October 31, 2018

Proposed Treasury Regulations Would Limit the "Deemed Dividend" Rule of Section 956 and May Impact Guarantee and Collateral Packages of U.S. Corporate Borrowers

Today, the Treasury Department and the Internal Revenue Service issued proposed regulations that would largely eliminate a puzzling inconsistency created by the 2017 U.S. tax reform legislation commonly referred to as the Tax Cuts and Jobs Act (the "Tax Act"). The Tax Act adopted an exemption for dividends *actually* received by U.S. corporations (other than REITs and RICs) from their 10 percent owned non-U.S. corporate subsidiaries but—to the surprise of many—left unchanged the historic treatment of dividends that are "*deemed*" received from non-U.S. subsidiaries pursuant to Section 956 of the Internal Revenue Code. The proposed regulations would alleviate the federal tax consequences of these "deemed" dividends, and in turn may also affect guarantee and collateral packages in traditional U.S. corporate financing arrangements.

Section 956 generally requires U.S. persons that are 10 percent or greater shareholders of U.S.-controlled foreign corporations (or "CFCs") to include in income, on a current basis, their pro rata share of such foreign corporations' "investment in U.S. property" (but generally not in excess of previously untaxed earnings and profits of a CFC). For this purpose, a guarantee by a CFC of an obligation of its U.S. shareholder, as well as any pledge of a CFC's assets or 66.66% or more of its voting stock to secure such an obligation, is treated as an investment in U.S. property. As a result, Section 956 historically has operated as an impediment to such guarantees and pledges.

The proposed regulations would largely eliminate the disparate treatment of actual dividends and Section 956 "deemed" dividends received by U.S. corporations from 10 percent owned non-U.S. corporate subsidiaries by allowing such deemed dividends to qualify for the exemption from U.S. federal income tax to the same extent as an actual dividend would. The proposed regulations will generally be effective once finalized, but in the interim may be relied upon by taxpayers with respect to CFC taxable years beginning after December 31, 2017. The proposed rules import certain limitations applicable to the exemption for actual dividends (*e.g.*, a one-year holding period requirement and exception for so-called "hybrid dividends") and certain questions remain about their application, including in the case of foreign subsidiaries held through partnerships, which will require scrutiny by corporate borrowers. However, we expect that, in many cases, the proposed regulations may operate to eliminate the adverse U.S. tax consequences previously resulting from CFC guarantees and pledges of CFC stock or assets.

U.S. corporate borrowers should assess carefully the impact of the new rules on guarantee and pledge provisions in their debt agreements to make sure that the removal of this tax related constraint will not have the unexpected effect of *requiring* the borrower to add its foreign subsidiaries as guarantors or pledgors. And going forward, U.S. borrowers should ensure that their future debt agreements are clear as to whether they will be required to cause foreign subsidiaries in certain jurisdictions to become guarantors or pledgors of the borrower's debt. While the proposed regulations may mitigate an important constraint, obtaining foreign guarantees and collateral will often remain an onerous exercise, due to the need for non-U.S. counsel and perfection steps, and limitations imposed by many local laws. As always, borrowers should stay abreast of the issue and negotiate carefully. Even with the Section 956 constraints removed, the cost of adding foreign guarantors—particularly in non-traditional jurisdictions—will often outweigh the benefits.

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