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Effective Dividends to Receive a 100% Deduction under New Proposed Treasury Regulations

INTERNATIONAL, TAX, TAX REFORM
BY ANTOINETTE LUCHINI

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It should come as no surprise that taxpayers seek to minimize tax liability and maximize tax benefit. One way to achieve that result is for taxpayers to defer income recognition, and thus defer tax liability into the future. Prior to 1962, one popular mechanism of deferral employed by controlled foreign corporations ("CFC") was to invest earnings in U.S. property, such as corporate stock or real property, instead of distributing a dividend to its U.S. shareholders. This deferral mechanism was highly effective because earnings of CFCs are taxable when repatriated to the United States, which, until 1962, was only done through the distribution of a dividend. The overseas cash was brought back to the U.S. without a tax cost.

However, in 1962, with the purpose of eliminating the above deferral mechanism, Congress added § 956 to the Internal Revenue Code. Section 956 classifies the investment of CFC earnings in certain U.S. property as "substantially equivalent to a dividend." Congress determined that the investment in U.S. property, in substance, achieves the same result to the U.S. shareholder as a dividend distribution, and should have the same effect on deferral as a dividend distribution. Thus, effective dividend distribution treatment ended this deferral technique.

Fast-forward to the passage of the Tax Cut and Jobs Act ("TCJA") and the addition of the dividend received deduction for the foreign portion of an actual dividend received *(see previous article).* While the TCJA added a significant benefit to corporate shareholders receiving actual dividend distribution in § 245A, the Act did not add an equivalent deduction to the Code for the foreign source component of § 956 payments.

The failure to update § 956 created a new disparity, in direct opposition to the purpose of § 956, which was to create symmetry between the treatment of actual dividends and payments that are "essentially equivalent to a dividend." Due to this newly created imbalance, on October 31, 2018, the Internal Revenue Service issued a Treasury Regulation to restore symmetry in the treatment of actual and effective dividends received from CFCs.

The proposed regulation allows a U.S. corporate shareholder to take a deduction for the foreign source portion of the § 956 payment that would otherwise be treated as "essentially equivalent to a dividend." Which, to the satisfaction of the corporate shareholder-taxpayer, means essentially tax-free repatriation of earnings, regardless of which mechanism is used to repatriate those earnings! Additionally, as noted in my previous article, we may see similar guidance issued with regard to all or some categories of Subpart F soon.

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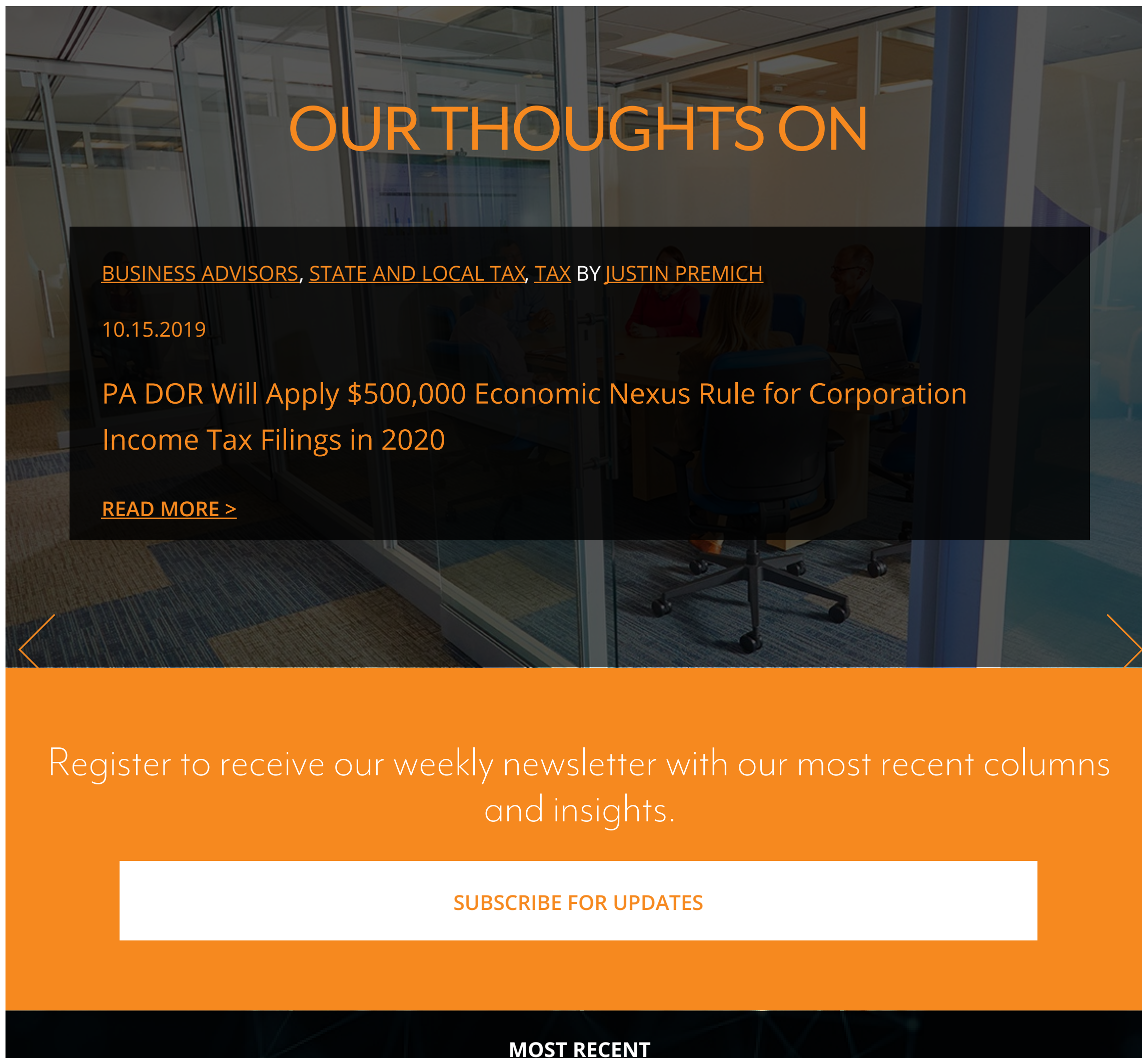

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