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Tax Group Client Alert:
New Proposed Treasury Regulations Under Section 956 May Facilitate Granting Foreign Collateral for Loans

On October 31, 2018, the Internal Revenue Service ("IRS") and the U.S. Treasury issued proposed regulations under section 956 of the Internal Revenue Code to resolve certain inconsistencies caused by the Tax Cuts and Jobs Act (the "TCJA"). These changes make it easier for foreign affiliates of some U.S. borrowers to provide credit support without the adverse tax consequences that previously would have resulted.

Prior to the TCJA, most earnings of foreign subsidiaries of U.S. persons other than certain categories of passive or mobile income ("Subpart F" income) generally were not taxed on a current basis to the subsidiaries' U.S. owner. Under section 956 undistributed earnings of a controlled foreign corporation ("CFC") (generally, a foreign corporation more than 50% owned (by vote or value) by one or more U.S. 10% shareholders) generally are deemed to be distributed and taxed as dividends when invested in certain U.S. property. Pledges, guarantees and other credit support provided by CFCs to support borrowings by related U.S. persons may be treated as an indirect investment in U.S. property and trigger current taxation of the earnings by the U.S. owner. The original purpose of this rule was to ensure that U.S. 10% shareholders could not benefit from the untaxed earnings of their CFCs without incurring the tax that would have resulted if the CFCs had distributed an actual dividend. Accordingly, section 956 historically achieved some degree of symmetry between the tax treatment of a CFC's actual dividends and its deemed dividends.

Following the TCJA, in addition to current taxation of Subpart F income, a U.S. 10% shareholder of a CFC is subject to current tax on its share of other earnings (so-called global intangible low taxed income ("GILTI")), except certain earnings corresponding to an assumed formulaic rate of return on tangible qualified business assets of the CFC. The latter earnings are not taxed until the earnings are distributed.

Moreover, the TCJA's new section 245A generally affords corporate U.S. 10% shareholders, which meet a holding period requirement, a 100% dividends received deduction on the foreign-source portion of such actual dividends received from CFCs (the "Participation Exemption"). Nevertheless, the TCJA retained section 956. Technically, an income inclusion under section 956 is not a "dividend" for this purpose and the TCJA therefore did not provide parallel treatment to a corporate U.S. 10% shareholder for a section 956 deemed dividend. Thus, post-TCJA, section 956 had the potential to convert certain untaxed earnings that might otherwise have been repatriated tax-free to a corporate U.S. 10% shareholder by way of an actual dividend under the new Participation Exemption into fully taxable income.

The proposed regulations are intended to correct this inconsistency between a CFC's actual dividends and section 956 deemed dividends. To that end, the proposed regulations reduce a corporate U.S. 10% shareholder's section 956 inclusion that would have otherwise resulted (the "aggregate tentative section 956 amount") by the section 245A deduction it would have been entitled to claim had it instead received an actual dividend distribution from the CFC in an amount equal to the aggregate tentative section 956 amount.

The proposed regulations do not apply until final regulations are issued, but 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. 10% shareholder in which or with which such taxable years of a CFC end, provided the taxpayer and parties related to it consistently apply the proposed regulations to all CFCs in which they are U.S. 10% shareholders.

The IRS and Treasury note that the proposed regulations are meant to reduce costs and compliance burdens of corporate U.S. 10% shareholders. In particular, the IRS and Treasury were focused on eliminating the need for complex and expensive restructurings where a CFC acquires a U.S. target ownership of which would constitute an "investment in U.S. property" for purposes of section 956. In addition, and just as importantly, the proposed regulations largely eliminate U.S. federal income tax that previously could have resulted from guarantees by, and pledges of the stock and assets of, CFCs owned by corporate U.S. borrowers provided as credit support for amounts borrowed. After the TCJA already significantly reduced the potential impact of section 956 by subjecting the previously untaxed earnings of CFCs to a one-time deemed repatriation tax under section 965 as well as introducing the new tax on a CFC's so-called GILTI (and thus reduced the pool of untaxed earnings that could potentially be deemed repatriated under section 956), the proposed regulations represent a further important step towards eliminating the need for limitations on foreign collateral supporting the obligations of corporate U.S. borrowers.

Accordingly, when negotiating credit agreements, lenders should consider pushing back on exclusions of foreign collateral and guarantees and require U.S. corporate borrowers to provide additional credit support from foreign subsidiaries as long as no material adverse tax consequences result. However, because of section 245A's holding period requirement, it may make sense to not fully include newly-acquired CFCs as part of the collateral until the holding period requirement is met.

Presently, the proposed regulations only alleviate the impact of section 956 for corporate U.S. 10% shareholders. However, the IRS and Treasury have requested comments and are considering the appropriate application of section 956 to U.S. partnerships and their U.S. corporate partners. Consistent with the provisions of the TCJA, no such benefit is being considered for U.S. shareholders (directly or through partnerships) that are individuals.

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Please feel free to discuss any aspects of this Client Alert with your regular Milbank contacts or any of the members of our Tax Group.

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