Client Alert: New IRS Proposed Regulations Under Section 956 Substantially Reduce 'Deemed Dividend' Concerns With Respect To The Use Of Foreign Credit Support For US Corporate Financings

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On October 31, 2018, the Internal Revenue Service and the Department of the Treasury released proposed regulations under Section[1] 956 of the Internal Revenue Code (the Proposed Regulations) that, for certain U.S. corporate shareholders, generally undo the "deemed dividend" rules that have applied to foreign corporate subsidiaries for decades. As a result of the proposed regulations, collateral packages in financing transactions involving a U.S. corporate borrower with foreign corporate subsidiaries potentially can be expanded because, in many circumstances, the "deemed dividend" resulting from foreign subsidiary guarantees and other collateral support for borrowings by the U.S. corporate parent would be eliminated.

Background

Prior to the Tax Cuts and Jobs Act of 2017 (the TCJA), a U.S. corporation that owned at least a 10% interest in a controlled foreign corporation (a CFC)[2] was (with certain exceptions) not taxed on the earnings of the CFC until those earnings were distributed to the U.S. corporate shareholder as actual dividends. Under Section 956, however, undistributed earnings of a CFC generally were *deemed* to be distributed to such a U.S. corporate shareholder and taxed as dividends (generally referred to as deemed dividends) when the CFC provided a pledge or guarantee, or when at least 66 2/3% of the voting stock of the CFC was pledged, in each case in support of debt of a U.S. person. Thus, to avoid deemed dividends under Section 956, credit support obtained by a U.S. borrower from a CFC is typically limited to a pledge of no more than 65% of the voting stock of a first-tier CFC (and no pledge of lower-tier CFC stock). Most existing financing documents contain restrictions on CFC stock and asset collateral to allow U.S. borrowers to avoid the deemed dividend issue.

Tax Reform

The TCJA altered the federal taxation of dividends from foreign corporations to U.S. corporate shareholders owning at least a 10% interest in the foreign corporation (applying attribution rules) and meeting certain holding period requirements (a 10% U.S. Corporate Shareholder). Under the TCJA, the portion of such a dividend generated from foreign sources that is actually received by a 10% U.S. Corporate Shareholder is generally exempt from U.S. tax because the 10% U.S. Corporate Shareholder is entitled to an offsetting dividends received deduction equal to 100% of the foreign-source portion of the dividend. However, the TCJA failed to extend this deduction to deemed dividends under Section 956.[3] This has created an odd result where actual dividends received by a 10% U.S. Corporate Shareholder from a CFC generally have become exempt from U.S. tax, while Section 956 deemed dividends have remained subject to tax. As such, post-TCJA market practice with respect to collateral packages from CFCs has remained the same, with credit support generally limited to a 65% pledge of the stock of first-tier CFCs and with financing documentation containing restrictions on CFC credit support.

The Proposed Regulations

The Proposed Regulations address the inconsistency in the Internal Revenue Code between “actual” dividends and “deemed” dividends that are paid to 10% U.S. Corporate Shareholders satisfying a one-year holding period requirement for the CFC stock. For such 10% U.S. Corporate Shareholders, the Proposed Regulations provide that the Section 956 deemed dividend amount is reduced by the amount of the dividends received deduction the 10% U.S. Corporate Shareholder would have been allowed had it received an actual dividend from the CFC in the amount of the Section 956 deemed dividend. In other words, actual dividends and deemed dividends will be taxed the same way and generally excluded from income by a 10% U.S. Corporate Shareholder of a CFC.

Takeaways and Limitations

The biggest takeaway is that the Proposed Regulations effectively eliminate adverse U.S. tax consequences for many U.S. corporate shareholders of CFCs, arising from the taking of guarantees and other credit support from CFCs in connection with U.S. corporate financings. In deciding whether or not to now include credit support from CFCs in existing and future U.S. credit facilities, the following should be considered:

- ***Only Applicable to U.S. Corporations.*** The Proposed Regulations are only applicable to U.S. corporations. Section 956 continues to apply to individuals, partnerships (including limited liability companies taxed as partnerships), real estate investment trusts, regulated investment companies and corporations that do not satisfy the applicable ownership or holding period requirements.

- ***Holding Period.*** The Proposed Regulations apply only where a one-year holding period requirement on the CFC stock is satisfied.

- ***Effective Date.*** Although the Proposed Regulations are not yet final, pending the issuance of final regulations, they generally may be relied upon for taxable years of a CFC beginning after December 31, 2017, provided that the Proposed Regulations are consistently applied to all CFCs held by the taxpayer and certain affiliates of the taxpayer. Taxpayers entering into credit facilities based upon the Proposed

Regulations should consider including "change-in-law" provisions allowing for adjustments to CFC credit support in the event that the rules change under final regulations.

- ***Existing Credit Facilities.*** Parties to existing U.S. corporate credit facilities should examine their "further assurances," "excluded property," "additional collateral/guarantees," and the other credit support provisions (and the definitions related thereto) in their existing financing documentation. These provisions may permit a secured party to require (or may automatically require) a borrower to provide additional credit support if doing so would not result in adverse tax consequences.
- ***Non-Tax Considerations.*** Although the Proposed Regulations remove many of the tax impediments to CFCs providing credit support to U.S. corporate borrowers, there are many non-tax reasons for why a U.S. corporate shareholder of a CFC may prefer not have the CFC provide a guaranty and/or additional credit support. For example, there may be foreign tax, legal, regulatory, capital maintenance and other similar foreign legal requirements that may make the giving of the additional credit support difficult, as well as practical considerations such as higher transactional costs. Lenders may also have threshold regulatory and tax considerations with accepting certain foreign guaranties and collateral.

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[1] All references to "Section" are references to sections of the Internal Revenue Code of 1986, as amended.

[2] Generally defined as foreign corporations more than 50% owned (by vote or value) by one or more U.S. persons, each of which owns at least a 10% interest in the foreign corporation.

[3] Special rules apply if the CFC (or any subsidiary CFC) has already received a U.S. tax benefit with respect to the foreign earnings.