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Newly Proposed US Tax Regulations Open Possibility of Full Credit Support from Foreign Subsidiaries

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On October 31, 2018, the U.S. Treasury Department and the Internal Revenue Service (the "IRS") proposed new regulations under Section 956 of the Code[1] (the "Proposed Regulations") that are likely to enhance the availability of foreign subsidiary credit support for many U.S. borrowers.

The Proposed Regulations generally exempt a corporate U.S. borrower from recognizing income inclusions as a result of receiving credit support from foreign corporate subsidiaries. Prior to the Proposed Regulations, a corporate U.S. borrower would have been subject to potentially substantial U.S. income tax if its foreign subsidiaries that are "controlled foreign corporations," or "CFCs,"[2] provided credit support in the form of direct guarantees by the CFCs or pledges of exceeding 2/3 of the voting stock of the CFCs. The Proposed Regulations should enable corporate U.S. borrowers to provide full credit support from its CFCs without suffering adverse tax consequences, but would 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 changes under the Proposed Regulations, corporate U.S. borrowers may now seek to obtain more favorable lending terms in exchange for enhanced credit support and increased liquidity available to service their borrowing (subject to non-U.S. withholding and foreign currency exchange considerations). Lenders may also wish to review existing credit agreements to confirm whether the borrower is required to provide additional foreign credit support to the extent a change of law (such as the Proposed Regulations) eliminates the adverse tax consequences to the borrower of doing so. Because the Proposed Regulations apply only to U.S. corporations, U.S. borrowers operating in non-corporate form will generally resist changes to prior market practice in future agreements.

There may be non-tax considerations for the parties in determining how to structure foreign credit support, particularly with respect to foreign guarantees and pledges of assets of foreign subsidiaries in jurisdictions where there may be heightened challenges and costs to enforcing foreign guarantees and perfecting security arrangements. However, even under these constraints, a corporate U.S. borrower should in most cases be able to pledge 100% of its directly held assets — including up to 100% of the voting and non-voting stock of directly held CFCs.

Although the Proposed Regulations are not yet final, U.S corporate borrowers may rely on them for tax years of CFCs beginning after December 31, 2017, provided the borrower and any parties related to the borrower apply the Proposed Regulations consistently.

Policy Rationale behind the Proposed Regulations

Under Section 245A, added to the Code in December 2017, an actual distribution of foreign-source earnings by a CFC to a United States shareholder (generally, a 10% or more owner by vote or value) that is a U.S. corporation (a "corporate U.S. shareholder") is generally exempt from tax. Prior to the Proposed Regulations, however, a corporate U.S. shareholder of a CFC was nevertheless required to include in current income, and be subject to tax on, its pro rata share of a CFC's earnings attributable to an "investment in United States property" (a "Section 956 inclusion"), including guarantees by a CFC and pledges (exceeding certain thresholds) of CFC stock to secure such borrower's debt. This created a mismatch whereby a Section 956 inclusion of a corporate U.S. borrower would be subject to U.S. corporate income tax, but an *actual* dividend to such borrower generally would not be. The Proposed Regulations address this mismatch by generally allowing a corporate U.S. shareholder of a CFC to exclude the foreign-source portion of a Section 956 inclusion attributable to such CFC from its income.

Even prior to the Proposed Regulations, recent changes in the Code — in particular the introduction of the "global intangible low-taxed income," or "GILTI," tax regime and the transition tax on deferred foreign earnings under Section 965 — substantially mitigated the adverse tax consequences of a Section 956 inclusion to many corporate U.S. borrowers. Nevertheless, to avoid the marginal impact of any further acceleration of U.S. income tax liability of a U.S. borrower, credit agreements have frequently limited credit support from CFCs for a U.S. borrower's obligations. With the Proposed Regulations' further relieving corporate U.S. borrowers from U.S. federal income tax on a Section 956 inclusion (in many cases, entirely), lenders seeking full foreign credit support from corporate U.S. borrowers should generally be met with less resistance.

A more detailed discussion on the Proposed Regulations is available here.

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.

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[1] All references to section numbers are references to sections of the Internal Revenue Code of 1986, as amended (the "Code"), and the Treasury regulations promulgated thereunder.

[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.

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