

# To Our Clients and Friends

# Memorandum

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## *Final Regulations Limit the Impact of Section 956 on Foreign Credit Support of U.S. Debt*

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Recently finalized U.S. federal income tax regulations make it easier for U.S. borrowers to receive credit support from foreign affiliates without triggering adverse U.S. federal income tax consequences. Specifically, on May 23, 2019, the U.S. Treasury Department published final regulations (the “Final Regulations”) that reduce or eliminate deemed income inclusions under Section 956 of the Internal Revenue Code for a corporate U.S. shareholder of a controlled foreign corporation (a “CFC”) caused by the CFC’s provision of credit support for debt of a U.S. borrower. The Final Regulations largely mirror proposed regulations (the “Proposed Regulations”) that were released on October 31, 2018.

### **EXISTING LAW**

Section 956 generally requires a U.S. person that owns (or is deemed to own) 10% or more of the stock of a CFC (a “10% U.S. shareholder”) to include in income its allocable share of the CFC’s unrepatriated earnings if, among other things, the CFC provides a guarantee or pledge in support of debt borrowed by a U.S. person. Section 956 was designed to prevent the tax-free repatriation of CFC earnings by requiring 10% U.S. shareholders to recognize a deemed dividend in the case of transactions thought to be economically similar to an actual repatriation, including upstream guarantees, asset pledges and certain stock pledges.

The 2017 Tax Cuts and Jobs Act (the “Tax Act”) substantially changed the taxation of U.S. corporations that repatriate earnings from CFCs. Under new Section 245A of the Internal Revenue Code, a 10% U.S. shareholder that is a corporation and that receives a dividend from a CFC is allowed a deduction equal to the portion of the dividend that is attributable to the CFC’s foreign earnings, provided that the U.S. shareholder satisfies a holding period requirement and certain other requirements. This is sometimes referred to as a “participation exemption.” As a result, an actual dividend of a CFC’s foreign earnings to a corporate 10% U.S. shareholder is generally exempt from tax. However, since the Tax Act did not alter Section 956, a deemed dividend under Section 956 remained subject to tax.

### **THE FINAL REGULATIONS**

For corporate 10% U.S. shareholders, the Final Regulations extend the tax-free repatriation of a CFC’s foreign earnings under Section 245A to deemed repatriations under Section 956. Thus, for a corporate 10% U.S. shareholder of a CFC, a deemed dividend that would have occurred under Section 956 is reduced to the extent that the U.S. shareholder would be allowed a deduction under Section 245A. As a result, the provision by a CFC of a guarantee or pledge in support of debt of a U.S. borrower would generally not result in a deemed dividend to a corporate 10% U.S. shareholder of the CFC in many typical scenarios.

The Final Regulations largely mirror the Proposed Regulations, with certain technical changes relating to (i) CFCs owned by U.S. partnerships that have U.S. corporate partners and (ii) CFCs that have unrepatriated earnings from current and prior years.

The Final Regulations apply to taxable years of a CFC beginning on or after July 22, 2019. However, a taxpayer may apply the Final Regulations retroactively for taxable years of a CFC beginning after December 31, 2017, provided that the taxpayer, and all U.S. persons that are considered “related” to the taxpayer, consistently apply the Final Regulations across all of their holdings. It should be noted that “relatedness” is determined under complex tax attribution rules and, in some cases, it may be difficult for a U.S. person to ensure that all related persons report consistently.

### **CERTAIN REMAINING LIMITATIONS ON FOREIGN CREDIT SUPPORT**

Although Section 956 has long served as a significant impediment to the provision of credit support for debt of U.S. borrowers by foreign affiliates, it has not been the only impediment. In many situations, the Final Regulations may cause cost-benefit analyses and non-tax constraints—such as local law limitations, procedural requirements and the need for local counsel advice—to assume a larger role in determining the extent to which foreign credit support may be provided.

In addition, while the publication of the Final Regulations mitigates concerns that the Proposed Regulations could have been significantly revised or revoked, it does not eliminate the need to analyze whether the provision of foreign credit support could cause adverse U.S. federal income tax consequences. For example, the Final Regulations do not undo or limit the application of Section 956 for any 10% U.S. shareholder of a CFC that would not be entitled to a participation exemption under Section 245A, such as a U.S. individual, S corporation, REIT or RIC. Accordingly, credit support from a CFC with respect to a 10% U.S. shareholder that is a U.S. individual, S corporation, REIT or RIC would still give rise to a potential deemed dividend under Section 956.

Also, Section 245A imposes certain requirements that need to be met in order to avoid giving rise to a deemed dividend under Section 956. For instance, the corporate 10% U.S. shareholder must satisfy a meaningful holding period requirement with respect to the stock of the foreign subsidiary. A U.S. shareholder that fails to satisfy this holding period requirement would be subject to tax on the full amount of the deemed dividend under Section 956.

### **FOREIGN CREDIT SUPPORT IMPLICATIONS OF THE FINAL REGULATIONS**

- Foreign subsidiaries with U.S. corporate parents will, in certain circumstances, be able to provide guarantees and pledges in support of debt incurred by the U.S. corporate parent or its U.S. subsidiaries without giving rise to a deemed dividend under Section 956.
- Despite the finalization of the regulations, consideration should be given to the remaining tax and non-tax constraints applicable to the provision of foreign credit support, including that the U.S. corporate parent must qualify for the participation exemption under Section 245A at all relevant times, as well as any local law limitations and procedural requirements that may apply.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its contents. If you have any questions about the contents of this memorandum, please call your regular Fried Frank contact or an attorney listed below:

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