent were to merely pledge the stock of the CFC in support of its debt.

Since the early 1960s, section 956 has made it very difficult for U.S. multinationals to provide a lender with its preferred collateral for a CFC. The reason is that the section 956 regulations provide that if the CFC guarantees or pledges its assets in support of a U.S. shareholder's borrowing, the CFC is viewed, for federal income tax purposes, as holding the loan to the U.S. shareholder.[1] And because a CFC's loan to a U.S. shareholder would be viewed as "U.S. property" for purposes of section 956, the CFC's earnings would become subject to those rules.[2] In general, section 956 is designed to prevent a CFC from indirectly repatriating its earnings to a shareholder through credit support to a lender who, wholly or partially based on that credit support, transfers assets to the U.S. shareholder.

The provision applies even if only CFC stock is pledged for a loan. If the U.S. shareholder pledges at least 66.67 percent of the total combined voting power of classes of stock of the CFC entitled to vote (and provides certain negative covenants on the disposition of assets or the incurrence of liabilities outside the ordinary course of business), the pledge will be considered an indirect pledge of the assets of the CFC for purposes of section 956 (and the CFC will, again, be viewed as holding the loan made to the U.S. shareholder borrower).[3] Thus, creditors are restricted even to the extent to which they can obtain indirect credit support — a pledge of the stock of a CFC — even though the pledge is suboptimal credit insofar as it is structurally subordinated to the creditors of the CFC.

Pre-TCJA, it was relatively easy for U.S. shareholders to reject lender requests for CFC collateral consisting of (1) CFC guarantees, (2) CFC asset pledges, or (3) pledges of CFC stock exceeding 66.67 percent of the voting stock of the CFC (for purposes of this report, (1), (2), and (3), taken together, are referred to as section 956 CFC collateral) because each of these arrangements is directly implicated by section 956. Some more complicated permutations might have arisen that would have required more detailed analysis about whether property was section 956 CFC collateral; for example, a U.S. shareholder might pledge an intercompany loan that it made to the CFC as security for its own borrowing.[4] Still, both the lender and the U.S. shareholder had a common understanding that in the more straightforward scenarios, section 956 CFC collateral would not be provided. Pre-TCJA, most of a CFC's earnings were untaxed, other than a usually small portion that had been previously taxed because of subpart F.[5] Thus, if there was section 956 CFC collateral, the CFC would be considered to hold the lender's loan to the U.S. shareholder, which loan would be section 956 property, which in turn would often cause the untaxed earnings of the CFC to become subject to current taxation. Moreover, because there would usually be multiple CFCs providing section 956 CFC collateral, each of which might have untaxed earnings subject to inclusion (up to the amount of the borrowing being guaranteed), there could be multiple section 956 inclusions across multiple CFCs, and section 956 specifically permits the total inclusions across multiple CFCs to exceed the amount of the borrowing.[6]

After the TCJA, the perspective of many lenders changed. The change is the result of the TCJA's enactment of section 245A, which provides for a 100 percent dividends received deduction (DRD) for certain distributions from a CFC to a U.S. shareholder that is a corporation. Section 245A does not, on its face, affect the inclusion under section 956. However, on May 22, 2019, the

[1] Reg. section 1.956-2(c)(1).

[2] Reg. section 1.956-2(a)(1)(iii).

[3] Reg. section 1.956-2(c)(2).

[4] *See* Kimberly S. Blanchard, "Guidance Needed for CFC Lending Transactions," *Tax Notes*, Jan. 11, 2010, p. 201.

[5] *See* Kevin Liss, "Who's Afraid of Deemed Repatriations?" *Tax Notes Federal*, July 15, 2019, p. 337.

[6] *Id.*, citing reg. section 1.956-1(e)(2).

IRS and Treasury issued regulations under the broad grant of authority under section 956 that reduce the amount determined under section 956 by the section 245A DRD that would be allowed on a hypothetical distribution of that section 956 amount by the CFC to its U.S. shareholder.[7]

Thus, from most lenders' perspectives, a U.S. multinational borrower that is eligible for the section 245A DRD should be willing to provide section 956 CFC collateral because a hypothetical distribution associated with a section 956 inclusion would presumably be reduced by an equal and offsetting section 245A DRD, in which case there would be no net section 956 inclusion to the U.S. shareholder-borrower.

That presumption, however, is based on an oversimplification of the breadth of the reduction of the section 956 amount for the section 245A DRD. U.S. multinational borrowers need to consider their specific facts before permitting their CFCs to collateralize the debt in a manner that would implicate section 956. There is often a significant possibility that a section 956 inclusion might occur as a result of section 956 CFC collateral, despite the section 245A DRD, because of several exceptions that might apply, and in particular a possible "nimble dividend" exception to section 245A. In that case, a U.S. shareholder borrower could be subject to tax at the full ordinary income rate on a significant amount, if not all, of the CFCs' earnings, and because the same rule discussed above permitting a cumulative inclusion exceeding the amount of the domestic borrowing continues to apply post-TCJA, the effect might be felt across multiple CFCs. And worse, the CFCs' earnings will usually have already been subject to tax in the CFC's jurisdiction or elsewhere, and after the TCJA, the U.S. tax liability arising from a section 956 inclusion cannot be eliminated or reduced by a foreign tax credit in the United States.[8] Thus, the effective tax rate on earnings subject to tax under section 956 could be 40 percent or higher, consisting of 21 percent in the United States, in addition to a significant tax in the CFC's jurisdiction.

This report explores circumstances in which, despite lender expectations to the contrary, section 956 CFC collateral might result in an inclusion to a U.S. multinational borrower, despite the section 245A reduction described above. It describes what factors U.S. multinationals must evaluate before agreeing to provide section 956 CFC collateral to a lender and how a possible nimble dividend exception to section 245A could cause a section 956 inclusion as a result of section 956 CFC collateral. Finally, it offers some strategies that U.S. multinational borrowers can undertake to avoid a section 956 inclusion in these circumstances.

I. Determining the Section 956 Inclusion

Section 951(a)(1)(B) provides that a U.S. shareholder of a CFC is required to include "*the amount determined under section 956* with respect to such shareholder for such year (but only to the extent not excluded from gross income under Section 959(a)(2))" (emphasis added).[9] Section 959(a)(2) refers to the exclusion for previously taxed earnings and profits (PTEP).

The amount determined under section 956 is calculated as follows:

> In the case of any controlled foreign corporation, the amount determined under this section with respect to any United States shareholder for any taxable year is the *lesser* of (1) the excess (if any) of (A) such shareholder's pro rata share of *the average of the amounts of United States property held* (directly or indirectly) by the controlled foreign corporation as of the close of each quarter of such taxable year, over (B) the amount of earnings and profits described in section 959(c)(1)(A) with respect to such shareholder, or (2) such shareholder's *pro rata share of the applicable earnings* of such controlled foreign corporation.[10]

[7] Reg. section 1.956-1(a)(2).

[8] Reg. section 1.960-2(b) ("No foreign income taxes are deemed paid under section 960(a) with respect to an inclusion under section 951(a)(1)(B).").

[9] *See* section 951(a)(1)(B).

[10] *See* section 956(a).

> The amount taken into account under paragraph (1) with respect to any property shall be its adjusted basis as determined for purposes of computing earnings and profits, reduced by any liability to which the property is subject. [Emphasis added.]

If this were the only calculation required under section 956, section 956 would still be very complicated. However, as we will see, a complicated interaction among several different code sections and Treasury regulations is needed to make a proper determination under section 956.

The above calculation requires that the lesser of two amounts be determined for each CFC providing section 956 CFC collateral. The first (1) is a determination of the adjusted basis of the U.S. property held by the CFC, reduced by "the amount of earnings and profits described in section 959(c)(1)(A)," which is equal to the E&P previously taxed under section 956 (section 956 PTEP). The second (2) is a determination of the "applicable earnings" of the CFC, a concept that will be discussed below.

Regarding (1), if a lender obtains section 956 CFC collateral for a U.S. borrowing — for example, if a CFC guarantees a U.S. shareholder's borrowing — the CFC will be viewed as holding the loan to the U.S. shareholder borrower, which loan is itself section 956 property.[11] Thus, (1) will generally be equal to the U.S. tax basis of the loan, which will be approximately equal to the amount of the borrowing and in many cases will be an amount significantly exceeding the accumulated earnings of any single CFC that guarantees it. Number (1) is reduced by undistributed section 956 PTEP, which is generally relevant only if the CFC has prior inclusions under section 956 or if certain reclassifications are made under the PTEP rules.

The second calculation, part (2), is the amount of the applicable earnings of the CFC. As noted, unless a CFC is very profitable, the adjusted basis of the U.S. shareholder borrower's obligation will often exceed the amount of the CFC's accumulated earnings. Thus, because the formula is based on the lesser of (1) the adjusted basis of the loan or (2) applicable earnings, applicable earnings are particularly important to the section 956 computation because they will in many cases determine the amount included under section 956.

Applicable earnings are defined as "the sum of (A) the amount (not including a deficit) referred to in section 316(a)(1) [E&P accumulated after February 28, 2013,] to the extent such amount was accumulated in prior taxable years, and (B) the amount referred to in section 316(a)(2) [E&P of the current tax year (computed as of the close of the tax year without diminution by any distributions made during the taxable year), without regard to the amount of earnings and profits at the time the distribution was made]."[12]

Thus, (A) will generally reflect E&P accumulated through the end of the prior year, and importantly, if the CFC has a deficit, (A) will be zero, not the negative number. (B), on the other hand, represents E&P for the current year. Thus, if a CFC has a very large deficit for prior years but a positive earnings amount in the current year — a nimble dividend amount — applicable earnings will be equal to the nimble dividend amount.

The flush language of section 956(b) provides that applicable earnings are "reduced by distributions made during the taxable year and by earnings and profits described in section 959(c)(1)." Section 959(c)(1) refers to undistributed section 956 PTEP, which reduction, as noted, applies only if the CFC has prior section 956 inclusions or if certain reclassifications are made under the PTEP rules.

For example, assume that a domestic corporate borrower owns 100 percent of a CFC and that on January 1 the CFC provides section 956 CFC collateral, such as a guarantee for a U.S. shareholder's obligation of $100. CFC has an accumulated deficit of $50 through the beginning of the previous year (section 316(a)(1) earnings) but current earnings of $25. Assume also that those earnings are not included in the U.S. shareholder's income as global intangible low-taxed income under section 951A nor as subpart F under section 951(a). Also, the CFC has made no

[11] *See* reg. section 1.956-2(c)(1), -2(a)(1)(iii).

[12] *See* section 956(b)(1).

distributions during the year and has no section 956 PTEP.

The amount determined under section 956 will be the lesser of (1) (A), the excess of the shareholder's pro rata share of the average of the amounts of U.S. property held (directly or indirectly) by the CFC as of the close of each quarter for the tax year ($100), over (B), the amount of E&P described in section 959(c)(1)(A) regarding the shareholders (undistributed section 956 PTEP) ($0), or (2) the shareholder's pro rata share of the applicable earnings of the CFC ($25), consisting of the sum of accumulated earnings in prior tax years (but not less than zero) ($0) and current earnings ($25). Thus, the amount determined for section 956, the lesser of (1) or (2) above, is $25.

II. Reduction for Subpart F and GILTI Inclusions

A. How the Reduction Is Calculated

Section 951(a)(1)(B) requires that this $25, the amount determined under section 956 regarding the shareholder for that year, be included in gross income. The first line of defense, however, is that there will not be a section 956 inclusion to the extent the applicable earnings (or, if a lesser amount, an amount of applicable earnings equal to the section 956 property) have been included in a U.S. shareholder's income as subpart F or GILTI and have not yet been distributed. The section 956 inclusion is reduced to the extent "excluded from gross income under Section 959(a)(2)," which will have the effect of reducing the section 956 inclusion by the cumulative amount of undistributed current GILTI and subpart F inclusions.[13]

The section 959(a)(2) exclusion has always been important to the operation of section 956, but it is even more important post-TCJA. Pre-TCJA, the current earnings of $25 subject to tax under section 956 might also have been taxed under subpart F, but subpart F inclusions are relatively unusual. However, after the TCJA, most and possibly all of the CFC's non-subpart F earnings might be tested income subject to tax as GILTI. Absent section 959(a)(2), the CFC's earnings would be subject to tax twice in the United States — first as subpart F or GILTI and second under section 956.

Section 959(a) provides that:

> For purposes of this chapter, the earnings and profits of a foreign corporation attributable to amounts which *are*, or have been, included in the gross income of a United States shareholder under Section 951(a) shall not, when
>
> (1) such amounts are distributed to, or
>
> (2) such amounts would, but for this subsection, be included under Section 951(a)(1)(B) in the gross income of such shareholder . . . directly or indirectly through a chain of ownership described under Section 958(a), be again included in the gross income of such United States shareholder. [Emphasis added.]

Section 959(f)(1) provides that:

> For purposes of this section, amounts that would be included under subparagraph (B) of section 951(a)(1) (determined without regard to this section) shall be treated as attributable first to earnings described in subsection (c)(2) [GILTI/subpart F PTEP, as defined below], and then to earnings described in subsection (c)(3) [untaxed earnings].

Each tax year, there is a three-step process to give effect to the highlighted language above (that is, E&P that "are" included in gross income as subpart F or GILTI reduce the section 956 inclusion). First, the GILTI and subpart F amounts that are included in the U.S. shareholder's income in the current tax year, if any, create GILTI or subpart F PTEP, as the case may be (GILTI and subpart F PTEP together are hereafter referred to as "GILTI/subpart F PTEP").[14] Second, actual distributions from the CFC, if any, reduce section 956 PTEP and GILTI/subpart F PTEP in that order.[15] Third, after current-year GILTI/subpart F PTEP is calculated under the rules above and the CFC's GILTI/subpart F PTEP is reduced by actual

[13] *See* section 951(a)(1)(B).

[14] *See* sections 959(a), 951A(f).

[15] *See* section 959(f)(2).

distributions in that year, the section 956 amount is first sourced to GILTI/subpart F PTEP under section 959(f)(1) before it is sourced to untaxed earnings of section 959(c)(3). And because GILTI/subpart F PTEP are amounts that "are, or have been" included in income, section 959(a)(2) reduces the section 956 amount by those earnings.[16] The GILTI/subpart F PTEP is then reclassified as section 956 PTEP to the extent of the section 956 amount excluded.[17]

In future years, that section 956 PTEP reduces the adjusted basis of section 956 property and applicable earnings in the initial step of the calculation. This reduction makes sense because the U.S. multinational has included unrepatriated amounts in income under either subpart F or GILTI, and that inclusion operates as a sort of credit going forward, either for future distributions or section 956 inclusions.

So taking the example above in which the section 956 inclusion would otherwise have been $25 if the $25 was included in the U.S. shareholder's income as GILTI or subpart F, then GILTI/subpart F would be increased by $25 and, absent an actual distribution, the section 956 amount of $25 would be sourced to the $25 of GILTI/subpart F PTEP and therefore would not be "again included" in income under section 956.

This helpful reduction for subpart F and GILTI inclusions is usually the first line of defense for U.S. shareholders that might be subject to a section 956 inclusion regarding section 956 CFC collateral. If, for each tax year the CFC continues to be a pledgor or a guarantor of a U.S. shareholder debt, the CFC will earn only amounts that are included in the U.S. shareholder's income as subpart F or GILTI, then the GILTI/subpart F PTEP will effectively offset whatever applicable earnings might cause the U.S. shareholder to have a section 956 inclusion and reduce the section 956 inclusion to zero.

B. Evaluating This First Line of Defense

To evaluate this first line of defense, the U.S. multinational will first need to assess whether all of a CFC's earnings are expected to be properly characterized as tested income (or subpart F income) or alternatively subject to an exception. Second, the U.S. multinational needs to determine whether the CFC's tested income is includable as GILTI and not subject to a reduction on account of qualified business asset investment (that is, tangible personal property) or a tested loss of another CFC.

If both of these conditions are met for each CFC and are expected to be met for each tax year that the section 956 CFC collateral is provided, then the GILTI/subpart F PTEP that will result each year should prevent a section 956 inclusion for section 956 CFC collateral.

After the TCJA, in many cases, all the earnings derived by a CFC will be tested income subject to tax as GILTI. The relevant exceptions for current-year earnings are earnings that are (1) U.S.-source effectively connected income, (2) subpart F income, (3) high-tax earnings, (4) dividends received from a related person, and (5) foreign oil and gas extraction income.[18]

The exception in category (1), earnings that are U.S.-source ECI, is very unlikely to apply because most CFCs will not conduct a U.S. trade or business. Regarding category (2), subpart F income will usually itself create GILTI/subpart F PTEP, which will reduce the section 956 amount under section 959(a)(2) and thus prevent those earnings from otherwise causing a section 956 inclusion.

Regarding category (4), a CFC might receive a distribution from a related U.S. or non-U.S. corporation. Distributions from related U.S. corporations are unusual and generally would be limited to multinationals with foreign sandwich structures. A dividend from a related U.S. corporation to a CFC parent generally would be eligible for a 65 percent DRD, and the remainder would be subpart F income.[19] Thus, there would be section 956 exposure for the 65 percent of the earnings eligible for the DRD and not included as subpart F income.

[16]The now-withdrawn section 959 regulations provided that this reduction is equal to the amount of the reclassification. Prop. reg. section 1.956-1(c)(2) (REG-114540-18).

[17]*See* section 959(f)(1).

[18]Section 951A(c)(2).

[19]Section 243(a)(1), (c); reg. section 1.952-2. *See also* LTR 200952031 (indicating that a CFC can properly claim a DRD).

A dividend from a related foreign corporation that is a CFC will be sourced to either PTEP or untaxed earnings and thus shift PTEP or untaxed earnings between two CFCs (in the case of untaxed earnings, the distribution will usually be exempt from subpart F under section 954(c)(6)). The shifting of earnings between CFCs might matter if the transferee CFC owned section 956 property and the transferor did not (or vice versa), but in the case of section 956 CFC collateral, typically all the CFCs jointly and severally guarantee the U.S. shareholder's debt. Thus, CFC-to-CFC dividends in connection with section 956 CFC collateral generally will not affect the section 956 inclusion.

Concerning category (5), only a small subset of CFCs will derive foreign oil and gas extraction income, but if one does, those earnings would be untaxed and therefore vulnerable to a section 956 inclusion.

Of the five exceptions, the high-tax exception in clause (3) is the exception that is most likely to exclude a CFC's earnings from the definition of tested income (and thus GILTI). Exception (3), as written, excludes "gross income excluded from the foreign base income (as defined in section 954) and the insurance income (as defined in section 953) of such corporation by reason of section 954(b)(4)."[20] This exception, as written, was narrowly tailored because it would exclude only gross income that otherwise would have been subpart F income. In 2019 the IRS issued regulations that would apply the high-tax exception to items of gross income that would otherwise be tested income.[21] And if a high-tax election were made, then it would generally be applicable regarding all high-taxed income of CFCs within the group.[22]

Thus, a U.S. multinational that is providing section 956 CFC collateral needs to consider whether it has made a high-tax election. If the high-tax election is made, then the general rules that are likely to treat substantially all of a CFC's gross income as tested income will not apply, and much of the CFC's gross income could be untaxed earnings not subject to GILTI (and possibly subpart F) and thus subject to section 956.[23]

Even if a U.S. multinational has not made a high-tax election, and the other tested income exceptions do not apply, the CFC, or a group of CFCs, still might have attributes that prevent tested income from being included in its income as GILTI.

Because the GILTI inclusion is (1) based on a U.S. shareholder's net tested income (determined based on the shareholder's pro rata share of tested income reduced by the pro rata share of tested losses) less the shareholder's net deemed tangible income return (the amount of which is calculated based on the amount of QBAI) and (2) is measured by reference to all CFCs directly or indirectly owned, then tested losses and deemed tangible income return could cause tested income to be untaxed, even if those items reside in a different CFC.[24] Thus, a U.S. shareholder that has provided section 956 CFC collateral for its borrowing will need to evaluate the extent to which one or more of its CFCs have tested losses or QBAI, which might reduce the GILTI inclusion (and thus the GILTI/subpart F PTEP).

III. The Section 245A DRD

When the TCJA was first enacted, it seemed that a U.S. multinational might have only this one line of defense against a section 956 inclusion. That is, absent a GILTI or subpart F inclusion, earnings would be untaxed and thus subject to U.S. taxation under section 956 to the extent the CFC had provided section 956 CFC collateral or otherwise held section 956 property.[25]

On October 31, 2018, the IRS and Treasury exercised their regulatory authority under section 956 to issue regulations providing that the section 245A DRD would apply to untaxed earnings included under section 956 to the same extent as if those earnings were distributed as a dividend. Those regulations fundamentally changed the

[20] Section 951A(c)(2)(A)(i)(III).

[21] Reg. section 1.951A-2(c)(7)(i).

[22] Reg. section 1.951A-2(c)(7)(v)(E).

[23] There are also other, relatively unusual circumstances that could cause earnings to be untaxed, such as (1) pre-1987 accumulated E&P, (2) GILTI gap period earnings, and (3) earnings of newly acquired foreign targets not subject to a section 338(g) election. *See* Liss, *supra* note 5, at 198.

[24] *See* reg. section 1.951A-1(c).

[25] Section 965 PTEP would also be subpart F PTEP for this purpose. *See* Notice 2019-1, 2019-3 IRB 275.

manner in which section 956 would operate. Specifically, the preamble to the proposed regulations, after citing a history of regulations since 1964 that had been issued to tailor the operation of section 956 to its intended purpose, stated that:

> The proposed regulations continue the Treasury Department and the IRS's longstanding practice of conforming the application of section 956 to its purpose. The proposed regulations exclude corporate U.S. shareholders from the application of section 956 to the extent necessary to maintain symmetry between the taxation of actual repatriations and the taxation of effective repatriations. In general, under section 245A and the proposed regulations, respectively, neither an actual dividend to a corporate U.S. shareholder, nor such a shareholder's amount determined under section 956, will result in additional U.S. tax.
>
> To achieve this result, *the proposed regulations provide that the amount otherwise determined under section 956 with respect to a U.S. shareholder for a taxable year of a CFC is reduced to the extent that the U.S. shareholder would be allowed a deduction under section 245A if the U.S. shareholder had received a distribution from the CFC in an amount equal to the amount otherwise determined under section 956.* The proposed regulations provide special rules with respect to indirect ownership. *Due to the broad applicability of section 245A, in many cases a corporate U.S. shareholder will not have a section 956 inclusion as a result of a CFC holding U.S. property under the proposed regulations*. [Emphasis added.][26]

That regulation modified reg. section 1.956-1; was finalized on May 23, 2019; and operates by creating a complex "hypothetical distribution" by the CFC regarding the U.S. shareholder's shares in the CFC. The regulation reduces the section 956 amount by the amount of the section 245A DRD the U.S. shareholder would otherwise be entitled to regarding a hypothetical distribution of a dividend in an amount equal to the tentative section 956 inclusion and assuming the U.S. shareholder had directly owned the CFC's shares.[27] The tentative section 956 inclusion is "the amount that would be determined under section 956 with respect to such share for the taxable year, absent the application of this paragraph (a)(2) for the taxable year."[28] The hypothetical distribution is treated as attributable first to GILTI/subpart F PTEP (in which case there is no section 956 inclusion/possible section 245A reduction) and then to untaxed earnings (in which case there is).[29]

This deemed section 245A DRD comprises a U.S. shareholder's second line of defense against a section 956 inclusion for section 956 CFC collateral. In the example above, assume that the $25 of current earnings were not included either as subpart F or subject to a GILTI inclusion. In that case, on account of a failure of the first line of defense, the U.S. shareholder would have a tentative section 956 inclusion of $25. However, the section 956 regulation described above would then reduce the $25 inclusion to the extent the U.S. shareholder would have been eligible for a $25 DRD under section 245A from the CFC on account of a $25 hypothetical distribution. If, on the other hand, the $25 of current earnings were subject to a subpart F or GILTI inclusion, the hypothetical distribution would have no effect because the section 245A DRD would be zero and the section 956 inclusion of $25 would be excluded because of the rules discussed above.[30]

There are a few important exceptions that appear within the text of the regulation or are demonstrated within the examples, First, section 245A applies only based on the "foreign source portion" of a dividend, which is an amount that bears the same ratio to a dividend as "(A) the undistributed foreign earnings of the specified 10-percent owned foreign corporation [which term includes CFCs], bears to (B) the total

[26] *See* preamble to prop. reg. section 1.956-1 (REG-114540-18).

[27] Reg. section 1.956-1(a)(1).

[28] Reg. section 1.956-1(a)(2).

[29] Reg. section 1.956-1(a)(2)(C).

[30] Reg. section 1.956-1(a)(3)(ii), Example 2.

undistributed earnings of the foreign corporation."[31] Undistributed foreign earnings represent all earnings of the specified 10 percent-owned foreign corporation other than (1) U.S.-source ECI and (2) dividends directly or indirectly from an 80 percent-owned (by vote and value) domestic corporation.[32]

Thus, ECI, as well as dividends from 80 percent-owned domestic corporations, will not be eligible for a section 245A DRD, in which case those items will bypass the second line of defense (as well as the first for the reasons discussed above), but fortunately this type of income is relatively unusual. But the other items that might bypass the U.S. shareholder's first line of defense — for example, income subject to a high-tax exclusion, foreign oil and gas extraction income, and tested income offset by tested losses or deemed tangible income return — generally should be part of the foreign-source portion of the undistributed earnings, eligible for a section 245A DRD in a hypothetical distribution, and therefore reduce the amount of the section 956 inclusion by the full amount of those earnings.

Also, section 245A does not apply to U.S. shareholders that are individuals, S corporations, or U.S. partnerships, although a domestic corporation can claim a section 245A DRD to the extent it meets the U.S. shareholder ownership requirements indirectly through the partnership.[33] Thus, those shareholders will have to exclusively rely on the first line of defense. TCJA's repeal of section 958(b)(4) — the restriction on downward attribution — caused more foreign corporations to become CFCs on account of brother-sister U.S. corporations, making it more likely that a U.S. person that is not a corporation might be a U.S. shareholder (and thus subject to section 956).

For example, assume a U.S. corporation and a non-U.S. corporation that are each 100 percent owned by a non-U.S. corporation are both co-obligors on a debt. The foreign corporation will be viewed as both a CFC, on account of the repeal of downward attribution, and a guarantor of the U.S. corporation's debt for purposes of section 956. If the guaranteeing CFC has an indirect U.S. shareholder through the foreign corporate owner that is a U.S. individual, the U.S. shareholder might have a section 956 inclusion, and that inclusion will not be eligible for the section 245A reduction.

Moreover, to obtain the section 956 reduction on account of the hypothetical distribution, the U.S. shareholder must own the CFC, directly or indirectly, for a 366-day holding period during a 731-day period beginning 365 days before the measurement date.[34] For this purpose, the measurement date is "the last day during the [CFC's] taxable year on which the foreign corporation is a controlled foreign corporation."[35]

If a U.S. shareholder acquires a CFC during a tax year and the CFC provides section 956 CFC collateral to the U.S. shareholder's lender, then the 366-day holding period will not be satisfied by the end of the CFC's tax year. Fortunately, the 366-day holding period can be met on a prospective basis based on ownership after the end of the CFC's tax year during the year of acquisition.[36] That being said, because many U.S. corporations file their tax return approximately nine months after the end of that tax year, some U.S. multinationals might not satisfy the holding period when they file that return. In that case, there is some question about whether and how that U.S. shareholder can demonstrate that it will satisfy the holding period prospectively after the filing is made.

In Example 4 of reg. section 1.956-1, a U.S. multinational indirectly acquires on December 1 stock of a CFC that holds a loan on its U.S. shareholder for the entire tax calendar year. On June 30 of the following year, the CFC sells the stock, so the example concludes that the holding period is not met.[37] It might be possible to draw an inference from this example that, absent the sale, the U.S. multinational could have taken a filing position that the holding period would have been met regarding the year 1 section 956 tentative inclusion despite the fact that the 366-day holding period would not be met at the time it filed its year

[31] Section 245A(c)(1), (2).

[32] Section 245A(c)(3).

[33] Section 245A(a).

[34] Reg. section 1.956-1(a)(2)(ii)(B).

[35] *Id.*

[36] Section 246(c)(1), (c)(5); reg. section 1.956-1(a)(2)(ii)(B).

[37] *See* reg. section 1.956-1(a)(3)(iv), Example 4.

1 tax return. In any case, in these circumstances, it might make sense for the U.S. multinational to attach a statement to its year 1 tax return stating that it intends to hold the stock for the 366-day holding period and that if it does not, it will file an amended return to remove the deduction.

Finally, a hybrid dividend rule would call off the section 956 reduction if the CFC, or any CFC through which the U.S. shareholder owns the CFC, has issued an instrument that is treated as equity for federal income tax purposes but "for which the controlled foreign corporation received a deduction (or other tax benefit) with respect to any income, war, profits, or excess profits taxes imposed by any foreign country or possession of the United States."[38] Thus, unlike the "hypothetical distribution" which assumed a direct distribution from the CFC to the U.S. shareholder, the hybrid dividend rules test each intermediate CFC owner, as well as the CFC itself, to determine if it has issued hybrid equity.

Importantly, taxpayers should consider not only structured hybrid equity but also diligence, whether any instrument that is in form a debt instrument might be viewed as equity for federal income tax purposes on account of, say, thin capitalization of the issuer, because that instrument would also qualify as a hybrid instrument for this purpose.

Despite these pitfalls, which need to be appropriately managed, all the requirements often will be readily satisfied by a CFC. In that case, the second line of defense would generally protect a U.S. multinational and reduce the section 956 inclusion by the amount of the section 245A DRD that would be available to the U.S. shareholder if that amount were hypothetically distributed as a dividend. As the preamble to the regulation indicates, "in many cases" that reduction will reduce the section 956 inclusion to zero.

IV. The Achilles' Heel of the Section 245A DRD

From the perspective of many lenders, the first and second defenses should be a sufficient basis for the U.S. multinational to provide section 956 CFC collateral for its borrowing. That is, in the lenders' view, most of the CFC's earnings will likely be tested income subject to a GILTI inclusion or alternatively subject to a subpart F inclusion. In the event there is some leakage because of, say, tested losses, deemed tangible income return, or a high-tax election, then they would expect that the section 245A hypothetical distribution should step in and clean it up, absent an unusual case such as a hybrid dividend, a sandwich structure, or ECI. Thus, the initial reaction is for the U.S. multinational to readily provide section 956 CFC collateral for a U.S. shareholder borrowing.

However, there might be a significant disconnect between section 245A and section 956 that many lenders do not always appreciate. Although it is not entirely clear, section 245A might not apply to a CFC that pays a nimble dividend amount described in section 316(a)(2). Applicable earnings for purposes of section 956, on the other hand, certainly includes current E&P in the context of an accumulated deficit.[39] Thus, a CFC could be exposed to a section 956 inclusion if the CFC has provided section 956 CFC collateral and it has current, but not accumulated, E&P.

In the earlier example the CFC had $50 of an accumulated deficit and $25 of current earnings. In that case, the CFC had "applicable earnings" equal to the sum of the accumulated earnings and the current earnings, but for that purpose the accumulated earnings could not be less than zero. Thus, applicable earnings were $25, which was the amount of the section 956 inclusion, subject to reductions for the first (GILTI and subpart F inclusions) and the second (section 245A reduction) lines of defense.

Section 245A, on the other hand, is based on the foreign-source portion of the hypothetical distribution.[40] As discussed above, the foreign-source portion is the "amount which bears the same ratio to such dividend as (A) the undistributed foreign earnings of the specified foreign corporation, bears to (B) the total undistributed earnings of such foreign corporation."[41]

[38] Section 245A(e); reg. section 1.956-1(a)(2)(A)(2), (3).

[39] *See* section 956(b)(1)(B).

[40] Section 245A(a).

[41] Section 245A(c)(1).

Importantly, the term "undistributed earnings" means:

> The amount of the earnings and profits of the specified 10-percent owned foreign corporation (computed in accordance with sections 964(a) and 986) —
>
> (A) as of the close of the taxable year of the specified 10-percent owned foreign corporation in which the dividend is distributed, and
>
> (B) without diminution by reason of dividends distributed during such taxable year.[42]

So the amount of the E&P of the CFC is "computed in accordance with Section 964(a)," which provides that the earnings "will be determined in a manner substantially similar to domestic corporations." There are no specific rules for determining the E&P of domestic corporations, except for certain rules set forth under section 312, but those rules do not incorporate the nimble dividend rule of section 316(a)(1) into the calculation. Thus, unlike the definition of "applicable earnings" for purposes of computing the section 956 amount, there does not seem to be a specific rule that would incorporate the nimble dividend rule of section 316(a)(1) into the section 245A undistributed earnings calculation and cause a positive amount of earnings to exist when the CFC otherwise has an overall deficit in the calculation of its total E&P.

So where does that leave us? If a CFC has positive current and accumulated earnings (or a current deficit that is less than the accumulated earnings), then the section 245A reduction, the second line of defense, should align with the computation of "applicable earnings" in section 956 and clean up any possible section 245A inclusion. For example, if a CFC had $50 of accumulated earnings and positive current earnings, then the applicable earnings for purposes of the section 956 calculation will be the sum of those two, which will be equal to a positive number. And the undistributed earnings will be equal to the amount of the E&P as of the end of the year, which should also be the sum of the two — that is, the same amount as the amount of the applicable earnings. And absent one of the exceptions applying, the ratio of undistributed foreign earnings to undistributed earnings will be 100 percent, in which case the hypothetical section 245A distribution should fully offset the section 956 inclusion.

However, in the example above, in which the CFC had $50 of accumulated deficit and $25 of current earnings, the amount of the undistributed earnings is -$25, and absent a relevant exception applying, the undistributed foreign earnings are also -$25. By contrast, the section 956 calculation provides that an accumulated deficit cannot be less than zero, so the applicable earnings were $25. Thus, there is a disconnect between the calculation of earnings under the section 956 and section 245A rules.

Some advisers, using a sort of mathematic jiujitsu move, multiply the hypothetical distribution, which is $25, by a fraction of 100 percent, calculated based on the negative undistributed foreign earnings (-$25) ($50 of overall deficit plus $25 of current earnings) divided by the negative undistributed earnings (-$25) (calculated the same way). The 100 percent calculation is based on the offset of two negative numbers, which are identical absent one of the aforementioned section 245A exceptions applying.

There is substantial risk to this approach. It leans heavily into mathematical niceties, but it also arguably ignores the plain meaning of "undistributed earnings," which is determined by reference to the amount of the CFC's E&P. The E&P in the case of a CFC with an accumulated earnings deficit might be properly viewed as zero, rather than a negative number. That is, undistributed earnings are defined as E&P, and if the result is less than zero, there might be no E&P, or alternatively, a deficit, but not "negative earnings and profits." In that case, the aforementioned fraction would be zero over zero,

[42] Section 245A(c)(2).

which advisers have fervently asserted to be zero in other contexts in which it suits their interests.[43] Second, a House bill that was a predecessor to section 245A would have adopted an additional rule that explicitly provided for "the treatment of distributions of a specified 10-percent owned foreign corporations in excess of undistributed earnings."[44] The bill acknowledged the nimble dividend concept and then would have determined "the foreign-source portion of such a distribution . . . in a similar manner as for other types of dividends" (that is, section 316).[45] Unfortunately, the final version of section 245A did not follow the House bill in this respect, perhaps indicating an intent of Congress to leave nimble dividends by the wayside.

A response to all this might be that there is no reason why, as a policy matter, nimble dividends should be excluded, and Congress did not specifically indicate an intent to exclude them from section 245A. Still, repatriation by nimble dividend was problematic under the old "pooling" FTC rules pre-TCJA, and perhaps Congress intended to continue the same disfavored treatment of nimble dividends in the context of repatriation post-TCJA. It is unclear.

There is a better case for a 245A DRD for a nimble dividend when the current earnings exceed the accumulated deficit; for example, assume current earnings are $50 and the accumulated deficit is $25. In that case, the applicable earnings and tentative section 956 inclusion are $50, but the undistributed foreign earnings and undistributed earnings are each $25. And the ratio of undistributed foreign earnings to undistributed earnings is 100 percent, so the amount of the section 245A DRD is arguably $50, calculated as $50 multiplied by ($25/$25).

The nimble dividend problem would be more manageable if section 956 required only that the U.S. multinational make a single section 956 determination at the time it provides the section 956 CFC collateral to the lender. Unfortunately, determining whether a CFC might earn a nimble dividend amount requires a U.S. multinational to be exceptionally clairvoyant. Often, a U.S. multinational will acquire a CFC as part of a qualified stock purchase and will make a section 338(g) election for the CFC. That election will step up the basis of the CFC's assets, including goodwill, for federal income tax purposes, thereby creating significant amortization and depreciation deductions that can drive a CFC into a deficit position in the years immediately following the acquisition. Even if a CFC is not forecasting a deficit, business uncertainties could change that. Finally, if there is an initial accumulated deficit in a CFC, then when the CFC becomes profitable, there is likely to be a future section 956 inclusion that might not be offset by a section 245A DRD.

For example, assume a CFC has an initial deficit of $100 in its first tax year. If the CFC has current earnings in year 2 of an amount that is up to $100, there will be applicable earnings equal to those current earnings but an undistributed earnings deficit. Thus, U.S. multinationals that have one or more CFCs with an earnings deficit, or even one or more CFCs that might incur a deficit in a future tax year that might drive it into a net accumulated deficit position, will need to carefully scrutinize their first line of defense. If there is significant QBAI, the possibility of CFC tested losses, or other income that might not be tested income, the U.S, multinational might want to restrict the extent to which the CFC guarantees the borrowing and otherwise limit the pledge of the CFC's stock to less than 66.67 percent of the vote and value of that stock.

V. Check-the-Box Elections and Other Planning

Given the change in lenders' attitudes post-TCJA, a U.S. multinational that does not provide section 956 CFC collateral for a U.S. borrowing might receive significant pushback from the lender, including the threat of a higher interest rate on account of the deterioration of the collateral package. Thus, the U.S. multinational will need to consider taking whatever steps are possible to solve the issue so it can provide a full collateral package to the lender.

In some cases, advisers suggest providing full section 956 CFC collateral and then reducing it

[43] *See* Kevin M. Cunningham and Ian A. Simmons, "Saving Private Equity: Avoiding Phantom Inversions," *Tax Notes Federal*, Apr. 22, 2024, p. 613 (fraction of zero over zero determined to be zero for purposes of the inversion rules).

[44] H.R. Rep. No. 115-466, at 596 (2017).

[45] *Id.*

automatically under the terms of the legal documents to the extent a CFC incurs a nimble dividend amount. The problem, though, is that, while the determination of the CFC's earnings (or in in this case, a deficit) will likely be made after or toward the end of the tax year, section 956 amounts are determined based on a quarterly averaging throughout the tax year in question. Therefore, it is very likely that the section 956 CFC collateral will still have been in place on at least one, and possibly as many as four, of the relevant determination dates and the legal documents will therefore not be altered until after the CFC has incurred significant section 956 tax liability.[46] Thus, automatically altering the section 956 CFC collateral under the terms of the legal documents, in many ways, is like the fireman that arrives at the fire after the house has already burned down.

In the case of a CFC with an accumulated deficit that wholly owns a profitable CFC, the profitable CFC could make a distribution of a dividend that exceeds the accumulated deficit of the recipient CFC, driving the undistributed earnings into a positive number.

If the profitable CFC instead owns the CFC with the accumulated deficit, the deficit CFC, assuming it is otherwise an eligible entity, could file a check-the-box election to be treated as a disregarded entity for federal income tax purposes. The election would result in a deemed liquidation of the CFC, and the accumulated deficit would become a hovering deficit. If the recipient CFC has positive accumulated E&P, the hovering deficit will not merge with the positive E&P of the recipient CFC.

The hovering deficit rules are complicated and set forth in reg. section 1.381(c)(2)-1(a)(5):

> The total of any such deficits shall be used only to offset earnings and profits accumulated, or deemed to have been accumulated under subparagraph (6) of this paragraph, by the acquiring corporation after the date of distribution or transfer. In such instance, *the acquiring corporation will be considered as maintaining two separate earnings and profits accounts after the date of distribution or transfer*. The first such account shall contain the total of the accumulated earnings and profits as of the close of the date of distribution or transfer of each corporation which has accumulated earnings and profits as of such time, and the second such account shall contain the total of the deficits in accumulated earnings and profits of each corporation which has a deficit as of such time. *The total deficit in the second account may not be used to reduce the accumulated earnings and profits in the first account* (although such earnings and profits may be offset by deficits incurred, or deemed to have been incurred, after the date of distribution or transfer) but shall be used only to offset earnings and profits accumulated, or deemed to have been accumulated under subparagraph (6) of this paragraph, by the acquiring corporation after the date of distribution or transfer. [Emphasis added.]

For example, assume the liquidating CFC (CFC 2) has an accumulated deficit of $50 and the recipient CFC (CFC 1), which wholly owns CFC 2, has accumulated earnings of $25. After the liquidation, CFC 1 has two earnings pools, one positive $25 and one negative $50, which do not offset each other under the hovering deficit rules set forth above.

Although it is not entirely clear for the tax year that includes the distribution, CFC 1's applicable earnings are likely $25 plus whatever current earnings it derives in that year, based on what should be a reasonable conclusion that the deficits not taken into account for purposes of determining CFC 1's applicable earnings would also include hovering deficits as well.

The question is whether the check-the-box planning would permit CFC 1 to still derive a section 245A reduction on account of the hypothetical distribution, despite the hovering deficit account. Stated another way, would the check-the-box election align the calculation of E&P under section 956 with the calculation of E&P under section 245A? As discussed above, the hypothetical distribution is deemed to occur "on the last day during the taxable year in which the foreign corporation is a controlled foreign

[46] *See* section 956(a)(1)(A) (quarterly average of amount of U.S. property throughout the tax year).

corporation."[47] Because CFC 1's current earnings for that tax year will not have accumulated as of that time, the hovering deficit will not be available to offset the current earnings under the rules set forth above. Thus, CFC 1's hypothetical distribution should be equal to the $25 of accumulated earnings plus the current earnings (without reduction for the hovering deficit) — that is, the same amount as the applicable earnings of the CFC for purposes of section 956.

The final question is the ratio for purposes of section 245A. Because the instruction of reg. section 1.381(c)(2)-1 is that "the total deficit in the second account may not be used to reduce the accumulated earnings and profits in the first account," then undistributed earnings should presumably be calculated without regard to any deficit. In that case, undistributed earnings should be a positive number and, absent an applicable exception, the ratio should be 100 percent, which would permit a full section 245A offset for the section 956 inclusion. Thus, making a check-the-box election and converting an accumulated operating deficit into a hovering deficit could solve the section 245A problem and permit the U.S. multinational to provided section 956 CFC collateral for the CFC.

In summary, with all the possible defenses available to it, hopefully a U.S. multinational will be able to provide a lender with a full collateral package for its CFCs. However, until it is clear that a nimble dividend can fully qualify for section 245A, U.S. multinationals will have to be especially cautious and carefully evaluate their facts to determine whether section 956 CFC collateral will create the risk of a section 956 inclusion. If the U.S. multinational is unable to prove that it will not have a section 956 inclusion throughout the life of the entire borrowing, it might need to provide only the 66 percent stock pledge that borrowers provided under the old rules and run the risk of a higher interest rate as a result.[48] ■

[47] *See* reg. section 1.956-1(a)(2).

[48] The foregoing information is not intended to be "written advice concerning one or more Federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230. The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This report represents the views of the author(s) only and does not necessarily represent the views or professional advice of KPMG LLP.