Section 956 and the Section 245 DRD: Avoiding Multiple Layers of Taxation

by Ken Brewer, Alon Kritzman, and Logan M. Kincheloe

Ken Brewer is a senior adviser and international tax practitioner with Alvarez & Marsal Taxand LLC in Miami, Alon Kritzman is a managing director in the firm's New York office, and Logan M. Kincheloe is a director in the firm's Boston office.

In this article, the authors urge Congress to make a commonsense change to the tax code, or for Treasury and the IRS to issue guidance, making it clear that a dividends received deduction under section 245 is available to reduce an inclusion under section 956.

"If it feels so right, so right,
How can it be wrong?"

The above quote comes from the lyrics of a song written by Ben Weisman and Fred Wise and originally recorded by Elvis Presley.[1] That language could also serve as the answer to the question of whether a dividends received deduction (DRD) under section 245 should be available for the U.S.-source portion of a section 956 inclusion.

I. Background

A. DRDs in General

Conducting activities (whether business operations or investment) in corporate form gives rise to the possibility of double (or more) taxation of the same earnings: once at the corporate level, and a second time at the shareholder level, when earnings are distributed, or deemed distributed, as a dividend. In recognition of that possibility, Congress has enacted several deductions that reduce or eliminate double taxation when corporate earnings are distributed as a dividend. Those deductions, typically referred to as "dividends received deductions," are found in section 243 (dividends received from domestic corporations), section 245 (U.S.-source dividends received from foreign corporations), and section 245A (foreign-source dividends received from foreign corporations).

B. Section 956 and DRDs

Back in 1962, Congress enacted section 956 as backstop to the antideferral provision of subpart F (of subchapter N of chapter 1) of the Internal Revenue Code. Under section 956, as a general rule, when a controlled foreign corporation invests an amount in U.S. property, its U.S. shareholders are required to include that amount in gross income, much like an actual dividend paid by the CFC (that is, the taxable inclusion is limited to the current and accumulated earnings and profits of the CFC).

Because a section 956 inclusion is not an actual dividend, there has been some uncertainty whether a U.S. shareholder of a CFC is entitled to a DRD for any portion of a section 956 inclusion from a CFC. As explained in more detail below, in the case of the foreign-source portion of section 956 inclusions, Treasury has recognized the propriety of a DRD and, to provide that effect, issued final regulations (T.D. 9859) in 2019 under its authority in section 956 that reduce section 956 inclusions by the amount for which the shareholder would qualify for a DRD under section 245A if the section 956 inclusion was a dividend.

[1] Presley, "It Feels So Right" on *Elvis Is Back* (RCA Victor 1960).

The purpose of this article is twofold. First, it makes the case for the allowance of a section 245 DRD against section 956 inclusions based on the relevant statutory text of section 245. There appears to be sufficient authority to interpret the statutory language in section 245, section 956, or both to grant that DRD benefit. The same argument applies to the section 245A DRD. But Treasury's action under section 956 rendered that argument redundant. The second purpose of this article is to suggest that, in the absence of legislative action, Treasury issue guidance to make clear that a DRD under section 245 is available to reduce an inclusion under section 956.

C. The Section 245 DRD

Foreign corporations, including CFCs, are subject to U.S. corporate income tax under section 882 on a net basis (that is, after the allowance of deductions), just like domestic corporations, on any taxable income (whether from U.S. or foreign sources) that is deemed to be effectively connected with the conduct of a trade or business in the United States. In light of that, Congress saw fit to allow a partial DRD under section 245 for what is described (somewhat misleadingly) as the U.S.-source portion of any dividends received from a "qualified 10 percent (or more) owned foreign corporation." The term "U.S.-source portion" is defined to include effectively connected income, regardless of its source, and dividends from domestic corporations that are at least 80 percent owned by the CFC.

By virtue of the section 245 DRD, double taxation is mitigated for dividends attributable to ECI and certain dividend income of 10 percent (or more) owned foreign corporations. However, that partial exemption from double taxation is not clearly mirrored under section 956 if a CFC lends those earnings to its U.S. shareholders or otherwise invests those earnings in U.S. property. The nonapplication of the section 245 DRD to section 956 inclusions attributable to ECI or dividends from an 80 percent or more owned domestic corporation would produce a result that is odd, in that it does not align with the purpose of section 956 — to treat effective repatriations from a CFC to its U.S. shareholders the same as actual repatriations from a CFC to its U.S. shareholders.

It is important to remember that a foreign corporation for which this question about the interaction of sections 245 and 956 is relevant is one that is already subject to U.S. corporate income tax and branch profits tax at the entity level on some or all of the earnings that are included in its actual or deemed dividends.

II. Interaction of Sections 245A and 956

Although the nonapplication of section 245 to section 956 inclusions has always (since 1962) presented an odd and often overlooked result, it is even more so now, after the enactment of the Tax Cuts and Jobs Act. The TCJA added section 245A to the code, and Treasury's response was to amend reg. section 1.956-1 to allow what is in effect a section 245A DRD for a section 956 inclusion. We have been unable to identify any discernable policy rationale for the disparate treatment of section 245 eligible earnings and section 245A eligible earnings, or for the interaction of those sections with section 956. In fact, in certain instances, it is punitive to *not* provide a reduction in the section 956 inclusion for amounts that would otherwise qualify for a section 245 DRD because otherwise, those earnings may be subject to tax not once, not twice, but three times.

Section 956 subjects a U.S. shareholder of a CFC to tax on that CFC's investment in U.S. property. A CFC's investment in U.S. property is generally the lesser of two amounts: the net increase of a CFC's investment in U.S. property year-over-year, or a subset of the CFC's current and accumulated earnings. At the risk of oversimplifying, a section 956 amount is taxed substantially the same as a subpart F inclusion.

The legislative history indicates that section 956 was enacted to create parity between actual dividends repatriated by a CFC to its U.S. shareholders and effective repatriations through investments in U.S. property (for example, a shareholder loan). That is to say, section 956 was intended to ensure that U.S. tax could not be circumvented merely by changing the form of the payment from the CFC to its U.S. shareholder. When initially enacted in 1962, this made sense because the United States employed a worldwide system of corporate income taxation. However, with the transformation of the U.S. system of corporate income taxation to a somewhat territorial system by way of the TCJA, the need to ensure that there will be a U.S. tax on the repatriation (actual or deemed) of foreign-source income of CFCs has become far less relevant.

In a post-TCJA world, nearly all of a CFC's foreign-source earnings are subject to current U.S. taxation (albeit at reduced rates), and those that are not may generally be distributed to certain U.S. shareholders free of U.S. tax by way of the section 245A DRD (if other requirements are satisfied).

The TCJA did not explicitly address the interaction of newly enacted section 245A and section 956, leaving Treasury and the IRS to fill the gap. By way of comparison, the computation of a U.S. shareholder's inclusion from a section 956 amount expressly permits a reduction for the U.S. shareholder's previously taxed E&P (PTEP). This is necessary to fulfill the purpose of section 956 — to tax actual repatriations and effective repatriations alike. That is, if a CFC can distribute PTEP free of tax in an actual dividend, it should be able to invest those same earnings in the United States free of tax.

Unlike the exclusion for PTEP, there is no clear statutory provision to prevent the foreign earnings of a CFC from inclusion under section 956, even though those earnings would be shielded from U.S. taxation under section 245A if included in an actual dividend. So, relying on its authority under section 956, Treasury wrote a rule to provide the same section 245A treatment for section 956 inclusions as applies to actual dividends.

Reg. section 1.956-1 provides that a U.S. shareholder's inclusion resulting from section 956 is reduced by the amount of the U.S. shareholder's pro rata share of section 245A eligible earnings. Reg. section 1.956-1 accomplishes this result by requiring a hypothetical distribution before computing a U.S. shareholder's section 956 inclusion. Simply, just as PTEP reduces a section 956 inclusion, so does any amount that would be eligible for a section 245A DRD had it been distributed. The result: Actual dividends and effective repatriations under section 956 are treated the same, so long as the earnings are from foreign sources.

III. A Section 245 DRD for Section 956 Inclusions

A. The Policy Argument

Nothing in the section 956 regulations provides for a similar reduction to a section 956 inclusion for amounts that would qualify for a DRD under section 245. However, the following excerpts from the preamble to the 2018 proposed section 956 regulations (REG-114540-18) — which originally proposed the reduction for amounts that would qualify for a section 245A deduction — strongly support the position that, at least for some purposes, section 956 inclusions should be treated as "substantially the equivalent to a dividend":

> Congress determined that certain investments by a CFC of its earnings in United States property are "substantially the equivalent of a dividend" and enacted section 956 to provide similar treatment for dividends and certain investments in United States property constituting effective repatriations. S. Rep. No. 1881 at 88.
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> As noted, the purpose of section 956 is generally to create symmetry between the taxation of actual repatriations and the taxation of effective repatriations, by subjecting effective repatriations to tax in the same manner as actual repatriations.

To justify providing a section 245A benefit for section 956 inclusions, the preamble went on to say:

> The application of section 956 after the Act to corporate U.S. shareholders of CFCs that would qualify for section 245A deductions would result in disparate treatment of actual dividends and amounts "substantially the equivalent of a dividend" — a result directly at odds with the manifest purpose of section 956.

That argument might also support the position that the term "dividends received," as used in section 245 (as well as section 245A), should be interpreted to include section 956 inclusions. That Treasury and the IRS recognized the need to carve out an exclusion under section 956 for amounts that would have qualified for a section 245A deduction does not preclude a taxpayer from interpreting section 245 or section 956 in a way that achieves the same purpose (as the carveout for section 245A in the section 956 regs) by either:

- interpreting section 245 to treat section 956 inclusions as "substantially the equivalent to a dividend"; or
- interpreting section 956 to exclude an amount equivalent to a section 245 DRD (that is, earnings that were already subjected to an entity-level U.S. corporate income tax).

B. The Constructive Dividend Argument

Importantly, aside from section 956, there are other aspects of U.S. tax law that confer dividend treatment on transactions that do not take the legal form of dividends. This includes judicial doctrines (for example, the substance-over-form doctrine) that treat a corporate payment that does not take the legal form of a dividend as a constructive dividend. It also includes an "adjustment to conform accounts," resulting in dividend treatment under reg. section 1.482-1(g)(3) when a transaction between a corporation and a shareholder is priced in a way that warrants a primary adjustment under section 482 because it confers a non-arm's-length benefit on the shareholder. In either case, the payment in question is not actually a dividend but is treated as a constructive dividend.

There appears to be no question that those other types of constructive dividends, which are not actually dividends, are properly treated as dividends by taxpayers and the IRS for purposes of section 245 (as well as section 245A). Similarly, if it is correct to say that a section 956 inclusion is substantially equivalent to a dividend, a section 956 inclusion should arguably receive the same treatment under section 245 (as well as section 245A) as any other type of constructive dividend (that is, it should be treated the same as an actual dividend).

C. The Constitutional/Statutory Construction Argument

In further support of interpreting section 956 to exclude an amount equivalent to a section 245 DRD, or interpreting section 245 to apply to section 956 inclusions, is the canon of statutory construction that says statutory provisions should be interpreted, if possible, to produce results that do not conflict with the Constitution. While there may not be anything in the Constitution that prevents Congress from intentionally subjecting income to double taxation, some of the analysis by the majority in the Supreme Court's recent *Moore*[2] decision supports the position that an interpretation of sections 245 and 956 that would deny the benefit of a section 245 deduction for effectively connected E&P is not constitutionally permissible. That interpretation would cause section 956 to violate the Constitution by imputing income to the shareholder of a CFC that was already taxed at the entity level (by virtue of the denial of a DRD under section 245).

The majority opinion in *Moore* described the limit of its holding as follows:

> That said, we emphasize that our holding today is narrow. It is limited to: (i) taxation of the shareholders of an entity, (ii) on the undistributed income realized by the entity, (iii) which has been attributed to the shareholders, *(iv) when the entity itself has not been taxed on that income. In other words, our holding applies when Congress treats the entity as a pass-through*. [Emphasis added.]
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> To be clear, as we indicated earlier, the Due Process Clause proscribes arbitrary attribution. . . . And nothing in this opinion should be read to authorize any hypothetical congressional effort to tax both an entity and its shareholders or partners on the same undistributed income realized by the entity. In such a scenario, the entity would not simply be a traditional passthrough. [Citations omitted.]

That analysis (in particular the inclusion of condition (iv) in the limit on the majority's holding) would suggest that the majority in *Moore* would find a deemed dividend under section 956 to violate the due process clause in any situation in which the CFC itself was also subjected to tax on the same earnings required to be included by the shareholder under section 956.

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[2] *Moore v. United States*, 602 U.S. 572 (2024).

The majority's analogy to passthrough treatment envisions a passthrough regime (for example, partnership or S corporation passthrough treatment) that taxes the income of the entity only at the level of the owner and not at the entity level. Denying a section 245 DRD benefit for the U.S.-source portion of a section 956 inclusion would result in an entirely different form of passthrough treatment than envisioned by the majority in *Moore* — both the entity and its owner would be taxed on the same underlying income of the entity. That type of passthrough regime would not seem to satisfy the due process requirements envisioned by the majority in *Moore*.

Note that the denial of a section 245 DRD benefit for the U.S.-source portion of a section 956 inclusion may result not just in double taxation; it may result in triple U.S. taxation of the same earnings: once under the regular U.S. corporate income tax; a second time under the BPT of section 884; and a third time under section 956. It seems fairly clear that the majority in *Moore* would not find that interpretation of sections 956 and 245 constitutionally permissible.

In its purest form, the constitutional argument would seem to favor interpreting section 956 to exclude an amount equivalent to a section 245 DRD, rather than interpreting section 245 to apply to section 956 inclusions. The former interpretation eliminates the constitutional infirmity (that is, it eliminates the attribution to the shareholder of any income that has already been taxed at the corporate level). The latter interpretation only mitigates the problem, by way of a 50 percent or 65 percent DRD at the shareholder level.

IV. Treasury's Action Does Not Preclude Alternative Interpretation

Under the canon of statutory construction *expressio unius est exclusio alterius* ("the express mention of one thing excludes all others"), one could argue that because Treasury and the IRS provided the benefit of a section 245A DRD for section 956 inclusions, they intentionally did not provide the benefit of a section 245 DRD for section 956 inclusions. However, canons of statutory construction do not constitute absolute rules. Rather, they require presumptions that apply in appropriate circumstances.

That it is quite common for CFCs to have foreign-source income and much rarer for them to have ECI should explain why Treasury and the IRS recognized the need for a section 245A DRD benefit for section 956 inclusions and may have overlooked the far less pressing need for a section 245 DRD benefit for section 956 inclusions.

As explained above, the theoretical basis for both types of DRDs for section 956 inclusions can be derived from an (admittedly strained) interpretation of the statutory language in sections 245 and 245A. That Treasury and the IRS decided to explicitly provide for the section 245A benefit by way of regulations under section 956 does not preclude the application of a section 245 benefit by virtue of a logical interpretation by the taxpayer of the statutory language in section 245 or section 956 (rather than a similar amendment by the IRS to the section 956 regulations).

V. Proposal for Legislative or Administrative Fix

Rather than leaving taxpayers in the somewhat risky position of taking a novel and uncertain tax position (however well-reasoned), this concern could be conclusively resolved (perhaps even retroactively) by either Congress or Treasury and the IRS. In either case, the most theoretically sound approach, at least from a constitutional point of view, would be to revise section 956 or its regulations to exclude effectively connected E&P, in the same manner that Treasury and the IRS revised the section 956 regulations to deal with earnings qualifying for the section 245A DRD. The second choice would be to amend section 245 and its regulations to explicitly treat section 956 inclusions as dividends for purposes of section 245.

VI. Conclusion

We understand that the allowance of a section 245 DRD benefit for a section 956 inclusion under current law requires an admittedly strained interpretation of either section 956 or section 245. Nonetheless, we believe that interpretation is warranted and supportable in light of the treatment of other types of constructive dividends, the rules of statutory construction, and the U.S. policy of encouraging repatriation of earnings and investment in the United States.

Given the novelty and uncertainty involved, taxpayers (and tax return preparers) wishing to take this position would be well advised to include adequate disclosure in their tax return filings to avoid penalties if the IRS sustains the contrary position.

But in light of the uncertainty under current law, we propose that either Treasury and the IRS or Congress conclusively resolve the matter in line with the principles discussed above. ■