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PERFECTING ON FOREIGN SUBSIDIARIES REVISITED:

AVOIDING SECTION 956 OF THE INTERNAL REVENUE CODE

by David G. Crumbaugh and Joseph M. Kronsnoble

This article sets forth the means to overcome what has been, and continues to be, a barrier to a secured lender's ability to obtain a guaranty from foreign subsidiaries, or obtain a lien on the assets or capital stock of the foreign subsidiaries[1] of a U.S. borrower: namely, potential tax consequences arising from the application of Section 956 of the Internal Revenue Code. In other words, the deemed dividend dilemma. In 1995, one of the authors of this article co-authored an article on Section 956[2] that made three essential points:

- Deemed dividends would be a growing issue as more and more U.S. companies formed foreign subsidiaries to manufacture or sell goods overseas.
- Many concerns of U.S. borrowers about deemed dividends were overstated, and where the collateral value of the assets or capital stock of foreign subsidiaries were a compelling part of the overall credit picture, dire claims of adverse Section 956 tax consequences needed to be carefully examined before agreeing to limit foreign subsidiaries' credit support to a pledge of 65 percent of such foreign subsidiaries' stock.
- One means of limiting the effect of Section 956 was to require the U.S. borrower to form an intervening, bankruptcy-remote domestic corporation, which, in turn, would own all of the stock of various foreign subsidiaries, and to obtain a pledge of 100 percent of the stock of that intervening holding company.

As the saying goes, being right on two out of three ain't bad. First, structuring issues which arise out of Section 956 are growing in frequency for secured lenders, as virtually every middle-market credit transaction now involves a foreign subsidiary with some degree of importance to the overall credit. Second, the concern of U.S. borrowers over the impact of Section 956 continues to be overstated in many cases, and where the benefits of locking up foreign collateral outweigh the costs, a closer examina-

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tion of the present and future impacts of Section 956 deemed dividend issues often demonstrates that those impacts are not material. Third, unfortunately, where Section 956 has a real impact, the intervening holding company strategy is no longer considered a viable technique for avoiding the application of Section 956. However, a new approach has recently developed which is discussed.

What is Section 956?

Prior to the enactment of Section 956, income generated by foreign subsidiaries generally was only subject to taxation in the U.S. at the time it was repatriated by dividends to the U.S. parent. Recognizing that U.S. corporations were obtaining the economic benefit of foreign subsidiaries' earnings through various means, such as investments, loans or guarantees provided by foreign subsidiaries, that were in substance little different from the receipt of a dividend,[3] Congress enacted Section 956 in 1962.

The commonsense basis of Section 956 as applied in the commercial loan context is this: If a U.S. borrower obtains upstream credit support from its foreign subsidiaries to support loans to the U.S. borrower, it is essentially obtaining the benefit of the past and future earnings of those foreign subsidiaries.

Under Section 956, when a foreign subsidiary (also referred to as a "controlled foreign corporation") provides certain kinds of credit support for the borrowings of a U.S. parent, the accumulated "earnings and profits"[4] of that foreign subsidiary[5] are deemed to have been distributed to the U.S. parent and, accordingly, subject to U.S. corporate income tax.[6] Furthermore, as long as that credit support remains in place, future earnings and profits of that foreign subsidiary will similarly be deemed to be distributed to the U.S. parent on a periodic basis.[7]

What forms of credit support trigger Section 956?

Under Section 956, an obligation of the U.S. parent to a third-party lender[8] triggers a deemed distribution of the current and accumulated earnings and profits of a foreign subsidiary to the U.S. parent up to the amount of the obligation, if one of the following three events occurs:

- ➤ Stock representing two-thirds (66-2/3 percent) or more of the voting power of a foreign subsidiary is pledged to the lender advancing loans to the U.S. parent;[9]
- ➤ The foreign subsidiary guarantees payment of loans made to the U.S. parent;
- ➤ The foreign subsidiary grants a security interest to the lender in its assets (including the stock of second-tier foreign subsidiaries) to secure loans to the U.S. parent.

The consequences of Section 956 can be disastrous

Assume, for example, a loan to a U.S. borrower of $100 million which is guaranteed by a Canadian subsidiary and secured, in part, by a pledge of 100 percent of the voting stock of that Canadian subsidiary and supported by a guaranty by that Canadian subsidiary. Assume further that the Canadian subsidiary has accumulated earnings and profits of $20 million that have never been repatriated into the United States and that no counterbalancing circumstances (as described below) apply — admittedly a rare circumstance. In the foregoing circumstance, the U.S. borrower's simple act of signing the pledge or causing its foreign subsidiary to sign the guaranty, causes the U.S. borrower to incur a U.S. income tax liability of $7 million.

Perhaps of equal concern, future earnings and profits of the Canadian subsidiary will be subject to U.S. income taxes so long as the loan is outstanding.

The U.S. borrower's typical negative response

As a result of the consequences described above, most U.S. borrowers have an immediate, visceral reaction when asked to pledge the assets or capital stock of their foreign subsidiaries as additional collateral for a loan. They refuse to consider it. When faced with that response, without further inquiry, many lenders relent and accept a pledge of 65 percent of the voting stock of the foreign subsidiaries of their U.S. borrower together with negative covenants relating to the foreign subsidiaries, but recognize that such a pledge, even with negative covenants, has substantially diminished collateral value. That compromise may be appropriate when the foreign subsidiary has no significant collateral value or where the loans are fully collateralized by the assets of the U.S. borrower in the U.S. and the assets or capital stock of the foreign subsidiary are viewed primarily as "boot collateral" in the sense of something that would be nice to have, but is not essential. In other instances where the value of foreign subsidiary credit support is critical to making the deal work, lenders should respond by seeking further information and clarification from the U.S. borrower as to their specific tax circumstances.

The no-harm no-foul rules

The first step in examining Section 956 consequences is to determine whether a pledge of 100 percent of the capital stock of the foreign subsidiaries, an upstream guaranty or liens on the assets of the foreign subsidiaries truly results in an increase in the tax liabilities of the U.S. borrower. Assume that the lender is requesting all three forms of credit support because, if one trigger is tripped, there is no further harm in getting all three forms of credit support. There are a number of reasons why this credit support may have no material adverse tax consequences to a U.S. borrower:

- *No historic earnings and profits*. The foreign subsidiaries of U.S. borrowers often have very little or no accumulated earnings and profits. Many borrowers' counsel will automatically argue that their clients need to preserve flexibility and should not have their foreign subsidiaries provide credit support because their foreign subsidiaries may begin to generate earnings and profits in the future. However, the truth is that U.S. borrowers not only try to minimize their U.S. income taxes, but also endeavor to reduce or eliminate their foreign income taxes. As a result, there is little likelihood that those foreign subsidiaries will ever generate any material amount of earnings and profits. This is especially true in high-tax foreign jurisdictions where a taxpayer will try to maximize deductions and shift income to other lower tax jurisdictions.
- *Foreign subsidiary is profitable, but deemed dividend has already occurred.* If the U.S. borrower's leverage is such that it has historically required upstream guaranties, 100 percent stock pledges and liens on its foreign subsidiaries' assets to support its domestic borrowings, Section 956 has already been triggered, the resulting taxes have been paid and,

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absent the prospect of substantial future earnings and profits, a new credit facility should continue to have the same foreign subsidiary credit support.

- *Foreign subsidiary is profitable, but earnings and profits have already been repatriated.* In many instances, the historic and future earnings and profits of foreign subsidiaries have been and are reasonably expected to be minimal. Moreover, past domestic debt amortization has been at sufficiently high levels that all available cash at foreign subsidiaries has been repatriated to the U.S. borrower to assist it in repaying debt. Furthermore, future debt amortization is expected to require repatriation of foreign subsidiaries' excess operating cash flow to meet debt-service obligations in the U.S. Under these circumstances, actual dividends may equal or exceed deemed dividends and the effect of triggering Section 956 is nil.
- *Pass-through foreign subsidiaries.* Many foreign subsidiaries are not treated as corporations for U.S. income tax purposes. For example, a German GmbH or a Brazilian limitada may be treated as a partnership for U.S. income tax purposes. In other instances, the U.S. borrower may have "checked the box" in conjunction with the formation of a wholly owned foreign subsidiary. By doing so, the U.S. borrower has elected to treat the foreign subsidiary as a branch or division of a domestic subsidiary or of the U.S. borrower for U.S. income tax purposes. In all of those instances, the U.S. borrower and its finance attorneys may rigorously oppose granting a full collateral package with respect to the foreign subsidiary in question without consulting with their tax advisors, only to discover that the foreign subsidiaries are not "controlled foreign corporations" and thus not subject to Section 956.
- *Foreign tax credits eliminate or mitigate any deemed dividend.* Assume that a foreign subsidiary with substantial earnings and profits provides a full collateral package and causes a deemed dividend of those earnings and profits under Section 956. In conjunction with that deemed dividend, the Internal Revenue Code allows the U.S. parent to claim a credit against its U.S. tax liability for foreign income taxes previously paid by that subsidiary (known as "freeing up credits"). These credits, referred to as "deemed paid credits," become available as a result of the deemed dividend. These foreign tax credits are subject to a host of technical limitations and require careful analysis to determine the extent of the available tax benefits. Such foreign tax credits may substantially reduce the impact of the deemed dividend under Section 956, particularly where the foreign income tax rate exceeds the U.S. income tax rate.[10]
- *NOLs.* If the U.S. borrower is running current losses or has net operating loss carryovers (collectively, NOLs), deemed dividends triggered by Section 956 may be sheltered by those losses. Where the U.S. borrower is incurring losses, the lender's need for additional collateral is often the greatest. Although the U.S. borrower may object to using up its NOLs under these circumstances, the need of a lender to have a full foreign-subsidiary collateral package to support the loans often exceeds the U.S. borrower's desire to preserve its NOLs for future use.[11]

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In each of the circumstances listed above, the U.S. borrower should have no objection to pledging the foreign subsidiary's stock, having its foreign subsidiary guarantee loans to the U.S. borrower and having its foreign subsidiary grant liens on its assets to secure that guaranty.

Mitigating the effect of Section 956

In the event that the "no-harm, no-foul" options listed above do not help the lender obtain the full credit support of foreign subsidiaries and, at a minimum, the lender needs the equity value of the foreign subsidiaries for credit support, the structuring approach described below may help.

Assume that two of the U.S. borrower's foreign subsidiaries account for 45 percent consolidated EBITDA and (1) the subsidiaries have substantial earnings and profits that have never been repatriated and are expected to have substantial future earnings and profits, (2) the subsidiaries are treated as corporations for U.S. income tax purposes, (3) foreign tax credits provide no meaningful offsets to any U.S. tax that would result from a deemed dividend to the borrower and (4) the borrower has no NOLs to shield the impact of deemed dividends. Under these circumstances, the lender must confront the possibility of doing a typical lopsided credit structure, wherein loans in dollars are advanced to the U.S. borrower and separate loans in euros, pounds sterling or Canadian dollars are advanced to the foreign subsidiaries. The U.S. borrower grants liens to secure the payment of loans advanced to it, and guarantees payment of the loans to its foreign subsidiaries, which guaranties are also secured by its assets (such

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guaranty and liens may be *pari passu* with its obligations as a borrower or subordinated to such obligations). In contrast, the foreign subsidiaries grant liens to secure the loans advanced to them, but provide no guaranties or liens to support the loans extended to the U.S. borrower. In fact, the credit or loan agreement which governs both sets of loans, foreign and domestic, may expressly disclaim any liability of the foreign subsidiaries for obligations of the U.S. borrower. Under those circumstances, a partial solution may reside in the fact that as it relates to stock pledges, Section 956 is triggered only by a pledge of stock representing two-thirds or more of the foreign subsidiaries' voting power.

Assume further that each of the two foreign subsidiaries have 100 shares of voting stock outstanding, all of which are owned by the U.S. borrower. If each of the foreign subsidiaries issues 1,000 shares of nonvoting stock, with all of the economic attributes of the 100 shares of voting stock, and U.S. borrower pledges all 1,000 shares to the lender as primary or secondary collateral for its loans to U.S. borrower, along with 65 shares of the voting stock, the lender has effectively received approximately 97 percent of the equity value of the foreign subsidiaries while receiving a pledge of only 65 percent of the voting stock of the foreign subsidiaries.

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This structure should not trigger an adverse tax impact under Section 956.[12] If Congress or the Treasury[13] had desired to establish 66 2/3 percent of the *value* of all capital stock as a trigger point for Section 956, they could have easily done so, but they chose not to. Stock representing 66 2/3 percent of a corporation's voting power was established as a threshold because many state and foreign corporation laws provided that a corporation could be liquidated only upon the affirmative vote of the holders of two-thirds of its voting stock. Thus, the stock pledge rule is not based on the value of the stock being pledged, but rather its voting power. The intervening holding company structure described earlier should not avoid section 956 because in substance it constitutes a pledge of *all* of the foreign subsidiary's *voting* stock.

This structure is no substitute for a full collateral package that includes a guaranty from the foreign subsidiaries and liens on the assets of foreign subsidiaries. The lender is essentially structurally subordinated to the trade and other creditors of the foreign subsidiaries. The benefit is that practically all of the equity value of these foreign subsidiaries has been captured in the collateral package.

New dividend tax break does not lessen the impact of Section 956

New Code Section 965, enacted as part of the American Jobs Creation Act of 2004, provides a U.S. corporation with a deduction equal to 85 percent of the cash dividends received from foreign subsidiaries that are invested in the United States during a one-year window. This law should have a substantial positive impact on capital investment by large corporations which use that window to repatriate cash to the U.S. However, it will have little impact on lending structures for mid-cap companies which need to borrow money and enhance credit availability by granting a full collateral package with respect to their foreign subsidiaries.

Ironically, the tax-break window applies only to actual repatriations of cash, not to deemed dividends under Section 956. The game continues.

Conclusion

Lenders must insist their U.S. borrowers provide them with a careful analysis of any potential incremental tax impact resulting under Section 956 of the Internal Revenue Code rather than immediately conceding the inability to obtain a pledge of more than 65 percent of its foreign subsidiaries' capital stock, liens on those foreign subsidiaries' assets or guarantees from those foreign subsidiaries with respect to the borrower's debt. In many instances, the actual dollar impact from the application of Section 956 is far less serious than the imagined impact, or even nonexistent, and the pledge, liens and guaranty should be provided. In those instances in which the incremental impact of Section 956 is material, lenders should consider the structure described above to achieve the practical benefits of a 100-percent pledge of capital stock of the borrower's foreign subsidiaries, while not subjecting the U.S. borrower to the adverse tax consequences of Section 956. ▲

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Endnotes

[1] This article only covers so-called "controlled foreign corporations," that is, corporations in which U.S. share-holders (any U.S. person owning, directly or indirectly, at least 10 percent of the voting power of the corporation) own more than 50 percent of (i) the voting power of the corporation or (ii) the total value of the corporation's stock. Clearly, wholly owned foreign subsidiaries of a U.S. borrower fall within the definition. This article focuses on foreign subsidiaries that are not engaged in a U.S. trade or business so that they would not otherwise be subject to U.S. income taxes.

[2] When we refer to Section 956, we are also referring to the related Treasury Regulations.

[3] For example, an investment in U.S. property by a foreign subsidiary is little different than a dividend by the foreign subsidiary to its U.S. parent followed by the acquisition of the property by the parent.

[4] "Earnings and profits" is a tax concept somewhat similar to the accounting concept of "surplus" or "retained earnings." A distribution by a corporation is taxable as a dividend to the extent of its earnings and profits, while distributions in excess of earnings and profits are a nontaxable return of capital with any remaining excess constituting capital gain. "Earnings and profits" is a broader concept than taxable income and takes into account certain items that affect economic income, but that are neither deductible nor includible in taxable income. In any event, earnings and profits of a foreign entity are figured using U.S. tax accounting concepts.

[5] For these purposes, the earnings and profits of the foreign subsidiary are subject to certain adjustments, including reduction for distributions made during the tax year and for certain earnings previously included in the income of a U.S. shareholder. When we refer to earnings and profits, it is assumed to be after these adjustments unless we indicate otherwise.

[6] The current U.S. income tax rate on corporations is generally 35 percent. As discussed below, the amount of U.S. income taxes resulting from a deemed dividend from a foreign subsidiary may be reduced by a foreign tax credit.

[7] The amount of taxable income resulting from the deemed dividend is the lesser of (x) the amount of the loan to the U.S. parent or (y) the aggregate amount of accumulated earnings and profits of the foreign subsidiary plus the earnings and profits generated by the foreign subsidiary while the credits support remains in place. For purposes of this discussion, we have assumed that amount of the loan far exceeds the foreign subsidiary's earnings and profits. It is also possible that a deemed dividend could be further limited on policy grounds to the amount of assets of a foreign subsidiary (or to a portion of the assets of each of multiple foreign subsidiaries providing credit support for a single loan) because a deemed dividend should presumably never exceed the maximum amount of an actual dividend that could occur in a particular situation.

[8] The identity of the lender, namely U.S. or foreign, is irrelevant for this purpose.

[9] The pledge of stock representing 66 2/3 percent or more of the foreign subsidiary's voting power only triggers the application of Section 956 if it is accompanied by negative covenants or restrictions on the parent effectively limiting the foreign subsidiary's ability to dispose of assets or incur liabilities outside of the ordinary course of its business. The Treasury Regulations include an example of an impermissible stock pledge because it is coupled with restrictions or prohibitions on the ability of the foreign subsidiary to do any of the following without the consent of the lender: (i) borrow money or pledge assets (except in the ordinary course of business), (ii) guarantee, assume or become liable on another's obligation or invest in, or lend to, another, (iii) merge or consolidate with any other corporation or transfer shares of any controlled subsidiary, (iv) sell or lease (other than in the ordinary course of business) or otherwise dispose of any substantial part of its assets, (v) pay or secure any debt owing by the subsidiary to the parent, and (vi) pay any dividends, except as needed to pay debt service on the parent's loan. Of course, these are precisely the negative covenants that any prudent lender would require.

[10] One complication not addressed here is that the foreign tax-credit limitation is applied separately to nine categories (or "baskets") of income such as for passive income, financial services income and general income. The American Jobs Creation Act of 2004 reduces the number of categories to two (passive income and general income) for tax years beginning after December 31, 2006. In the case of foreign subsidiaries, certain "look-through" rules require preserving these separate categories. As a general proposition, separate basket limitations tend to produce a lower foreign tax-credit limitation than if an overall limitation applied. The analysis of the foreign tax-credit effect on the borrower must not be limited to the deemed dividend, but rather must consider the borrower's entire foreign tax-credit situation.

[11] A lender should obtain from the borrower the expiration dates of the NOLs to better understand how much value these NOLs are likely to have to the borrower. Generally, NOLs generated after 1997 may be carried forward for 20 years while those generated in earlier years may be carried forward for 15 years. In addition, if the borrower's balance sheet contains a valuation allowance for the NOLs, it generally means that there is substantial uncertainty as to whether such portion of the NOLs will ever be utilized by the borrower, and hence utilization of such NOLs to offset deemed dividend income may have little or no adverse tax consequences to the borrower.

[12] We recommend that any change in capital structure that is undertaken to implement this pledge arrangement be intended to be permanent and not be unwound immediately after the credit facility is repaid.

[13] The specific stock pledge rule is not in the Code, but rather is in Treasury Regulation section 1.956-2(C)(2) that was promulgated by the Treasury Department in 1980.