New Regs May Substantially Impact Multinational Financing

By **Steven Garden, Kenneth Klein and David Goett** · November 9, 2018, 3:21 PM EST

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On Oct. 31, 2018, the IRS released proposed regulations that, if finalized, may substantially impact the way in which multinational corporations finance their operations. The proposed regulations' stated goals are aimed at maintaining taxpayer neutrality between repatriating cash of offshore subsidiaries through the use of distributions or investments by the subsidiary in U.S. property. However, the proposed regulations also have the effect of denying indirect foreign tax credits that may otherwise be available in respect of a Section 956 inclusion.

Historically (i.e., prior to January 2018), taxpayers could achieve some level of deferral with respect to offshore earnings through the use of an offshore corporate subsidiary. Under the Subpart F regime, U.S. shareholders (i.e., 10 percent owners by vote)[1] of a controlled foreign corporation, or CFC — a foreign corporation owned more than 50 percent by U.S. shareholders — generally were only subject to immediate taxation on certain categories of passive and related-party income derived by the CFC. Other income generally was not taxed to U.S. shareholders until the earnings were actually distributed to the shareholders.

An important exception to this rule is found in Section 956, which generally results in a taxable inclusion to U.S.

shareholders if a CFC invested its earnings in “U.S. property.” A CFC investment in U.S. property could take place where the CFC purchased stock of a U.S. shareholder, loaned cash to a U.S. parent or guaranteed or otherwise supported borrowing by a U.S. parent, or acquired tangible or intangible property located or used in the United States. Congress viewed a CFC’s investment in U.S. property as an “effective repatriation of earnings,” which should result in taxing U.S. shareholders in the same manner as if the CFC had actually distributed cash to them. Thus, Section 956 was intended to prevent taxpayers from circumventing income recognition by repatriating cash through means other than a dividend. Both actual distributions by the CFC and “effective repatriations” under Section 956 resulted in taxable income to the CFC’s U.S. shareholders.

In December 2017, Congress enacted the (commonly called) Tax Cuts and Jobs Act and broke the parity between actual distributions and “effective repatriations” under Section 956 by passing Section 245A, which generally allows corporate shareholders a 100 percent dividend-received deduction on dividends received from a foreign corporation in which they hold at least a 10 percent interest by vote or value. Surprisingly, Congress did not, however, repeal Section 956. Furthermore, the dividends-received deduction under Section 245A did not apply to Section 956 inclusions because a Section 956 inclusion is not technically a dividend.[2] The net result was that an actual repatriation of cash from a foreign corporation to a 10 percent corporate shareholder was tax-free in the United States, but a deemed repatriation of cash was subject to tax. This is not necessarily a detriment (and can actually be beneficial) because Section 245A(d) disallows foreign tax credits associated with the dividend while Section 960(a) appears to allow foreign tax credits in respect of Section 956 inclusions.

The proposed regulations seek to re-establish the equivalence between actual distributions and Section 956 inclusions by allowing U.S. corporate shareholders to take advantage of the Section 245A dividends-received deduction principles with respect to deemed inclusions under Section 956.

Therefore, assuming that the proposed regulations are finalized in substantially the same form, both actual repatriations and deemed repatriations would be tax-free in the United States to 10 percent corporate shareholders (assuming the requirements of Section 245A are met), without associated foreign tax credits brought up to the U.S. corporate shareholder.

The proposed regulations accomplish this result by providing that the amount otherwise included under Section 956 is reduced to the extent that the U.S. shareholder would be allowed a deduction under Section 245A if the shareholder had received a distribution from the CFC in an amount equal to the Section 956 inclusion.[3] While some Section 956 inclusions can remain on account of Section 245A's nuances, in many (if not most) cases involving a 10 percent corporate shareholder, these rules will exempt Section 956 inclusions from U.S. tax. The proposed regulations illustrate several fact patterns under which there could still be partial or total Section 956 inclusions — taxpayers desiring to utilize foreign tax credits may wish to consider these fact patterns carefully.

Importantly, Section 956 will continue to apply to noncorporate shareholders because noncorporate shareholders are not entitled to the Section 245A deduction. The proposed regulations seek comment on the application of these rules to U.S. shareholders that are domestic partnerships, which may have partners that are domestic corporations, individuals or other persons. The proposed regulations note two possible treatments of domestic partnerships under the new rules. The first approach would allow the domestic partnership to reduce a Section 956 inclusion to the extent its corporate partners would be entitled to a deduction under Section 245A. The second approach would render the new rules inapplicable to the domestic partnership entirely but allow a corporate partner a deduction under Section 245A on its distributive share of partnership income attributable to the Section 956 inclusions.

Section 956 will continue to apply to corporate entities that are not eligible for

the Section 245A dividends-received deduction, such as regulated investment companies and real estate investment trusts.

The preamble to the proposed regulations addresses at some length why the U.S. Department of the Treasury believes it has authority under Section 956(e) to make such a substantial change (which may make Section 956 inapplicable to the overwhelming percentage of investments in U.S. property).

The proposed regulations apply to taxable years of a CFC beginning on or after the date on which the final regulations are published in the Federal Register and to the taxable years of a U.S. shareholder in which or with which such taxable years of the CFC end. Taxpayers are entitled to rely on the proposed regulations prior to their effective date and with respect to taxable years of CFCs beginning after Dec. 31, 2017, provided that the taxpayer and its related persons consistently apply the proposed regulations with respect to all CFCs in which they are U.S. shareholders.

Impact on Financing Transactions

As discussed above, Section 956 loomed large in the context of financing transactions because of the way that it defined “investments in U.S. property.” In general terms, under Code Section 956 and the regulations thereunder, an obligation of a U.S. borrower to a third-party lender is considered an investment in U.S. property if:

- Stock representing two-thirds or more of the voting power of such borrower’s CFC is pledged to the lender advancing loans to the U.S. borrower;
- The borrower’s CFC guarantees payment of loans made to the U.S. shareholder; or

- The borrower's CFC grants a security interest to the lender in any of its assets (including the stock of lower-tier subsidiaries) to secure the loans to the U.S. shareholder.

To avoid a Section 956 inclusion, loan agreements typically (A) only require 65 percent or 66 percent of the voting stock of a first-tier CFC (or a U.S. holding company whose material assets all of which constitute CFC stock (a "CFC holding company")) to be pledged to a lender to secure the U.S. borrower, (B) provide that any CFC or CFC holding company is not required to guarantee the U.S. borrower's obligations (or to be liable thereon on a joint and several liability basis) and (C) provide that any CFC or CFC holding company is not required to pledge its assets (including the stock of lower tier subsidiaries) to secure the U.S. borrower's obligations (such collateral and guarantee limitations, the "956 Limitations").

The proposed regulations would substantially eliminate the impact of Section 956 on corporate lending transactions (which include a limited liability company that elected corporate classification). Under the proposed regulations, where there is certainty that the borrower is a pure corporate entity, it may be possible to provide a more expansive collateral package without running afoul of the previous Section 956 deemed dividend concerns. Notwithstanding such fact, the viability of any such enhanced collateral and guarantee package would have to be considered in light of the costs and ultimate enforceability of pledges and guarantees in foreign jurisdictions.

In lieu of the 956 limitations described above, certain existing loan agreements provide a simpler formulation that requires that all directly and indirectly held assets must be pledged and that all direct and indirect subsidiaries must become guarantors of the U.S. borrowing, except, in each case, to the extent that it would cause a material adverse tax event to the borrower. The application of any such provisions to a purely corporate borrower would need to be reevaluated in light of the proposed regulations because the proposed regulations could eliminate a potential material adverse

tax event and therefore give rise to an immediate requirement to provide a pledge and/or guarantee. As a result, it will be important for many existing U.S. borrowers to review their loan agreements to establish whether they could be in default if they do not provide all such pledges and/or guarantees and to take related actions such as providing corporate resolutions and legal opinions and perfecting liens during such period, automatically upon implementation of the proposed regulations.

As mentioned above, the proposed regulations do not apply to noncorporate entities. Thus, in many (if not all) situations in which the borrower is an individual or an entity treated as a partnership that has noncorporate 10 percent U.S. shareholders, the 956 limitations will likely need to be retained. In addition, the various fact patterns under which there may still be Section 956 inclusions must be taken into account.

Impact on Planning Considerations

The proposed regulations also impact tax planning. Prior to the proposed regulations, the rules resulted in disparate treatment of actual distributions versus Section 956 inclusions, particularly in the foreign tax credit context. While actual distributions no longer result in U.S. corporate shareholders being deemed to have paid a portion of the foreign subsidiary’s foreign taxes, Section 960 does allow an indirect credit for inclusions under Section 951(a)(1) (which includes Subpart F income and Section 956 inclusions). Although not entirely clear, a Section 956 inclusion, as a result, appears to bring with it indirect foreign tax credits to U.S. corporate shareholders. This means that a U.S. corporate shareholder may be able to access different consequences depending on an actual versus a deemed repatriation. The proposed regulations would foreclose this possibility with respect to any amounts that give rise to a Section 245A dividends-received deduction and, thus, can be detrimental to taxpayers (although it appears that foreign tax credits may still be accessed through Section 956 inclusions in the 2018 and 2019 tax years given that, unless a taxpayer elects to consistently apply the

proposed regulations to each of its CFCs, the rules would only become effective for tax years beginning after the publication of the final regulations, which is unlikely to occur until 2019). Some taxpayers may wish to consider structuring in a way that the proposed regulations would not apply to them.

CFCs generally now would be able to invest directly in the United States, such as by acquiring businesses or property in the United States or lending cash directly to their U.S. parents. This may be a desirable alternative to distributing dividends up the chain of ownership (because of foreign income and withholding taxes that may be imposed). However, taxpayers would need to carefully analyze a number of considerations in connection with these alternatives, including U.S. source of income, effectively connected income/permanent establishment rules and branch profit tax rules. Specifically with respect to the lending of cash by a CFC to its U.S. parent, taxpayers would want to consider U.S. withholding tax implications under applicable U.S. tax treaties, limitations on the deductibility of the U.S. parent's interest and U.S. and foreign taxation of the CFC's interest income.

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[1] After the passage of the (commonly called) Tax Cuts and Jobs Act, the definition of a "US shareholder" was changed to include any US person that owns 10% or more of a foreign corporation by vote or value.

[2] See Rodriguez v. Commissioner, 722 F.3d 306 (5th Cir. 2013).

[3] Generally, if the U.S. shareholder owns the stock of the CFC indirectly, the requirements of Section 245A will be tested as if the U.S. shareholder owned the stock directly (a “hopscotch” approach), except that the hypothetical distribution will be deemed to have been made through the chain of CFCs for purposes of applying the rule that denies the deduction for hybrid dividends.