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New IRS proposed regulations under Section 956 substantially reduce "deemed dividend" concerns with respect to pledges and guarantees by CFCs

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Background

Until the issuance of the Proposed Regulations described below, under Section 956 of the Internal Revenue Code of 1986 (IRC) and Treasury Regulations thereunder, deemed dividends were potentially created when a U.S. borrower pledged as security two-thirds or more of the voting stock in a foreign subsidiary considered to be a "controlled foreign corporation" (CFC) for U.S. tax purposes, or if the CFC guaranteed or pledged its assets as security for the U.S. parent's debt. As a result, credit agreements for U.S. borrowers have typically been drafted to exclude CFCs as guarantors, to exclude the pledge of any assets of a CFC, and to limit any pledge of voting stock of a CFC to no more than 65 percent of the voting stock. These provisions often treated domestic subsidiaries with no assets other than stock in one or more CFCs to be the equivalent of CFCs.

The origin of the Section 956 deemed dividend rules was the fact that a U.S. parent was generally able to defer paying U.S. taxes on earnings of a CFC (with certain exceptions) until the earnings were actually distributed to the U.S. parent. The purpose of the Section 956 deemed dividend rules was to prevent a U.S. parent from benefitting from the earnings of a CFC, e.g., by causing the CFC to guarantee or pledge its assets in support of a borrowing by the U.S. parent, without paying the U.S. taxes that would result from an actual distribution of the earnings to the U.S. parent. The Section 956 rules addressed this issue by potentially triggering a "deemed dividend" to the U.S. parent for U.S. tax purposes in the event of such a pledge or guaranty.

The Tax Cuts and Jobs Act

One of the major changes included in the Tax Cuts and Jobs Act (TCJA) enacted in December of 2017 was a participation exemption system effectively exempting from U.S. federal income taxation the foreign-source portion of dividends that are paid to a U.S. corporation by a foreign corporation with respect to which the U.S. corporation is a 10 percent or greater shareholder. So, after the TCJA, and subject to certain exceptions, there is no U.S. taxation on dividends from a CFC to its U.S. corporate parent.

Since an actual dividend from a CFC to its U.S. corporate parent is generally not subject to U.S. taxation under the TCJA provisions, both the House and Senate versions of the TCJA logically also included provisions that would have repealed the deemed dividend rules of Section 956 for U.S. corporations with CFCs that qualify for the new participation exemption. However, inexplicably, the final enacted version of the TCJA did not include the repeal of the Section 956 deemed dividend rules for U.S. corporations with CFCs. As result, the TCJA created a trap for the unwary by retaining the rules under which a pledge or guarantee by a CFC in support of a debt of its U.S. corporate parent could result in deemed dividends subject to U.S. taxation, even though an actual dividend would not result in U.S. taxation.

The proposed regulations

On October 31, 2018, the U.S. Department of the Treasury and the Internal Revenue Service (IRS) released proposed regulations (the Proposed Regulations) under Section 956 that would in most situations eliminate the deemed dividend that otherwise would result from a pledge or guarantee by a CFC in support of the debt of its U.S. corporate parent. The Proposed Regulations fix the disparity in the U.S. tax treatment of actual and deemed dividends from CFCs by reducing the amount includible in income as a result of Section 956 to the extent that an actual dividend paid by the CFC would not be subject to U.S. federal income tax as a result of the participation exemption system enacted under the TCJA.

The Proposed Regulations will apply to taxable years of a CFC beginning on or after the date of publication of final regulations in the Federal Register and to taxable years of a U.S. shareholder in which or with which such taxable years of the CFC end. However, prior to the finalization of the Proposed Regulations, taxpayers may rely on the Proposed Regulations for taxable years of a CFC beginning after December 31, 2017, and for taxable years of a U.S. shareholder in which or with which such taxable years of the CFC end. **Accordingly, CFCs of U.S. corporate borrowers may be able to provide guarantees and pledges immediately without triggering adverse U.S. federal income tax consequences to the U.S. parent corporation.**

Because the Proposed Regulations generally address only corporations eligible for the participation exemption system enacted under the TCJA, circumstances under which CFC pledges and guarantees still may result in adverse tax consequences after the issuance of the Proposed Regulations include the following:

- The U.S. borrower is not a corporation.
- Not all of the CFC's earnings are foreign source (e.g., CFC has income from a U.S. trade or business or from a U.S. subsidiary of the CFC).
- The CFC has issued instruments which pay "hybrid dividends," i.e., for which the CFC receives a deduction or other tax benefit related to taxes imposed by a foreign country.
- The U.S. borrower does not meet certain holding period requirements, e.g., has owned the CFC for fewer than 365 days over a specified period.

Potential impact on credit agreement provisions

As a result of the Proposed Regulations, lenders may begin asking for guarantees by CFCs and/or direct or indirect pledges of the assets of CFCs where the borrower is a U.S. corporation because the guarantees and/or pledges generally will not give rise to any adverse tax consequences to the U.S. borrower as a result of Section 956 except in certain limited circumstances. Similarly, U.S. corporate borrowers may seek additional credit support from CFCs in order to obtain more favorable loan terms. It should be noted, however, that non-tax considerations (such as local law issues) will still need to be considered in determining whether credit and/or collateral support from a foreign subsidiary are feasible.

Also, existing credit agreements should be reviewed to determine whether covenants which prohibit pledges and guarantees by CFCs only apply where the pledge or guarantee would result in adverse tax consequences to the borrower. If such covenants are indeed conditioned on adverse tax consequences to the borrower, CFC pledges and guarantees may now be required as a result of the Proposed Regulations' general elimination of the adverse U.S. federal income tax consequences arising from CFC pledges and guarantees.

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