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Memorandum

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Proposed Section 956 Regulations May Expand Foreign Credit Support of U.S. Debt

Recently proposed U.S. federal tax regulations could allow the provision of foreign credit support in the form of guarantees and collateral without triggering adverse tax consequences. Specifically, on October 31, 2018, the U.S. Treasury Department proposed regulations (the “Proposed Regulations”) that would 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 related U.S. borrowers.

CURRENT 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 has provided a guarantee or pledge of debt borrowed by a related 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 a transaction thought to be economically similar to an actual repatriation.

The 2017 Tax Cuts and Jobs Act (the “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 Act did not alter Section 956, a deemed dividend under Section 956 remained subject to tax.

THE PROPOSED REGULATIONS

For corporate 10% U.S. shareholders, the Proposed 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 U.S. debt would generally not result in a deemed dividend to a corporate 10% U.S. shareholder of the CFC in many typical scenarios.

Generally, a taxpayer is entitled to rely on the Proposed Regulations immediately, provided that the taxpayer and all U.S. persons that are considered “related” to the taxpayer consistently apply the Proposed 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.

FOREIGN CREDIT SUPPORT IMPLICATIONS OF THE PROPOSED REGULATIONS

- Foreign subsidiaries of many typical U.S. corporate-parented groups 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.
- Existing financing agreements that provide for “springing” credit support (e.g., a requirement that a foreign subsidiary provide a guarantee or pledge in support of U.S. debt if it would not result in adverse tax consequences) will need to be analyzed to determine whether guarantees or pledges by foreign subsidiaries will be required (taking into account any mitigating provisions in the agreements).
- In new financings involving typical U.S. corporate-parented groups, consideration should be given to whether providing guarantees and pledges from foreign subsidiaries continues to raise tax concerns, and such determinations may be subject to negotiation at the time that the financings are structured. Since it is possible that a corporate 10% U.S. shareholder may not meet all of the requirements of Section 245A at all relevant times, careful consideration should be given to any terms and conditions associated with such guarantees and pledges.
- Consideration should also be given to the possibility that the Proposed Regulations could be significantly revised prior to their final adoption (or revoked) while financing agreements are still in place.

CERTAIN REMAINING LIMITATIONS ON FOREIGN CREDIT SUPPORT

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

The Proposed 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, partnership, REIT or RIC. Accordingly, credit support from a CFC with a parent that is a U.S. partnership, REIT or RIC, or a CFC that has a 10% U.S. shareholder that is a U.S. individual, partnership, REIT or RIC, could generally still give rise to a deemed dividend under Section 956.

In addition, 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.

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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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