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Proposed Treasury Regulations Shift the Landscape in Debt Financings over Collateral of Foreign Subsidiary Stock

Proposed Treasury Regulations have been published that will permit many U.S. corporate borrowers to provide a lender with a greater collateral package in respect of its foreign subsidiaries without an adverse tax consequence to the borrower. Both lenders and borrowers should be aware of these proposed Treasury Regulations and their potential limitations, as reference to these new proposed Treasury Regulations are certain to arise in negotiations over the collateral package to be provided in debt financings.

On October 31, 2018, the Internal Revenue Service (the "IRS") and the Treasury Department released proposed regulations (the "Proposed Regulations") under Section 956 of the Internal Revenue Code (the "Code"). The Proposed Regulations dramatically change the landscape for debt financings of corporate borrowers with foreign subsidiaries, or so-called "controlled foreign corporations" ("CFCs").

Market practice for U.S. lenders is that a U.S. borrower with a CFC is not required to pledge more than 66 $^{2}/_{3}$ percent of its voting stock in the CFC. In addition, CFCs are not required to pledge any of their assets to the lender nor required to serve as a guarantor on the debt.

This market practice has been driven by Section 956 of the Code. Under Section 956 of the Code and the Treasury Regulations thereunder, certain transactions of a CFC result in a "deemed repatriation" or "deemed inclusion" of previously-untaxed earnings and profits, which, in turn, subjects the U.S. parent to taxation on such amount. Transactions that result in this deemed repatriation include a CFC's pledge of assets to secure the debt of a U.S. parent, a CFC's guarantee of the debt of a U.S. parent, and a U.S. parent's pledge of more than 66 $^{2}/_{3}$ percent of the voting stock of the CFC. A lender is typically willing to accept a lesser collateral so that Section 956 of the Code is not implicated.

This market practice began to shift with the enactment of the Tax Cuts and Jobs Act, P.L. 115-97 (the "Act") on December 22, 2017. The Act established Section 245A of the Code, which generally permits a U.S. corporate parent to take a dividend received deduction in an amount equal to the foreign-source portion of a dividend received by such U.S. corporate parent from a CFC, subject to limited exceptions. The Act also implemented a one-time tax on all previously-untaxed earnings and profits of a U.S parent's

CFC, and introduced a broad new category of income known as "GILTI" that is deemed to be repatriated as it is earned by a CFC. The net effect of these provisions of the Act is that a U.S. corporate parent is likely to have less, if any, previously-untaxed earnings and profits within a CFC (because all previously-untaxed earnings and profits have been eliminated in the deemed repatriation), and the likelihood of a U.S. parent being able to defer its offshore earnings and profits from U.S. taxation was reduced with the introduction of GILTI. Therefore, many CFCs no longer have, and are not likely to generate, a material amount of untaxed earnings and profits, and a pledge of more than 66 $^{2}/_{3}$ percent of the voting stock of the CFC in such a case will no longer adversely impact the U.S. borrower. The potential sting of Section 956 of the Code has been somewhat mitigated with the enactment of the Act.

While some lenders have been more aggressive on their collateral ask in this regard after the enactment of the Act, the market practice concerning the collateral of a CFC mainly persisted prior to the publication of the Proposed Regulations. The dividend received deduction under Section 245A of the Code does not apply to a deemed repatriation under Section 956 of the Code because a deemed repatriation under Section 956 of the Code is not a dividend. In other words, prior to the Proposed Regulations, there was a perceived asymmetry in that an actual distribution from a CFC to a U.S. parent is not subject to U.S. taxation under Section 245A of the Code, whereas a U.S. parent is potentially subject to tax on any deemed inclusions under Section 956 of the Code. Therefore, a borrower still maintained an interest in structuring the collateral in a manner such that Section 956 of the Code was not implicated.

The Proposed Regulations should mostly eliminate the market practice of limiting the collateral in a CFC where the borrower is a U.S. corporate parent. In particular, the Proposed Regulations provide "that the amount otherwise determined under section 956 with respect to a U.S. shareholder for a taxable year of a CFC is reduced to the extent that the U.S. shareholder would be allowed a deduction under section 245A if the U.S. shareholder had received a distribution from the CFC in an amount equal to the amount otherwise determined under section 956."

As previously mentioned, a corporate shareholder of a CFC will generally be eligible for a dividend received deduction under Section 245A of the Code in respect of dividends from such CFC, and to keep things congruent, the Proposed Regulations generally eliminate the deemed inclusion under Section 956 of the Code for a U.S. corporate parent. The asymmetry that existed prior to the Proposed Regulations, no longer exists.

Note that proposed Treasury Regulations (such as the Proposed Regulations) go through a notice and comment period whereby the general public is permitted to comment and submit a request for a public hearing on the proposed rules. In this case, the IRS has provided for a 30-day notice-and-comment period. In addition, while proposed Treasury Regulations often cannot generally be relied upon until they are published in final form, there is an exception when the proposed Treasury Regulations specifically permit taxpayers to rely on such proposed Treasury Regulations prior to their finalization. In this case, the IRS has expressly stated in the Proposed Regulations that taxpayers may rely on the Proposed Regulations for taxable years of a CFC that begin after December 31, 2017, so long as the U.S. shareholder of such CFC (and all of its related parties) consistently apply the Proposed Regulations with respect to all CFCs of the U.S. shareholder (and its related parties).

Given that the IRS has expressly permitted taxpayers to rely on the Proposed Regulations even prior to finalization, we would not expect the Proposed Regulations to vary significantly from the core substantive concept that the Proposed Regulations have set forth. We would also not expect the Proposed Regulations to be withdrawn or revoked in their entirety, although the IRS has the authority to do so.

In terms of the immediate future, U.S. lenders should have their legal team review existing credit agreements to determine whether their terms require the borrower to bump up its pledge in CFC stock to 100 percent. Prior to the Act being passed, there were rumors that the U.S. would move to a territorial taxation system and that Section 956 of the Code would be eliminated. In response to these rumors, some lenders required U.S. borrowers to agree to increase their pledge in stock of a CFC if there was a change

in law that would not be reasonably expected to result in an adverse tax consequence to the U.S. borrower. The Proposed Regulations likely reflect such a change in law.

In addition, we expect that lenders will start requesting that U.S. borrowers pledge 100 percent of the stock of all CFCs. And, based on the Proposed Regulations, there will be strong support for this position. However, U.S. lenders should expect a variety of responses to this request. First, U.S. borrowers will likely express their discomfort in relying on the Proposed Regulations prior to their finalization, even if the Proposed Regulations expressly allow taxpayers to rely on them for taxable years of CFCs beginning after December 31, 2017. If U.S. lenders accept this concern, perhaps U.S. lenders and U.S. borrowers will agree to a pledge of less than 66 $^{2}/_{3}$ percent of the CFC voting stock upfront, with a springing pledge of 100 percent of CFC stock upon the Proposed Regulations being finalized.

There may also be some limited instances where there is still an issue under Section 956 of the Code, even with the Proposed Regulations. For instance, in order to take advantage of Section 245A of the Code, a U.S. parent must generally hold its stock in the CFC for more than one year. Thus, for debt financings that are used by a U.S. borrower to acquire a new CFC, the collateral may need to be structured, initially, as a pledge of less than 66 $^{2}/_{3}$ percent of the voting stock, with a covenant by the U.S. parent to pledge the remaining voting stock of the CFC after the relevant holding period is met. Additional guidance on this issue from the IRS would be welcome.

Further, Section 956 will continue to apply without modification to a U.S. shareholder of a CFC other than a corporate U.S. shareholder (such as an individual). However, the IRS and the Treasury Department requested comment as to the appropriate application of the Proposed Regulations to a U.S. shareholder that is a domestic partnership, which may have partners that are a combination of domestic corporations, U.S. individuals, or other persons. We expect more guidance on this topic once the Proposed Regulations are finalized.

Despite some questions remaining concerning the Proposed Regulations, the IRS and the Treasury Department should be applauded for delivering a common-sense approach to the application of the tax laws. Lenders will certainly rejoice, and be very hesitant to continue accepting from a U.S. corporate parent a limited collateral of the stock of a CFC.

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