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Impact of Proposed Regulations Under Section 956 on Lending Arrangements Involving U.S. Corporate Borrowers

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Introduction

On October 31, 2018, the U.S. Treasury Department ("Treasury") and the Internal Revenue Service (the "IRS") proposed new regulations (the "Proposed Regulations")[1] that are likely to allow many controlled foreign corporations ("CFCs")[2] of U.S. multi-national borrowers to guarantee the debt of their parents and to allow the U.S. parent to pledge more than 66 2/3% of the voting stock of the CFC (and to have the CFC provide negative covenants), all without causing the U.S parent to recognize deemed dividend income under Section 956 of the Code.[3] Specifically, the Proposed Regulations will exempt a corporate "United States shareholder"[4] of a CFC from including its pro rata share of a CFC's earnings attributable to an "investment in United States property" (a "Section 956 deemed dividend") as income to the extent that such deemed dividend would be excluded from income if it was paid as an actual dividend under Section 245A. However, there will remain certain situations where Section 956 will still trigger deemed dividends.[5] Although the Proposed Regulations are proposed only (and may be amended before being finalized), corporate U.S. borrowers may rely on them so long as the borrower and all parties related to the borrower apply them consistently with respect to all CFCs of which they are United States shareholders.[6]

The Preamble to the Proposed Regulations states that the core intention of the Proposed Regulations is to align treatment of Section 956 deemed dividends with that of actual dividends paid by a CFC to a United States shareholder that is a U.S. corporation (a "corporate U.S. shareholder"). Prior to the Proposed Regulations, a United States shareholder of a CFC generally was required to include in current income, and be subject to tax on, its Section 956 deemed dividend amounts, including as a result of guarantees by its CFCs and pledges of more than 2/3 of any CFC's voting stock (where the CFC has provided negative covenants) to secure the shareholder's debt. This rule assured that both actual dividends from a CFC and investments in United States property that were "substantially the equivalent of a dividend" were subject to current U.S. income tax. However, under Section 245A(a), added to the Code in December of 2017, an actual distribution of foreign-source earnings by a CFC to a corporate U.S. shareholder is generally exempt from tax. This created a mismatch for corporate U.S. shareholders whereby a Section 956 deemed dividend of a corporate U.S. borrower would be subject to U.S. corporate income tax, but an *actual* dividend from a CFC to such borrower generally would not be—an asymmetry that runs counter to the purpose of Section 956.

The Proposed Regulations address this mismatch by generally allowing a corporate U.S. shareholder of a CFC to exclude the portion of a Section 956 deemed dividend that would not be taxable if actually paid as a distribution. The Proposed Regulations apply to Section 956 deemed dividends attributable both to directly- and to indirectly-held CFCs.

The Proposed Regulations, if finalized in their current form, should enable the CFC subsidiaries of corporate U.S. borrowers to provide full credit support for a U.S. parent's borrowing without suffering adverse tax consequences. Specifically, corporate U.S. borrowers should be able to pledge 100% of their stock in CFCs (whether voting or non-voting) and subsidiaries that are CFCs should be able to both act as guarantors and pledge their assets (including lower-tier CFC stock) in support of a corporate U.S. borrower's debt. Notably, the Proposed Regulations generally only help *corporate* U.S. borrowers (although guidance applying the Proposed Regulations to U.S. partnership borrowers that have corporate U.S. partners may be forthcoming).

As a result of the Proposed Regulations, the impact of potentially expanded foreign credit support should be expected to be reflected in the modeling for both the borrowers' and the lenders' analyses. Lenders and borrowers may also wish to review existing agreements as to the impact of the Proposed Regulations on the scope of foreign collateral. However, because the Proposed Regulations apply only to U.S. corporations, U.S. borrowers operating in non-corporate form can be expected to resist changes to prior market practice in future agreements. Also, if a CFC is not wholly owned, parties may be mindful of the impact of enhanced credit support on other United States shareholders of that CFC that are not loan parties and may not be operating in corporate form.

Technical Discussion

The income exclusion provided under the Proposed Regulations operates by reducing the amount includible in income by a corporate U.S. shareholder of a CFC under Section 956 (the "tentative Section 956 amount") to the extent that such amount would be allowed as a deduction from that shareholder's income under Section 245A(a) had the shareholder received an actual distribution from the CFC equal to the tentative Section 956 amount on the last day of the tax year on which such corporation was a CFC (a "hypothetical distribution"). Accordingly, all of the other requirements for a shareholder to qualify for the deduction under Section 245A must be satisfied for the shareholder to qualify for the reduction of its Section 956 inclusion amount under the Proposed Regulations. In addition, if a United States shareholder owns CFC stock indirectly, Section 245A(a) is applied to a hypothetical distribution as if the United States shareholder were a direct owner of such stock.[7]

Holding period requirement

To qualify for the deduction under Section 245A(a), a corporate U.S. shareholder must hold stock of the foreign corporation with respect to which the dividend is paid for more than 365 days during the 731-day period beginning on the date which is 365 days before the date on which such share becomes ex-dividend with respect to such dividend. For purposes of the Proposed Regulations, the holding period requirement is satisfied by a corporate U.S. shareholder that owns stock of a foreign corporation for more than 365 days during the 731-day period beginning 365 days before the last day during the applicable tax year in which the foreign corporation is a CFC.[8] The CFC must remain a CFC, and the corporate U.S. shareholder must remain a U.S. shareholder of that CFC, at all times during the 365-day holding period.

The holding period requirement generally should not be problematic in the acquisition-financing context, provided the corporate U.S. shareholder retains ownership for the 365-day period following the acquisition. The 731-day period would start 365 days before the last day of the CFC's tax year in which the CFC joins the credit agreement as a guarantor or the pledge of CFC stock is made.

Hybrid debt arrangements

Section 245A(a) does not apply to a "hybrid dividend," generally defined as a payment from a foreign corporation that is treated as dividends for U.S. federal income tax purposes but for which the foreign corporation received a tax deduction or other tax benefit from a foreign jurisdiction.[9] Therefore, a corporate U.S. borrower will still be restricted in its ability to provide credit support from a CFC that has issued hybrid debt instruments—for example, convertible preferred equity certificates or profit participating notes common in Irish Section 110 and Luxembourg Sàrl structures.

U.S. source earnings

The deduction under Section 245A applies only to the foreign-source portion of a dividend received from a foreign corporation by its corporate U.S. shareholder. If a CFC has U.S.-source earnings—including earnings attributable to U.S.-source dividends or U.S. effectively connected income—a portion of its Section 956 inclusion may still be subject to U.S. federal income tax under the Proposed Regulations. (Example 1 of Prop. Reg. 1.956-1(a)(3) provides an illustration of this rule.)

Structures involving U.S. partnerships

Corporate U.S. borrowers may own interests in non-wholly owned CFCs through subsidiaries that are treated as partnerships for federal income tax purposes. It is generally expected that a U.S. corporation that would otherwise meet the definition of a "United States shareholder" with respect to a foreign corporation if it were directly held will be eligible for the Section 245A(a) deduction on dividends from that foreign corporation, notwithstanding that it is held through a partnership.[10] As discussed above, the stated purpose of the Proposed Regulations is to align the treatment of a Section 956 deemed dividend of a corporate U.S. shareholder with that of an actual dividend received from a CFC under Section 245A. There are no obvious reasons why, given this stated policy principle, an ultimate corporate shareholder that holds its CFC interests through a U.S. partnership should not benefit from the Proposed Regulations. However, since Section 245A(a) does not apply to non-corporate United States shareholders, non-corporate partners of a partnership that is a United States shareholder of a CFC should not expect to reduce the amount of their Section 956 deemed dividends under the Proposed Regulations.

Clear policy mandate notwithstanding, the mechanics for applying this principle in the case of a corporate U.S. shareholder that is an indirect owner of a CFC remain unclear. Treasury and the IRS have solicited public comments regarding the application of the Proposed Regulations to U.S. partnerships that may have both corporate and non-corporate U.S. partners. Possible approaches discussed in the Preamble include reducing the Section 956 inclusion of a U.S. partnership by the amount of the deduction for which its U.S. corporate partners would be eligible on a hypothetical distribution under Section 245A(a). Alternatively, the amount of Section 956 inclusion could be determined at U.S. partnership level without regard to the status of its partners, but the distributive share of the Section 956 inclusion to a partner that is a corporate U.S. shareholder would not be taxable.

While further guidance is needed to clarify the IRS's position, parties may in the interim seek to include language in credit agreements with U.S. partnership borrowers allowing for increased foreign credit support should a future change in law (including proposed regulations or other IRS guidance on which taxpayers may rely) reduce or eliminate the adverse tax consequences to the borrower.

For further information about the impact of the Proposed Regulations on your particular interests, please contact your regular Proskauer contact or a member of the Proskauer tax department.

[1] REG-114540-18 (Oct. 31, 2018).

[2] A "controlled foreign corporation" is a non-U.S. corporation more than 50% of the total combined voting power or the total value of the stock of which is owned by one or more United States shareholders. Section 957(a).

[3] All references to section numbers are references to sections of the Internal Revenue Code of 1986, as amended (the "Code"), or to the Proposed Regulations, as applicable.

[4] A United States shareholder of a CFC generally means any U.S. person that is a 10% or more owner of the voting power or value of the CFC.

[5] As discussed below, U.S. individuals remain subject to Section 956. Also, Section 956 will continue to apply to certain "hybrid dividends," if the holding period requirement under Section 246(c) is not satisfied, to the extent a CFC has U.S. source earnings, and in certain structures involving entities that are treated as partnerships.

[6] More specifically, corporate U.S. borrowers may rely on them for tax years of CFCs beginning after December 31, 2017, and for tax years of United States shareholders (defined below) with or within which the tax years of such CFCs end, provided the borrower and any parties related to the borrower apply the Proposed Regulations consistently with respect to all CFCs in which they are United States shareholders. The term United States shareholder is described below.

[7] Prop. Reg. Section 1.956-1(a)(2)(ii)(A)(1).

[8] Section 246(c)(1), as modified by Section 246(c)(5) and Prop. Reg. Section 1.956-1(a)(2)(ii)(B).

[9] Section 245A(e); *see also* Prop. Reg. Section 1.956-1(a)(2)(ii)(A)(2), (3).

[10] *See* Conference Committee Report, Pub. L. 115-97 ("[I]f a domestic corporation indirectly owns stock of a foreign corporation through a partnership and the domestic corporation would qualify for the participation DRD with respect to dividends from the foreign corporation if the domestic corporation owned such stock directly, the domestic corporation would be allowed a participation DRD with respect to its distributive share of the partnership's dividend from the foreign corporation."); *see also* Section 245A(g) (instructing Treasury to prescribe regulations or other guidance governing the treatment of a United States shareholder owning stock of foreign corporations through a partnership).

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