Proposed Regulations Under Section 956

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Corporate taxpayers that own interests in controlled foreign corporations ("CFCs") should be aware that proposed regulations issued on October 31, 2018, would significantly curtail the application of longstanding U.S. tax rules under section 956 of the Code. The change would alter current practice in the commercial loan market in the case of a U.S. issuer borrowing with credit support from its CFCs.

I. Background

Section 956 generally requires a U.S. shareholder to include the foreign earnings of a CFC in income upon the deemed repatriation of those earnings through investments in U.S. property. Upstream guaranties of the debt of the U.S. shareholder or pledges of more than two-thirds of the stock of the CFC by the U.S. shareholder generally constitute an investment in U.S. property under existing Treasury regulations.

Prior to the enactment of the Tax Cut and Jobs Act of 2017 (the "TCJA"), the treatment of investments in U.S. property by a CFC paralleled the treatment of actual dividends paid by a CFC. The TCJA, however, enacted section 245A, which generally exempts from tax dividends from a CFC to its corporate U.S. shareholders, without modifying section 956. This created a divergence between the taxation of investments in U.S. property and dividends paid by a CFC to a corporate U.S. shareholder. The proposed regulations would restore the parallel treatment of dividend payments and investments in U.S. property by disapplying section 956 to the extent that the U.S. shareholder would not be taxed if the amount had been paid as a dividend. If finalized in their current form, the proposed regulations would be effective for taxable years of a CFC beginning on or after the date of their publication in the Federal Register, and for taxable years of a U.S. shareholder that contain or terminate with the end of the CFC's taxable year.

II. Lingering Traps for the Unwary?

The proposed regulations would operate by requiring a U.S. shareholder to calculate a "tentative" section 956 inclusion from each CFC as under the current rules, but then reduce the tentative inclusion by the amount that would have been eligible for the 100% participation exemption of section 245A if it had been received as a direct distribution from the CFC. For many holding structures, this rule should eliminate the significance of section 956 as a substantive matter, if not also as a compliance matter.

Section 956 may continue to be a consideration in rare cases in which dividends would not qualify for section 245A. For example, section 956 may still be relevant if distributions paid by a CFC would be a "hybrid dividend" (for which the CFC could claim a foreign tax deduction or other foreign tax benefit); where the U.S. shareholders lacks the requisite holding period for all of the CFC's stock; or in "sandwich" structures in which a U.S. shareholder owns a CFC that in turn owns a U.S. subsidiary.

The current-law rules will remain relevant for all individual U.S. shareholders, even those who make a section 962 election to be taxed at corporate tax rates. This approach is consistent with recent case law in *Smith v. Commissioner*, 151 T.C. No. 5 (September 18, 2018) confirming that the section 962 election affects only rate brackets and foreign tax credits, and does not create a hypothetical corporation for purposes of reasoning about other provisions of the Code (such as section 245A).

III. Impact on Commercial Loans

Importantly, the proposed regulations would expand many U.S. borrowers' access to credit support from a profitable CFC. Under current law, a U.S. shareholder may be subject to significant adverse U.S. tax consequences (in the form of taxable inclusions of the foreign earnings of a CFC) if its indebtedness is supported by an upstream guarantee from a CFC, the pledge of assets by a CFC, or the pledge of more than two-thirds of the stock of the CFC. As a matter of widespread market practice, however, lenders have not insisted on this type of credit support from CFCs or "CFC Holdcos" (*i.e.*, U.S. subsidiaries substantially all of whose assets consist of stock of CFCs, which implicate anti-abuse concerns). Going forward, however, U.S. borrowers should expect lenders to insist on full upstream guarantees and pledges by CFCs—possibly on a "springing" basis in the event the proposed regulations are finalized. Lenders may also suggest amending existing debt facilities in a manner that would enable them to take advantage of the new rules.

While enhancements to the collateral package would clearly benefit lenders, they also may benefit U.S. borrowers to the extent they reduce credit spreads. Borrowers and lenders evaluating amendment of existing facilities should be cognizant of the potential U.S. tax consequences of deemed debt-for-debt exchanges, particularly if the *quid pro quo* for expanding the collateral package entails a meaningful reduction of the credit spread on any tranche. Due to gaps that remain in the proposed regulations, borrowers should ensure that dividends from all CFCs providing such credit support would in fact be eligible for the benefit of the new rules.

The proposed regulations generally would reduce complexity attributable to section 956 in structuring commercial loans. Especially in the case of multi-borrower facilities involving loans to both U.S. entities and related CFCs, the change may affect loan documents beyond the definitions pertaining to the collateral package and the subsidiary guarantors, by relieving U.S. tax pressure on inter-creditor agreements, collateral allocation mechanisms, and savings clauses intended to ensure that lenders did not benefit from an indirect pledge of CFC assets.

IV. Regulatory Authority and Excess Foreign Tax Credits

The retention of section 956 despite the enactment of section 245A provided taxpayers with optionality in certain situations. A corporate U.S. shareholder could repatriate funds from a CFC by dividend and have no income inclusion and no foreign tax credits, or it could repatriate funds by loan and have an income inclusion under section 956 and foreign tax credits. This optionality was appealing to corporate groups with high-taxed foreign source income in some CFCs and low-taxed foreign source income (attributable to the same foreign tax credit basket, but not treated as dividend income or otherwise ineligible for section 245A) elsewhere. The proposed regulations

would eliminate this optionality. Thus, while for most U.S. shareholders the proposed regulations would provide for a welcome revenue concession, others might seek to challenge the validity of the regulations.

Both the House and Senate versions of the TCJA initially proposed to eliminate section 956 as applied to corporate U.S. shareholders. Congress ultimately declined to adopt this proposal in the Conference Agreement, with scant explanation. Treasury's proposed regulations effectively would implement the proposal notwithstanding its rejection by Congress, albeit in a more tailored (and complex) form.

The preamble to the proposed regulations provides a detailed assertion of the Treasury's authority to issue them, and may be intended to guard against challenge on the basis that Congress allowed corporate U.S. shareholders this flexibility. Treasury's argument seems weak when set beside Congress's explicit rejection of a similar statutory provision that contained a specific grant of authority to issue these regulations.

Attorneys in Caplin & Drysdale's Business, Investment & Transactional Tax practice group are here to help with any questions.

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