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Final Section 956 Regulations Open the Door to Foreign Credit Support for US Corporate Borrowers

Section 956 final regulations confirm those eligible for territorial dividend exemption can benefit from foreign guarantee and collateral support without incurring US tax.

On May 23, 2019, the US Treasury and Internal Revenue Service (together, Treasury) published final regulations (the Final Regulations) under Section 956[1] that allow US corporate borrowers to obtain credit support from non-US entities without incurring US tax, so long as certain conditions are met. The Final Regulations generally adopt the proposed regulations published by Treasury on November 5, 2018 (the Proposed Regulations).

The Final Regulations treat any deemed distribution resulting from the provision by foreign affiliates of credit support to borrowings by US corporations in generally the same manner as actual cash distributions, which US corporations in most circumstances can receive free of US tax under the "territorial" dividend exemption regime enacted by the Tax Cuts and Jobs Act (the Act)[2] in December 2017. As is also the case for the territorial dividend exemption, the relief provided by the Final Regulations is:

i. Limited to US corporations that own, directly, indirectly or constructively, 10% or more of the stock of the relevant foreign corporations by vote or value (US corporate shareholders)

ii. Subject to a holding period and certain other limitations

The Final Regulations will generally apply to taxable years of foreign corporations beginning on or after July 22, 2019, but taxpayers may apply the Final Regulations to taxable years beginning as early as January 1, 2018, if all related parties apply them consistently.

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 paying US tax, provided 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 meets the minimum holding period of one year.

However, the Act retained Section 956, which generally subjects a US shareholder to a taxable income inclusion (a Section 956 deemed dividend) for any previously untaxed offshore earnings of a foreign subsidiary that is a "controlled foreign corporation" (a CFC) when such CFC guarantees or provides certain collateral support for debt of a related US borrower or makes loans to or other investments in a US affiliate. The retention of Section 956 under the new territorial dividend exemption regime produced an incongruous result — Section 956 deemed dividends remained potentially subject to tax, while actual dividends paid to US corporate shareholders became exempt.

After the Act, some US borrowers have been able to offer CFC credit support without adverse US tax consequences in light of their circumstances, including the application of the transition tax, which generally eliminated pre-2018 untaxed earnings of CFCs, and other Act provisions, such as GILTI. However, most US borrowings have retained "customary Section 956 carve-outs," *i.e.*, (i) exclusion of CFCs from providing guarantees or pledging assets and (ii) limit on pledges of first-tier subsidiary CFC stock to less than $66^2/_3\%$ of the total combined voting power of all classes of voting stock.

On November 5, 2018, Treasury published the Proposed Regulations in an attempt to remedy this asymmetry, and the Final Regulations adopt the rules contained in the Proposed Regulations with very few changes.

- For analysis of the Proposed Regulations, read the *Client Alert* "New Proposed Treasury Regulations May Eliminate Adverse Tax Consequences on Use of Foreign Credit Support for US Corporate Borrowings" (November 5, 2018)
- For analysis of the provisions of the Tax Cuts and Jobs Act, read the *White Paper* "US Tax Reform Key Business Impacts Analyzed, with Transactional Diagrams" (January 10, 2018)
- For additional background and resources, visit the Latham & Watkins US Tax Reform Resource Center

Highlights of the Final Regulations

- 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 an actual cash distribution in the amount equal to such Section 956 deemed dividend from the CFC. This means that a US corporate borrower will generally not be subject to a deemed dividend under Section 956, if:[3]
  - The US corporate borrower (or a US corporate affiliate of the borrower owning the CFC) satisfies a one-year holding period requirement with respect to the CFC (which may also be satisfied retrospectively, by continuing to own the CFC after the date of the deemed dividend)
  - The dividend is not a "hybrid dividend" — generally, a 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
  - The dividend is foreign source — generally meaning that the CFC does not own a US business or US assets
- A US corporate partner in a borrower that is a US partnership, or LLC treated as a partnership for US tax purposes, will generally qualify for the same relief from the Section 956 deemed dividend

treatment as a US corporate borrower described above, provided that the partner is a US corporate shareholder with respect to the CFC.

- The DRD is *not* available to, and as such, relief from the Section 956 deemed dividend treatment does *not* extend to:
  - A US shareholder that is an individual (owning a CFC directly or indirectly through a US partnership or LLC treated as a partnership)
  - A REIT or RIC (owning a CFC directly or indirectly through a US partnership or LLC treated as a partnership)
- The Final Regulations apply to taxable years of a CFC beginning on or after July 22, 2019, but taxpayers may apply the Final Regulations for all taxable years of a CFC beginning after December 31, 2017, provided all related parties apply them consistently.

Practical Implications for US Borrowers and Their Lenders

1. US corporate borrowers (and US partnership borrowers with US corporate shareholders as partners) and their lenders now have certainty that deemed dividends resulting from the provision of foreign credit support are treated in a manner generally comparable to the receipt of cash dividends from the applicable CFCs and can structure their financings accordingly. The potential to provide additional credit support adds flexibility to improve execution on financings.

2. A US corporate borrower (or a US partnership borrower with US corporate shareholders as partners) that satisfies a one-year holding period requirement with respect to its CFCs should generally be able to receive credit support from such CFCs without incurring US tax, assuming certain conditions are met (see #5 below). In the case of an acquisition financing for a US corporate target with CFC subsidiaries, the one-year holding period requirement in respect of the CFCs may be satisfied through the US corporate target's historical ownership of the CFCs.

3. US borrowers may consider a springing guarantee if the one-year holding period requirement is not met at the time of closing the financing or if a CFC is newly acquired in the future.

4. A US partnership (including a US LLC treated as a partnership) borrower with individual or other US non-corporate partners, or with US corporate partners who are not US corporate shareholders with respect to the relevant CFCs, would continue to have deemed dividend concerns, and may need to retain the customary Section 956 carve-outs.

5. Even for a US corporate borrower (or a US partnership borrower with US corporate shareholders as partners) meeting the holding period requirement, due diligence is needed to ensure that:

   a) No "hybrid dividend" concern under foreign tax law exists

   b) The deemed dividend would be foreign source based on activities and assets of the CFC

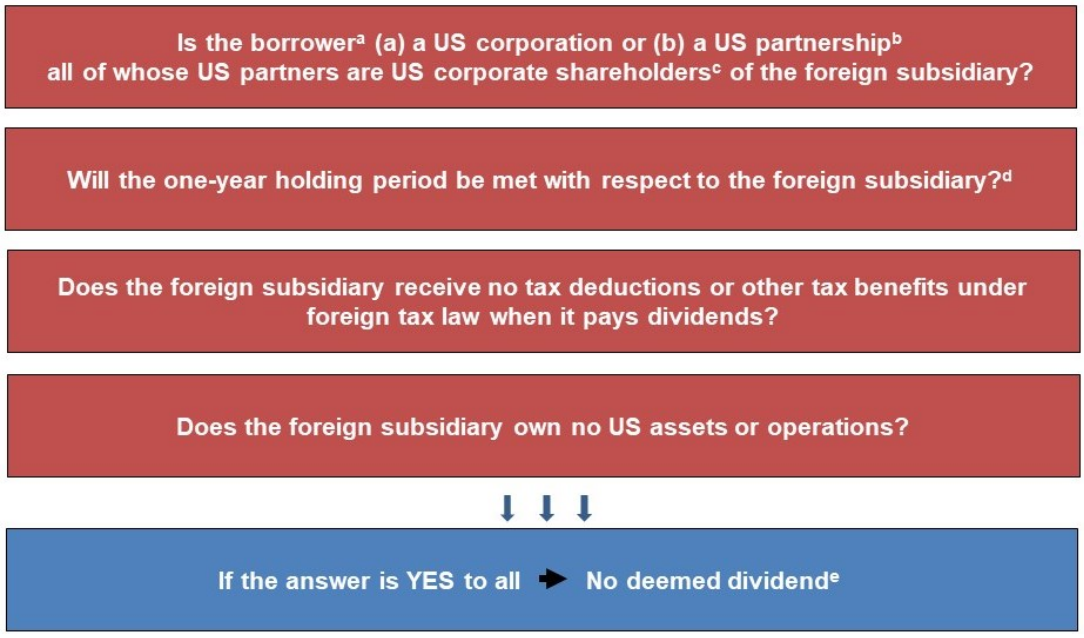
6. US corporate and partnership borrowers should conduct diligence to determine, as early as possible, the extent of their Section 956 exposure, if any, so that parties can focus on and work toward achieving the optimal credit support for efficient deal pricing.

7. Local law restrictions, including corporate benefit doctrine and financial assistance considerations, must still be taken into account for foreign guarantees or credit support.

8. Although the Final Regulations are not yet effective, taxpayers are given flexibility to apply them before they become effective and, for certain taxpayers, applying the Final Regulations early may be beneficial. However, in light of the related person consistency requirement noted above, taxpayers — particularly taxpayers that are portfolio companies of private equity funds — should confirm that all persons related to the portfolio company, to the extent relevant, apply the Final Regulations consistently.

9. A US corporate purchaser contemplating a direct purchase of stock in a CFC should conduct diligence regarding whether such CFC has been providing credit support to a US obligor and, if so, consider whether a Section 338(g) election should be made.

A Quick Guide for Assessing Section 956 Exposure
(assuming the borrower is a US entity with a 100%-owned foreign corporate subsidiary)



[a] If the US borrower does not directly own the foreign subsidiary, this question would apply to the most direct US owner of the foreign subsidiary.
[b] A "partnership" includes an LLC treated as a partnership for US tax purposes.
[c] A "US corporate shareholder" means a US corporation owning (directly, indirectly or by attribution) 10% or more of the stock of the foreign subsidiary by vote or value.
[d] The holding period may be met retrospectively. The determination is complex, especially if stock is sold to another US person.
[e] Subject to the effective date.

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Endnotes

1 All references to "Section" are references to sections of the Internal Revenue Code of 1986, as amended.

2 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.

3 The Final Regulations add certain technical fixes to the Proposed Regulations, including an ordering rule, to ensure this result.