

New Proposed Treasury Regulations May Eliminate Adverse Tax Consequences on Use of Foreign Credit Support for US Corporate Borrowings

But Holding Period and Other Requirements Add Complexity

On October 31, 2018, the US Treasury and Internal Revenue Service issued proposed regulations (the Proposed Regulations) that would eliminate, in most circumstances, the deemed dividend or repatriation tax resulting from the provision by foreign affiliates of guarantee and collateral support to borrowings by US corporations. The Proposed Regulations are intended to conform the rules governing foreign credit support of US borrowings with the “territorial” dividend exemption regime created in December 2017 by the Tax Cuts and Jobs Act (the Act).¹ Accordingly, the relief provided by the Proposed Regulations is limited to US corporate shareholders of foreign affiliates. Additionally, the relief is subject to limitations similar to those imposed on US corporations in order to receive foreign cash dividends free of US tax. Although the Proposed Regulations are not yet effective, a taxpayer may, subject to a consistency requirement, rely on them immediately for taxable years beginning after December 31, 2017.

Background

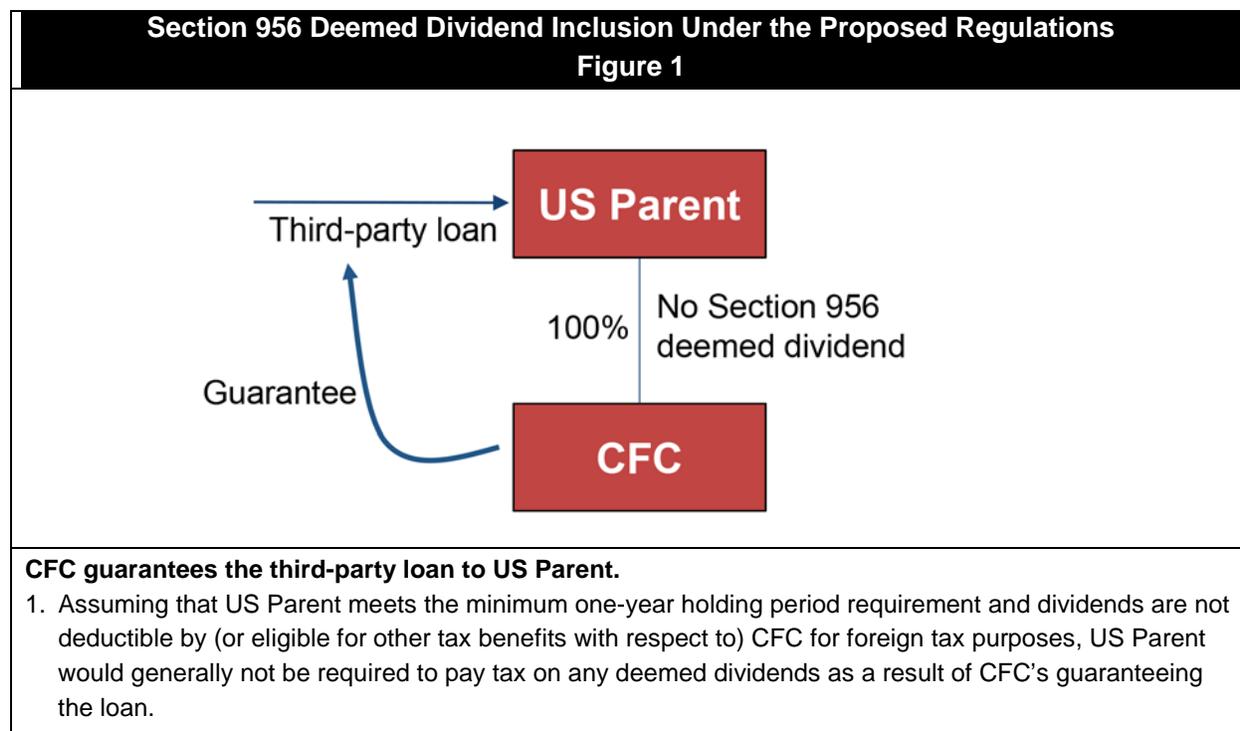
The Act introduced a territorial dividend exemption regime — subject to a one-time transition tax on accumulated pre-2018 foreign earnings — under which, earnings of foreign subsidiaries of US corporate parents can be repatriated without the incurrence of US income tax, if certain requirements are met. While a US shareholder may pay some level of current tax on offshore earnings of foreign affiliates under either the retained Subpart F rules or the new “global intangible low-taxed income” (GILTI) rules introduced by the Act, there is generally a 100% dividends received deduction (DRD) for the foreign-source portion of dividends received from a foreign corporation by a US corporate shareholder that owns 10% or more of that foreign corporation and meets the minimum holding period of one year. This DRD rule removed the historical US tax “friction” of a repatriation tax on actual distributions of offshore earnings.

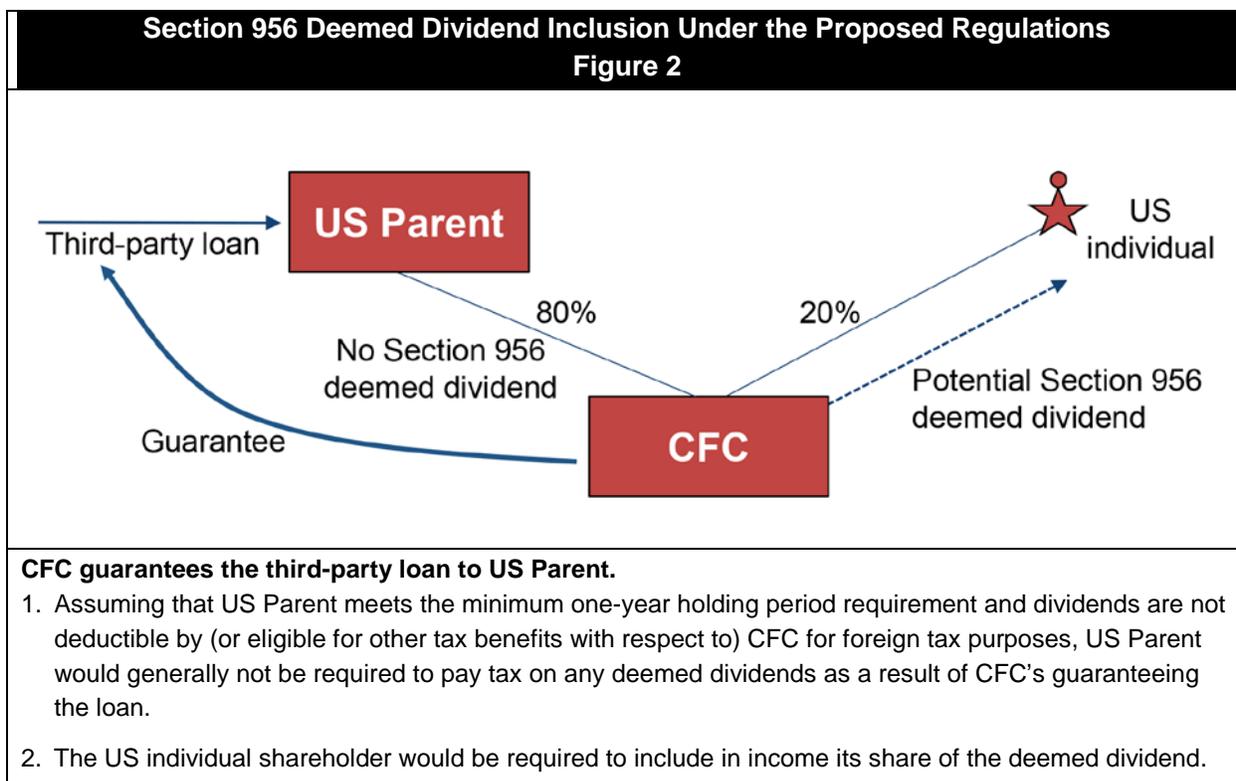
One unexpected provision in the Act, however, was the retention of Section 956,² which generally subjects a US shareholder to an income inclusion (a “Section 956 deemed dividend”) for the previously untaxed offshore earnings of a foreign subsidiary that is a “controlled foreign corporation” (CFC) with

respect to that US shareholder when the CFC guarantees or provides other collateral support for debt of a related US borrower or makes loans to or other investments in a US affiliate. Thus, in order to avoid income inclusions under Section 956 both before and after the Act, US borrowings have traditionally excluded CFCs from providing guarantees or pledging assets and limited the pledge of first-tier CFC stock to less than 66⅔% of the total combined voting power of all classes of voting stock. The potential practical impact of Section 956 after the Act was mitigated by the fact that many CFCs no longer have significant untaxed earnings due to paying the one-time transition tax. Nevertheless, the retention of Section 956 under the new territorial dividend exemption regime has produced an odd result — that Section 956 deemed dividends have remained subject to tax while actual dividends paid to US corporate shareholders generally have become exempt.

Proposed Regulations

The stated purpose of the Proposed Regulations is to harmonize the taxation of actual dividends and the taxation of Section 956 deemed dividends for US corporate shareholders. To achieve this result, the Proposed Regulations provide that a US corporate shareholder's Section 956 deemed dividend amount is reduced by the amount of the DRD that the US corporate shareholder would have been allowed had it received from the CFC an actual distribution of such Section 956 deemed dividend amount. As a result, under the aforementioned DRD and the Proposed Regulations respectively, neither a qualifying actual dividend to a US corporate shareholder nor a qualifying Section 956 deemed dividend to a US corporate shareholder would result in additional US tax as shown below in **Figure 1**. As shown below in **Figure 2**, non-corporate US shareholders remain subject to tax on Section 956 deemed dividends.





Takeaways, Limitations, and Open Issues

The big takeaway is that the Proposed Regulations largely eliminate adverse tax consequences arising from credit support from CFCs for US borrowings. However, the following exceptions and limitations apply:

- The relief is unavailable for individuals and for real estate investment trusts and regulated investment companies. The Proposed Regulations seek public comment regarding the appropriate treatment of US corporate partners in US partnership borrowers.
- A one-year holding period on the CFC stock generally is required. However, if such holding period ends up being satisfied after the end of a CFC's taxable year, any Section 956 deemed dividend for the CFC's taxable year could become retroactively exempt from taxation.
- The Section 956 deemed dividend cannot be considered a "hybrid dividend." A hybrid dividend is generally a Section 956 deemed dividend for which the CFC would have received a deduction (or other tax benefit) with respect to taxes imposed by a foreign country had the CFC paid an actual dividend. US corporate borrowers seeking credit support from CFCs may need to ascertain whether dividends are deductible by the CFC under its local tax law.

Importantly, if a taxpayer chooses to rely on the Proposed Regulations for Section 956 relief before they become effective, the taxpayer (and other related US persons) must apply the Proposed Regulations consistently to all CFCs it holds. Accordingly, a US borrower with multiple CFCs and other US and foreign affiliates may need to evaluate the consequences of "early" application of the Proposed Regulations in light of these consistency requirements. Parties to US corporate borrowings should also be mindful of the

requirements under their existing credit support provisions, especially if the credit documents automatically require the borrower to provide additional credit support in the absence of adverse tax consequences.

Treasury's decision to provide this relief may have been driven in part by a realization that a repatriation tax on offshore earnings of foreign affiliates providing credit support to their US shareholders is not consistent with the policy goals of a territorial dividend exemption regime. The decision may also have been based on the view that Section 956 might, following passage of the Act, be used by taxpayers in connection with affirmative foreign tax credit planning techniques that are inconsistent with Treasury's view of the new US international tax regime. Regardless, the Proposed Regulations remove the US tax impediments to the provision of foreign credit support to US borrowers in many instances. As discussed above, however, the application of the Proposed Regulations is subject to several requirements and limitations. In addition, while the Proposed Regulations remove many US tax impediments to foreign affiliates providing credit support to US corporate borrowers, any foreign tax, legal, regulatory, as well as other requirements and practical impediments precluding foreign collateral support remain unaffected by the Proposed Regulations. As a result, borrowers should seek legal advice when structuring US borrowings with foreign credit support.

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Endnotes

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- ¹ Public Law No. 115-97 (Dec. 22, 2017). Shortly before final Congressional approval of the legislation, the Senate parliamentarian struck the previously attached short title, the "Tax Cuts and Jobs Act." While the final legislation no longer bore a short title, many commentators have continued to refer to it as the Tax Cuts and Jobs Act.
 - ² All references to "Section" are references to sections of the Internal Revenue Code of 1986, as amended.