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SECURED TRANSACTIONS

Credit Agreements, the New Tax Act and the Deemed Dividend

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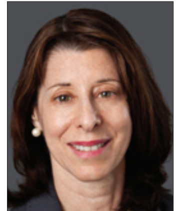

True confessions of a finance lawyer: I don't like dealing with tax issues. I won't go into why, but I'm happy that tax issues usually don't play a major role in most plain vanilla syndicated secured lending facilities. One area, however, that we finance lawyers have had to contend with, even in plain vanilla syndicated loan facilities, is §956 of the Internal Revenue Code (IRC).

With an exponential growth in overseas operations, large U.S. companies now derive a significant percentage of their earnings from foreign subsidiaries. But parties have rarely been able to use overseas assets or revenues as additional collateral or credit enhancement in finance transactions due to §956. Simply put, §956 was intended to prevent U.S. corporations from realizing benefits from overseas earnings "onshore" without first paying a tax on those earnings.

Prior to the new tax act, except in certain circumstances, U.S. taxes on overseas revenue were not due until the revenues were paid into the United States. A domestic company with foreign earnings was liable for U.S. taxes on those earnings once it received them through a dividend or otherwise. Section 956(d) created an exception to this rule relevant to credit agreements. Until recently at least, §956(d) provided that any U.S. shareholder owning at least 10 percent of an overseas subsidiary, specifically, a "controlled foreign corporation" (a "CFC," defined generally in IRC §957 as a foreign corporation majority-owned by U.S. 10% shareholders), received the functional equivalent of a dividend (i.e., a "deemed dividend") from its subsidiary when that subsidiary provided a pledge or guaranty to secure the obligations of its parent. In light of those possible adverse tax consequences, credit enhancement under finance facilities from foreign subsidiaries was usually limited to a pledge of less than two-thirds of the equity of first tier foreign subsidiaries of a U.S. obligor (the two-thirds limit being a response to relevant Treasury regulations).

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This has all now changed (or has it?) under the tax act signed into law this past December (informally known as the Tax Cuts and Jobs Act of 2017 (Pub. L. 115-97, 131 Stat.2054 (2017)).

The 2017 Tax Act

The new tax act effected several changes to the tax treatment of earnings and profits of foreign subsidiaries:

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(1) it mandated a one-time inclusion of all of a foreign corporation's undistributed earnings as of November 2 or Dec. 31, 2017, whichever amount is greater—essentially a deemed repatriation of those earnings into the United States; and

(2) it created a 100 percent "participation" exemption or "dividends-received" deduction for dividends (to the extent based on foreign income) received by U.S. corporate (and only corporate) shareholders from most foreign subsidiaries (excluding passive foreign investment companies).

This means generally that, going forward, 10 percent domestic corporate shareholders (who have owned their equity at least one year (which holding period can be satisfied post-distribution)) can receive distributions of accumulated and current earnings and profits from their non-U.S. subsidiaries without being subject to federal income tax. Overseas revenue of the foreign subsidiary of a U.S. parent will now either not be subject to U.S. income tax or taxed to the U.S. shareholder when earned under either the subpart F rules or the new "GILTI" rules discussed below. Note in particular that the new exemption/deduction applies only to corporate shareholders, notwithstanding that the §956 rules continue to apply generally to all types of shareholders.

Given that an actual repatriation of foreign earnings now can be achieved tax-free, these changes should rightly have translated into a repeal of §956 … and that repeal was generally anticipated. But to everyone's surprise, §956 remains in place.

Not only was §956 unexpectedly retained but the tax act changes two relevant rules that make application of §956 to borrowing arrangements more complicated than under prior law and could render the standard §956 provisions in credit agreement no longer adequate to protect the borrowing group from a deemed dividend.

First, the tax act expands the definition of a "United States shareholder" for purposes of the CFC rules. Under prior law, a "United States shareholder" was a U.S. person who owned (applying certain attribution rules) 10 percent or more of the combined voting power of all classes of voting stock of a foreign corporation. The tax act modifies this definition to also include U.S. persons who own 10 percent or more of the total *value* of shares of all classes of stock of the foreign corporation.

Second, the act adds downward attribution rules that result in stock owned by a foreign person being attributed to a United States person. As a result of these new rules, if a foreign company owns the majority of both a foreign and a U.S. subsidiary, the parent's ownership of the foreign subsidiary could be attributed to its U.S. subsidiary. This could result in the classification of the foreign subsidiary as a CFC even though it's not owned by a U.S. 10% shareholder. Accordingly, a guaranty by the foreign subsidiary of debt of its sister U.S. subsidiary could constitute a deemed dividend to a United States shareholder, assuming a U.S. person (including a U.S. partnership) owns directly or indirectly 10 percent or more of by voting power or value of the foreign parent.

> Parties to credit facilities with multinational companies are well-advised on both the borrower and lender side to review the structure and modeling of their collateral packages in light of the provisions of the new tax act (whether domestic parented or foreign parented).

Notwithstanding such concerns, there are fortunately some mitigants. Section 956 results in a deemed dividend only to the extent that the relevant CFC has untaxed earnings and profits. As discussed above, the tax act includes a special one-time deemed repatriation of deferred earnings and profits for all CFCs (for which United States shareholders were subject

to special tax rates). In addition, the act adds a new type of deemed income tax liability called "GILTI" (an acronym for "global intangible low-taxed income"). The GILTI tax imposes a tax on income from the performance of services for or sales of property to non-U.S. customers initially for corporate taxpayers at the lowered rate of 10.5 percent. It generally requires a U.S. shareholder of a CFC to include in income, as a deemed dividend, the excess of the U.S. shareholder's net CFC "tested income" over a net "deemed tangible income return." Therefore, between §965 and GILTI (and the unchanged subpart F income rules), many CFCs may have significant previously taxed earnings and profits, which when included pursuant to §956 as a deemed dividend, would not be subject to tax a second time. Finally, as noted above, there is now the ability to repatriate earnings without the imposition of U.S. federal taxes to domestic corporate shareholders.

The curious result of these changes, combined with the fact that §956 is unchanged in regard to pledges and guaranties, is a net negative for U.S. based borrowers and lenders alike. Overseas earnings can now be transferred via dividend to a U.S. parent tax free, but if the cash remains with the foreign subsidiary, and that foreign subsidiary provides a pledge or guaranty for its U.S. parent obligations, there will be a "deemed dividend" taxed at the regular corporate rate to the extent of the subsidiary's earnings that were not previously taxed. Clearly a somewhat questionable outcome.

Ultimately, the much reduced risk of adverse tax consequences to repatriation compared to the still significant negative consequences of a pledge or guaranty from a foreign subsidiary may encourage lenders and borrowers to consider new covenants and structures. Lenders may be interested in requiring repatriation of excess cash back to the United States from material foreign subsidiaries in exchange for giving borrowers more favorable pricing or loosening of restrictions on activities such as foreign acquisitions and investments. This would certainly make sense given that these monies can now be repatriated tax-free. This of course would need to be weighed against possible countervailing considerations, such as withholding taxes or similar assessments imposed by foreign jurisdictions on such distributions.

For other reasons, including new limitations under 163(j) and a new base erosion tax (the "BEAT") imposed by the tax act, U.S./non-U.S. co-borrower structures may be viewed more favorably than a foreign borrowing followed by an intercompany loan (or "debt push down") to U.S. affiliates (with the possibility of providing for a collateral allocation mechanism which, if properly structured, should not present additional §956 concerns).

It should be noted that there is no "grandfather" provision in the new tax statute, so that a transaction that would not have triggered a deemed dividend under prior law may now be subject to such adverse consequences unless the collateral package is modified to take into account the revisions contained in the new act.

Conclusion

Parties to credit facilities with multinational companies are well-advised on both the borrower and lender side to review the structure and modeling of their collateral packages in light of the provisions of the new tax act (whether domestic parented or foreign parented). Both existing agreements and the boilerplate provisions in new agreements may need to be reviewed and possibly amended both to avoid adverse tax consequences as well as to take advantage of new features put in place by this act.

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