ALERT MEMORANDUM

Proposed IRS Regulations Would Largely Eliminate "Section 956 Deemed Dividends" for U.S. Multinationals and Expand the Range of Credit Support From Non-U.S. Subsidiaries That They Can Provide to Lenders

November 1, 2018

Under proposed regulations issued yesterday (October 31), U.S. multinationals would generally be relieved from the "Section 956 deemed dividend rules" that have significantly limited their ability to provide lenders with credit support (for example, in the form of guarantees and collateral) from their non-U.S. subsidiaries. In general, under the proposed regulations, the credit packages provided to lenders will no longer need to exclude upstream guarantees from non-U.S. subsidiaries or limit the amount of foreign subsidiary stock that may be pledged to support the borrowing to 65% of the stock of first-tier foreign subsidiaries.

While the rules are in proposed form, taxpayers can rely on them for the tax years of their foreign corporations that start after December 31, 2017. However, many U.S. multinationals may prefer to continue to include existing limitations in their financing agreements until the regulations are finalized, and eventually to replace them in future agreements with narrower limitations targeted at those situations to which the Section 956 deemed dividend rules may continue to apply. Other reasons for continuing to exclude some or all non-U.S. collateral may continue to exist, including higher cost of granting and perfecting security interest, local legal limitations and lesser protections for secured lenders.

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Background

Under Section 956, a U.S. shareholder of a controlled foreign corporation ("CFC") is deemed to receive a taxable dividend if the CFC lends money to a related U.S. person *or* supports a borrowing by such person (or otherwise makes an investment in U.S. property). As a result, financings by U.S.-parented multinational groups routinely provide that foreign subsidiaries may not provide guarantees, and limit the amount of foreign subsidiary stock that may be pledged to support the borrowing to 65% of the stock of first-tier foreign subsidiaries. Section 956 also results in complicated structuring for multi-borrower facilities involving both U.S. and foreign borrowers.

The 2017 tax reform law enacted a participation exemption for U.S. corporate shareholders, so that dividends from 10% owned foreign subsidiaries to such shareholders would be exempt from U.S. tax. Early versions of the tax reform law also would have excluded U.S. corporate shareholders from the application of Section 956, but this provision was ultimately dropped from the final bill, presumably because of its budgetary impact (it was scored by the Congressional Budget Office to cost $2 billion over 10 years). As a result, the tax reform law left U.S. corporate shareholders of CFCs in a bizarre position: actual cash distributions from CFCs are exempt from tax, but deemed dividends under Section 956 were taxed. This inconsistency left a trap for the unwary, but also created opportunities for savvy taxpayers to take advantage of the deemed repatriation (*e.g.* through foreign tax credit planning).

The New Proposed Rule

Yesterday's proposed regulations correct this inconsistency by providing that, to the extent a distribution from a foreign subsidiary to a U.S. corporate shareholder would be eligible for the participation exemption, credit support by that foreign subsidiary (as well as other investments in U.S. property) will not be subject to Section 956. This should greatly simplify financing arrangements and structuring in many transactions and for many multinational groups.

However, importantly, Section 956 remains relevant in certain situations.

Section 956 will still apply to U.S. corporate shareholders in the following circumstances:

- To the extent the foreign subsidiaries have U.S.-source earnings
- If the foreign subsidiary stock is held for less than 365 days within the current and next taxable year
- If the U.S. corporate shareholder has hedged the investment in the foreign subsidiary
- If the Section 956 amount is treated as a dividend for U.S. tax purposes with respect to equity that gives rise to a deduction or other tax benefit to the foreign subsidiary

In addition, Section 956 still applies in full to U.S. shareholders that are individuals, trusts, RICs and REITs. Similarly, questions remain about the application of Section 956 to foreign corporations held through partnerships by such investors.

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