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Final Regulations on Section 956 and "Deemed Dividends" from Controlled Foreign Corporations

On May 22, 2019, the Internal Revenue Service (the "IRS") and the Department of the Treasury ("Treasury") released final regulations (the "Final Regulations") under Section 956 of the U.S. Internal Revenue Code of 1986, as amended (the "Code")[1] that generally adopt the proposed regulations that were released on October 31, 2018 (the "Proposed Regulations"), with some modifications. We discussed the Proposed Regulations and related matters in more detail in our prior client memorandum (the "Prior Memorandum"), and do not repeat that discussion here.

Under the Final Regulations, there will often no longer be a U.S. federal income tax impediment to a controlled foreign corporation ("CFC") providing credit support with respect to debt issued by its parent U.S. corporate borrower.[2] As noted in the Prior Memorandum, however, other considerations, including non-U.S. local law issues and limitations on the extent to which lenders can access foreign subsidiary guarantees and asset-level pledges, will continue to be a factor and could raise non-tax difficulties. Moreover, potential guarantee fees to CFCs could have non-U.S. and U.S. tax consequences that should be considered.

The Final Regulations apply only to U.S. corporate borrowers and U.S. partnership borrowers to the extent owned by U.S. corporations, and do not apply to individual borrowers or U.S. partnership borrowers to the extent owned by individuals (for which Section 956 continues to apply as it did before).[3] In addition, the Final Regulations make certain technical corrections, noted below. There are also certain situations discussed below where the Final Regulations do not apply.

The Final Regulations will apply to taxable years of a CFC beginning on or after May 23, 2019; but these rules have essentially been effective since the release of the Proposed Regulations, as the Proposed Regulations provided that a taxpayer can generally rely on the rules for taxable years of a CFC beginning after December 31, 2017.

1 All Section references in this memorandum are to the Code.

2 For these purposes, we refer to a "U.S. corporate borrower" as both a borrower under typical bank debt facilities and an issuer of bonds.

3 The Final Regulations also do not apply to S-corporation, RIC, or REIT borrowers or U.S. partnership borrowers to the extent owned by S-corporations, RICs, or REITs.

Evolution of Market Practice on CFC Credit Support

Pre-2017 Tax Act – CFC Credit Support Limited. As discussed in the Prior Memorandum, before the 2017 U.S. tax reform legislation commonly referred to as the Tax Cuts and Jobs Act (the "(2017 Tax Act"), to avoid Section 956 "deemed dividend" inclusions, a U.S. corporate borrower would typically pledge no more than 65% of the voting stock of its first-tier CFCs, and all of its CFCs would be excluded from the credit group, such that they provided no guarantees and pledges with respect to the borrowing of the U.S. corporate parent.

Post-2017 Tax Act, but before the Proposed Regulations – More of the Same. Following enactment of the 2017 Tax Act, and even before the release of the Proposed Regulations, lenders arguably could have sought immediate expansion of their collateral packages, because Section 956 would have limited or no negative tax consequences. Most "deemed dividends" would be exempt from tax because they would be treated as made from previously taxed income ("PTI") under the Subpart F rules and new GILTI rules or as a result of the one-time "transition tax" applicable to pre-2018 foreign earnings; and CFCs could pay "real dividends" clearly eligible for the Section 245A dividends received deduction to the extent that the Section 956 inclusion exceeds such PTI to "cover" the remainder of the inclusion. Other than in some scenarios involving distressed borrowers, however, market practice generally did not evolve to include full CFC credit support.

Post-2017 Tax Act, and after the Proposed Regulations. Following release of the Proposed Regulations, lenders were more likely to request that U.S. corporate borrowers include CFCs in their credit support packages, and U.S. corporate borrowers (particularly those in distressed situations) often considered providing additional credit support, including 100% equity pledges of CFCs, CFC guarantees, and asset pledges, where desiring to obtain better terms or increase the amount of borrowing. Interestingly, borrowers often successfully objected to the increased collateral permitted by the Proposed Regulations on the theory that there was no guarantee whether (and when) the rules would be finalized in their proposed form.

Going Forward? Now that the Final Regulations have been released and the uncertainty about what the final rules would entail has been alleviated, we expect that market practice will continue to shift towards a more expansive inclusion of CFCs in the credit support provided for debt of U.S. corporate borrowers, subject to the non-U.S. local law concerns mentioned above and the points noted below. In most cases, CFCs will be able to guarantee the debt and pledge their assets, and U.S. corporate borrowers will be able to pledge 100% of all CFC stock at all tiers, without any adverse tax consequences under Section 956. There are still several areas, however, where the additional credit support from non-U.S. subsidiaries can create issues and potential leakage that needs to be monitored and possibly modeled, even with the Final Regulations. A few areas of particular concern include the following:

- ***New CFCs***. To benefit from the participation exemption and the tax-free "deemed dividends" that the Final Regulations permit, U.S. corporate borrowers must meet a holding period requirement with respect to their CFC subsidiaries. Specifically, the U.S. corporate borrower must have owned the foreign subsidiary for more than 365 days during the 731-day period that straddles the last day during the taxable year on which the foreign subsidiary is a CFC. Thus, newly acquired or formed subsidiaries may continue to be excluded from credit packages (or included only to the extent of a pledge of 65% of the equity of a first-tier subsidiary, as before the 2017 Tax Act).

- ***Hybrid Instruments***. Section 956 "deemed dividends" could still be taxable to U.S. corporate borrowers in cases where the hypothetical distribution under the Final Regulations would be treated as a "hybrid dividend" (generally, a dividend resulting in a foreign tax benefit to the CFC), since "hybrid dividends" are not eligible for the Section 245A dividends received deduction. Therefore, taxpayers holding hybrid debt of their CFCs (such as "convertible preferred equity certificates," or "CPECs") should be cautious of the continued potential for adverse tax consequences under Section 956 resulting from credit support provided by those CFCs.

- ***Guarantee Fees?*** In some non-U.S. jurisdictions, a foreign subsidiary that guarantees debt of a U.S. parent may be deemed to receive a guarantee fee from the U.S. parent, which could be subject to tax in that non-U.S. jurisdiction. In addition, there may be good non-U.S. reasons to require the U.S. parent to pay the guarantee fee directly to the foreign subsidiary (e.g., to set the rate based on a transfer pricing determination, instead of permitting a taxing authority to impute a rate). This could create knock-on U.S. effects – the guarantee fee may be treated as Subpart F income or GILTI for the U.S. parent.

Technical Changes in the Final Regulations

Final Regulations are Slightly More Expansive and Apply to Domestic Partnerships Owned by U.S. Corporations. The Final Regulations provide that the Section 956 "deemed dividend" to a U.S. partnership borrower owned directly (or indirectly through other partnerships) by one or more U.S. corporations is reduced to the extent of the aggregate amount of Section 245A dividends received deductions that would be available to the U.S. corporations with respect to their distributive shares of the "deemed dividend" received by the partnership. This is an addition to the Proposed Regulations that is generally borrower favorable.

E&P Ordering Rules. The Final Regulations also set forth an ordering rule intended to obviate technical issues that could arise with respect to CFCs that have PTI attributable to prior Section 956 inclusions and current-year E&P that would be eligible for the Section 245A dividends received deduction if distributed.

Observation

Double Check Existing Credit Agreements. U.S. corporate borrowers and their lenders should consider reviewing their existing financing documents, as the provisions therein may be drafted in a manner requiring a U.S. corporate borrower to grant additional credit support from foreign subsidiaries if doing so would not result in adverse tax consequences. In such cases, U.S. corporate borrowers may need to provide additional collateral to comply with their existing covenants.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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