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New Proposed Regulations on Section 956 and “Deemed Dividends” from Controlled Foreign Corporations

On October 31, 2018, the Internal Revenue Service (“IRS”) and the Department of the Treasury (“Treasury”) released proposed regulations (the “Proposed Regulations”) under Section 956 of the U.S. Internal Revenue Code of 1986, as amended (the “Code”) that, for most U.S. corporations, effectively undo the “deemed dividend” rules that have applied to foreign corporate subsidiaries for decades.

This guidance may have a meaningful impact with respect to collateral packages for U.S. corporate borrowers and issuers¹ with foreign subsidiaries because, under the Proposed Regulations, in most cases there will no longer be a U.S. federal income tax impediment to foreign subsidiaries providing credit support. Note, however, that in many cases, other considerations, including local law issues, may continue to limit the extent to which lenders access foreign subsidiary guarantees and asset-level pledges. Moreover, the existing rules still apply for individual and U.S. partnership borrowers (and disregarded entities of these borrowers).

Pre-Tax Reform Law and Practice

- **Section 956 “Inclusions” and “Deemed Dividends.”** Before the 2017 U.S. tax reform legislation commonly referred to as the Tax Cuts and Jobs Act (“Tax Reform”), U.S. corporations with foreign corporate subsidiaries (what the Code refers to as “Controlled Foreign Corporations” or “CFCs”)² were generally not required to pay tax on income of those CFCs, and instead only had taxable income from the CFCs when (i) the CFCs paid actual dividends or (ii) the U.S. corporation received income “inclusions” from the CFCs (generally referred to as “deemed dividends”), including (a) under Section 956,³ where the U.S. corporation received certain types of credit support from a CFC (discussed in more detail below) and (b) with respect to certain passive income of CFCs.⁴

¹ This memorandum refers to borrowers and issuers as “U.S. corporate borrowers.”

² For ease of presentation, this memorandum assumes a foreign subsidiary wholly-owned by a U.S. corporation and does not address the CFC rules related to partially owned foreign subsidiaries in any detail.

³ All Section references are to the Code.

⁴ The “deemed dividends” were not actually dividends for tax purposes, but were technically constructive income “inclusions” (the importance of which is discussed below). Nevertheless, these inclusions have been referred to as “deemed dividends” and this memorandum adopts that approach.

- **Financing Practice – CFC Credit Support Limited to 65% Voting Stock of First Tier CFCs.** To avoid deemed dividends under Section 956, a U.S. corporate borrower would typically obtain very limited credit support from CFC subsidiaries and generally would pledge no more than 65% of the voting stock of a first-tier CFC. Guarantees and asset pledges by any CFC and stock pledges in excess of 65% of the voting stock of a first-tier CFC have been very unusual as they would often create deemed dividends for the U.S. corporate parent. Most debt documents contained restrictions on CFC collateral to permit U.S. corporate debtors to avoid this issue.

Tax Reform and the Participation Exemption

- **Participation Exemption.** Tax Reform created a “participation exemption” that overhauled the CFC regime. Under Section 245A, actual dividends that a U.S. corporation receives from a CFC are generally exempt from tax because the U.S. corporation is entitled to an equal and offsetting dividends received deduction.
- **Section 956 Remains in the Code – Asymmetry between “Real” and “Deemed” Dividends.** For reasons that are not entirely clear, though potentially related to revenue scoring, Tax Reform did not remove Section 956 from the Code. It remains in force, potentially creating “deemed dividends” in the same manner as before Tax Reform. Notably, these income inclusions are not treated as dividends for tax purposes and are, therefore, not eligible for the dividends received deduction described above.

This created a counterintuitive result where a U.S. corporation could receive actual dividends from a CFC free of tax because of the participation exemption, but “deemed dividends” under Section 956 would be taxable because the dividends received deduction is inapplicable.

- **Market Practice in Debt Documents Has Continued As before Tax Reform.** As a result of the rules above, post-Tax Reform market practice on credit support generally remained the same as pre-Tax Reform, with credit support of CFCs generally limited to 65% stock pledges of first-tier CFCs.

The Proposed Regulations

- **Proposed Regulations.** The IRS and Treasury noted the asymmetry between “real” dividends and “deemed dividends”, and decided that it did not make sense as a policy matter. Under the Proposed Regulations, in the case of a U.S. corporation that is a shareholder of a CFC, “deemed dividends” under Section 956 will effectively be treated as if they were actual dividends eligible for the dividends received deduction. In other words, “real” dividends and “deemed” dividends will be taxed the same way and generally not treated as income to a U.S. corporate shareholder of a CFC. To achieve this result, the Proposed Regulations reduce deemed dividends under Section

956 to the extent that a corporate shareholder of a CFC would have been allowed the dividends received deduction under Section 245A, if the shareholder had actually received a distribution from the CFC in an amount equal to the deemed dividends under Section 956.

- **Effective Dates.** The regulations would generally be applicable to taxable years of a CFC beginning on or after the date of the publication of the final regulations; but a taxpayer can rely on the proposed regulations for taxable years of the CFC beginning after December 31, 2017 – this effectively means that the regulations are applicable now if a taxpayer (or its lender) wants.
- **Rule Only Applicable to U.S. Corporations.** Note the Proposed Regulations are only applicable to U.S. corporations. Section 956 continues to apply as it did before with respect to U.S. partnerships and individuals, for example. The regulations request comments on these matters.

Practical Implications

- **U.S. Tax Rules May No Longer Be Viewed As an Impediment to Credit Support from CFCs Owned by U.S. Corporations.** Going forward, lenders may be more likely to require U.S. corporate borrowers to include CFCs in credit support because the U.S. federal income tax impediments to doing so have in large part fallen away. Similarly, U.S. corporate borrowers may wish to provide this additional credit support where available to obtain better terms or increase the amount of borrowing.⁵ In most cases, CFCs can now guarantee the debt of U.S. corporate parent entities and pledge assets, and 100% of all CFC stock can now be pledged (including for all tiers of CFCs, not just first-tier CFCs), in each case, without any deemed dividend concern under Section 956.⁶

⁵ U.S. corporate borrowers should also consider the new limits on deductibility under Section 163(j) in weighing the benefit of adding non-U.S. subsidiaries to U.S. credit packages. If interest is not deductible in the U.S. due to these limitations, it may still be advantageous from a tax perspective to leave foreign subsidiaries out of the U.S. collateral package and to borrow directly at the foreign subsidiary.

⁶ Note, however, that these rules, like the Section 245A rules, generally only apply if a U.S. corporation has owned a 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 (the Proposed Regulations provide that a hypothetical distribution occurs on this date). Because of this holding period requirement, financing documents may evolve to have two classes of CFC subsidiaries, where a U.S. corporate borrower is required to grant more extensive credit support from “old and cold” CFCs, but continue to provide less extensive credit support, consistent with existing practice, for newly acquired CFCs until the holding period requirements are met. Alternatively, credit agreements may continue to stipulate that all CFCs must provide credit support, if doing so would not have an adverse tax effect on the U.S. corporate borrower, which would be another way to address this holding period issue for newly acquired CFCs.

- In addition, the Proposed Regulations may create opportunities for CFCs to lend money to US affiliates, which could be useful where foreign jurisdictions have significant dividend withholding taxes.
- U.S. corporate borrowers should also examine their “further assurances,” “excluded property” and “additional collateral” clauses and definitions in existing financing documents. Many of these provisions are drafted to be mechanical, limiting CFC credit support to 65% of the stock of a first tier CFC, but some are not, and, for example, require a U.S. corporate borrower to grant additional credit support from foreign subsidiaries if doing so would not result in adverse tax consequences. In this instance, U.S. corporate borrowers may need to provide additional collateral to comply with their existing covenants.
- ***How Much Has Really Changed?*** Arguably, lenders could have sought expansion of their collateral packages immediately after the enactment of Tax Reform, without need for these regulations. Under the new GILTI rules and existing Subpart F rules, in many cases, Section 956 would have done limited or no harm, as any deemed distributions would have been treated as made from previously taxed income (or PTI), generally not subject to tax in any event, and CFCs may not have had significant earnings not otherwise picked up by these rules. Actual distributions eligible for the participation exemption (instead of deemed distributions) could have covered the remaining areas where Section 956 would have otherwise applied. In other words, even before the Proposed Regulations, in many cases it may have been possible to obtain guarantees and 100% stock pledges from CFCs without adverse tax consequences. For the most part, however, this did not happen (except in some distressed scenarios). Given that lenders largely did not reach for incremental credit support before the Proposed Regulations, it is possible that they will not do so after the Proposed Regulations. If anything, however, the Proposed Regulations make the additional credit support more obvious and easier by eliminating some of the modeling exercises and actual distributions that would have been required before the Proposed Regulations. Time will tell how the market evolves.
- ***Non-Tax Considerations Will Continue to Be a Factor in Limiting Foreign Collateral and Credit Support.*** It is often the case that there are difficulties in obtaining guarantees or collateral in non-U.S. jurisdictions. Those difficulties could be legal in nature, such as financial assistance, corporate benefit or capital maintenance rules (just to name a few of the most prevalent), in which case the value of such credit support to the secured parties could well be significantly limited or even excluded altogether. The difficulties could also be practical, such as disproportionate costs (in the form of stamp duties, notarial fees, etc.) or the imposition of an unreasonable burden on the foreign grantor when perfection actions under local law, such as notices to contractual counterparties or requirements relating to identification of collateral, affect the grantor’s ability to conduct its business in the ordinary course. Therefore, a cost/benefit

analysis will be necessary to balance the benefit accruing to the secured parties in obtaining a particular guarantee or an asset-level pledge by a CFC, and the consequences, legal and practical, for the CFC, and the group as a whole, with respect to the provision of such credit support.

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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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