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New Proposed Rules Limit the Negative Tax Consequences of Section 956 "Deemed Dividends"

Certain Foreign Guarantees and Stock Pledges May Be Expanded to Support US Loans

On October 31, the Internal Revenue Service (**IRS**) released proposed regulations (the "**Proposed Regulations**") under Section 956[1] that could substantially increase the collateral packages made available by US corporate borrowers with foreign corporate subsidiaries. In most cases, under the Proposed Regulations, foreign corporate subsidiaries may guarantee the obligations of their US corporate parents and will permit the US corporate borrowers to pledge all of the voting and non-voting stock of their foreign corporate subsidiaries without the historical concerns of adverse US federal income tax consequences. For most US corporations, the Proposed Regulations effectively would reduce extensively the applicability of the Section 956 deemed dividend rules that have applied to them and their foreign corporate subsidiaries for more than 50 years.

At this point, it remains unclear whether the Proposed Regulations will have a large, practical effect on market practice with respect to foreign collateral in the short-term, although there may be substantial changes to market practice over time. Initially, borrowers and lenders may be hesitant to forgo traditional Section 956 protections in credit and loan agreements because other considerations with respect to foreign collateral, including foreign laws, corporate benefit and capital maintenance requirements, together with other legal, tax and accounting limitations, may continue to limit the extent to which foreign corporations may support the obligations of their US corporate parents. In addition, the Proposed Regulations apply only to US corporations, and do not affect the manner in which Section 956 applies to individuals, partnerships, other entities treated as partnerships for tax purposes, or entities disregarded as separate from any such individuals or partnerships.

Section 956's Historical Impact on Finance Transactions. To avoid causing a deemed dividend under Section 956 and the resulting tax consequences of that deemed dividend, typically a US borrower limits its foreign collateral to a pledge of 65 percent of the voting (and 100 percent of the non-voting) stock of its first-tier foreign corporate subsidiaries. Foreign corporate subsidiaries that are directly or indirectly wholly-owned by US persons are referred to as "**controlled foreign corporations**," or "**CFCs**," for

[1] Unless otherwise specified, all section references in this summary are to the US Internal Revenue Code of 1986, as amended.

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US federal income tax purposes.[2] Those first-tier CFCs typically will not guarantee or pledge their assets to support the US borrower's debt, neither will any subsidiaries (whether foreign or domestic) of those first-tier CFCs. These foreign collateral limitations often are described in detail in the credit and security agreements for US borrowers.

CFC Dividends After Tax Reform. The 2017 Tax Cuts and Jobs Act created a "**participation exemption**" under Section 245A, which provides that actual dividends that a US corporation receives from its CFC generally are not subject to US federal income tax because the US corporation is entitled to a "dividends received" deduction equal to the amount of the dividend. The participation exemption under Section 245A does not apply to the deemed dividend that could arise under Section 956 because the deemed dividend is not an actual dividend. This creates an awkward and confusing situation whereby a CFC could make an actual dividend to its US parent without US tax consequences, but a deemed dividend under Section 956 would be subject to tax.

The Proposed Regulations Address This Conflicting Result Between an Actual Dividend and a Deemed Dividend. In the Proposed Regulations, the IRS notes there is an inconsistency between the participation exemption under Section 245A, which effectively permits tax-exempt foreign dividends to a corporate US shareholder, and the Section 956 deemed dividends, which do not enjoy the tax exemption available to actual dividends. The IRS states that "as a result of the enactment of the participation exemption system, the current broad application of section 956 to corporate US shareholders would be inconsistent with the purposes of section 956 and the scope of transactions it is intended to address." As a result, the Proposed Regulations reduce deemed dividends under Section 956 to the extent that a corporate shareholder of a CFC would have been allowed the "dividends received" deduction under the participation exemption of Section 245A, if that shareholder had received an actual dividend from the CFC in an amount equal to the deemed dividend under Section 956 (determined without regard to such reduction).

The Proposed Regulations Only Apply to US Corporations. The Proposed Regulations only apply to US corporations and not US partnerships (including limited liability companies treated as partnerships for tax purposes), individuals, or other entities disregarded as separate from partnerships or individuals. The Proposed Regulations address an inconsistency in tax treatment between actual dividends by a foreign subsidiary to its US corporate parent and deemed dividends from that same foreign subsidiary to its US corporate parent. As a result, the Proposed Regulations only apply to corporate US shareholders, and Section 956 continues to apply (as it did prior to tax reform) with respect to such other entity types and individuals.

In addition, the relief provided by the Proposed Regulations applies only to the extent that the participation exemption under Section 245A would have applied if the deemed dividend were an actual dividend. As a result, there is a CFC stock holding period requirement that permits the Proposed Regulations to apply only if a US corporation owns a CFC for more than one year during the 731-day period that straddles the last day during the taxable year on which the foreign corporation is a CFC.

What Do the Proposed Regulations Mean for Finance Transactions Going Forward?

- Lenders potentially could require US corporate borrowers to pledge all of the voting and non-voting stock of their first-tier CFCs (and the subsidiaries of those CFCs) and to have those CFCs (and their subsidiaries) guarantee the debt obligations of the US corporate borrowers because the negative US federal income tax consequences of doing so typically may not apply.
- US corporate borrowers may seek to provide credit support from their CFCs (and their subsidiaries) to improve the terms of the US credit facility or loan, or to increase the amount those borrowers may borrow.
- Credit and loan agreements that exist in the market today may be affected by the Proposed Regulations to the extent that the foreign collateral requirements (usually found in the "further assurances" or "excluded assets" provision) provide that foreign stock pledges and foreign subsidiary guarantees will be limited only to the extent such pledges or guarantees would cause a material adverse tax consequence. To the extent Section 956 no longer imposes a material adverse tax consequence, the terms of those agreements may now provide that the US borrowers and their foreign subsidiaries should provide additional pledges or guarantees.

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2 For ease of discussion, this memorandum discusses only wholly owned subsidiaries, and does not discuss partially owned subsidiaries.

- In addition, many credit and loan agreements specifically exclude foreign collateral from their collateral packages to the extent foreign subsidiaries are not credit parties and may limit foreign collateral to a pledge of 65 percent of the voting equity of first-tier foreign subsidiaries (regardless of whether such subsidiaries are CFCs). Such agreements may provide for these restrictions due to non-tax concerns and in such cases the Proposed Regulations would not provide comfort to expand the foreign collateral packages.
- Other considerations may continue either to limit or prohibit these pledges and guarantees, or to encourage borrowing directly by CFCs. These include Section 163(j) limitations on the deductibility of interest, non-US legal and tax limitations, corporate benefit and capital maintenance requirements, transaction structures that do not involve US corporate borrowers, and US borrowers and their CFCs that do not satisfy the CFC stock holding period requirements.

Effective Date of the Proposed Regulations. The Proposed Regulations generally will be applicable to taxable years of a CFC beginning on or after the date of the publication of the regulations in final form; however, a taxpayer can rely on the Proposed Regulations for taxable years of a CFC beginning after 2017. As a result, this effectively means that the Proposed Regulations may be applied now by US corporate borrowers and their lenders if they like, so long as the US corporate borrowers consistently apply the Proposed Regulations to all of their CFCs.