

Treasury Department Releases Proposed Section 956 Regulations Relating to Foreign Subsidiary Credit Support Arrangements

By Sam Lichtman, Kenneth K. Bezozo, Don Shiman | November 1, 2018

RELATED PRACTICES Capital Markets and Securities, Corporate, Mergers and Acquisitions, Private Equity, International, Tax

On October 31, 2018, the Treasury Department released proposed regulations (“the Proposed Regulations”) providing guidance on the application of Section 956 of the Internal Revenue Code of 1986, as amended (the “Code”) following recent tax law changes under the Tax Cuts and Jobs Act (the “Act”). In particular, the Proposed Regulations are intended to conform the Section 956 rules with the recently enacted participation exemption regime under Section 245A of the Code.

Under Section 956 of the Code, earnings of a controlled foreign corporation (“CFC”) are deemed repatriated to its U.S. shareholders if the CFC makes an investment in “U.S. property.” In such case, the U.S. shareholders of the CFC are required to include the amount deemed repatriated in income for U.S. federal income tax purposes. For purposes of this rule, a pledge by a U.S. shareholder of more than 66 percent of the voting shares of a CFC, a pledge of CFC assets or a CFC guarantee of a U.S. parent loan are treated as an investment by the CFC in U.S. property.

The participation exemption system under Section 245A of Code, provides that a domestic corporation (other than a REIT or a RIC) is entitled to a 100 percent dividend received deduction for certain distributions received from a foreign corporation in which it owns a 10 percent interest (the “Foreign Source DRD”). The Foreign Source DRD does not apply income inclusions under Section 956, even if the CFC distributes an amount equal to the inclusions in the same taxable year.

Accordingly, in order to give effect to the new participation exemption system and to conform the treatment of a deemed repatriation under Section 956 with an actual distribution by a CFC to its U.S. shareholders, the Proposed Regulations reduce a U.S. shareholder’s 956 inclusion by the deduction a U.S. corporate shareholder would have been entitled to under Section 245A if the amount deemed repatriated under Section 956 had been distributed by the CFC to its corporate shareholder.

As a result, U.S. corporate borrowers may have more flexibility to utilize pledges of the equity or assets of foreign subsidiaries and to include foreign subsidiary guarantees in U.S. parent credit facilities. Credit agreement limitations on foreign subsidiary pledges and guarantees should not, however, be eliminated without confirmation that a dividend from the foreign subsidiary to its U.S. parent would be eligible for the 100 percent dividend received deduction in that particular circumstance. Taxpayers may rely on the Regulations for taxable years beginning in 2018.