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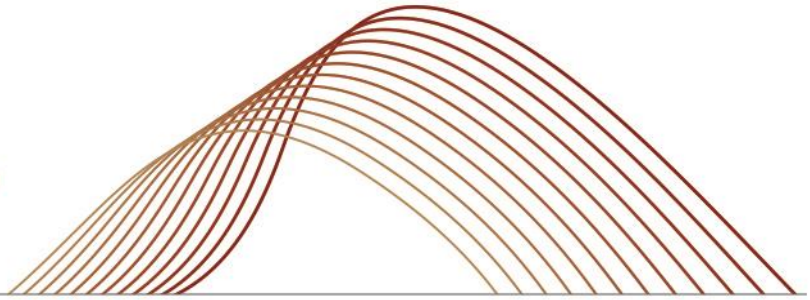

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Proposed IRS Regulations Significantly Curtail Impact of Section 956 for U.S. Corporate Borrowers

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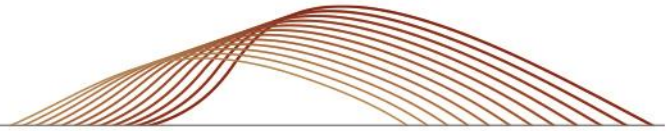
On October 31, 2018, the Internal Revenue Service (the "IRS") issued proposed regulations under Section 956 of the Code[1] (the "Proposed Regulations"), which are intended to harmonize Section 956 with recent changes made under the 2017 tax reform legislation commonly referred to as the Tax Cuts and Jobs Act (the "TCJA") that adopted a participation exemption system for certain foreign dividends. Under the TCJA, U.S. corporations are generally not subject to incremental U.S. taxes on receipt of dividends from their 10% or more owned foreign subsidiaries. However, the TCJA retained Section 956 which treats U.S. shareholders that own 10% or more of controlled foreign corporations ("CFCs") as receiving deemed distributions if the assets of such CFCs serve as security for the U.S. shareholder's borrowings. As a result, the assets of CFCs could not serve as security for a U.S. shareholder's borrowing and the U.S. shareholder could not pledge 66 2/3% or more of the voting stock of any first tier CFC without realizing a taxable deemed distribution from such CFC even though under the TCJA such U.S. shareholder could receive an actual distribution from the CFC without the imposition of U.S. tax. The Proposed Regulations fix this anomaly by allowing a corporate U.S. shareholder of a CFC to generally eliminate the Section 956 income inclusion described above (a "956 inclusion") that would otherwise be recognized upon a pledge of, or guarantee or pledge by, the CFC to secure an obligation of a U.S. person by an amount equal to the deduction such corporate U.S. shareholder would be permitted under the newly enacted participation exemption if such corporate U.S. shareholder received as a distribution an amount equal to its 956 inclusion. The Proposed Regulations could significantly impact how corporate U.S. borrowers may secure their U.S. borrowing with shares or assets of their foreign subsidiaries without triggering adverse U.S. tax consequences.

The Proposed Regulations are intended to provide "symmetry between the treatment of actual dividends and payments which are 'substantially the equivalent of a dividend.'" Such symmetry had previously existed prior to the enactment of the TCJA. Prior to the TCJA, dividends received by a U.S. shareholder from a foreign subsidiary were generally includible in the income of the U.S. shareholder and subject to income tax. Congress enacted Section 956 to ensure that taxpayers that engaged in transactions that were considered substantially the same as declaring a dividend from a CFC to its U.S. shareholder (e.g., an up-stream loan from the foreign subsidiary or a pledge of the foreign subsidiary's assets to secure borrowing in the United States) would be taxed as if a dividend had in fact been paid. This "deemed dividend" rule applies to situations where a CFC acts as pledgor or guarantor of (or otherwise permits its assets to directly or indirectly support) a U.S. borrowing.



The TCJA introduced a "participation exemption" under new Section 245A, which generally exempts from tax a dividend received by a 10%-or-greater U.S. corporate shareholder from a foreign subsidiary if certain conditions are satisfied (more specifically, the U.S. corporate shareholder is afforded a deduction against its income in an amount equal to the foreign-source portion of such dividend). The Section 245A deduction often fully offsets the amount required to be included in income by a 10%-or-greater U.S. corporate shareholder from the receipt of a dividend from a foreign subsidiary. The TCJA did not amend Section 956, which led to the inconsistent result that, following enactment of the TCJA, a "deemed dividend" arising under Section 956 from a CFC to its 10%-or-greater U.S. corporate shareholder was a taxable event even though an actual dividend of the same amount would not be taxable under new Section 245A.

Under the Proposed Regulations, a 10%-or-greater corporate U.S. shareholder will be able to reduce its 956 inclusion (referred to under the Proposed Regulations as a "tentative section 956 amount") by the amount of the deduction under Section 245A that the shareholder would be allowed if the shareholder received, as a distribution from the CFC, an amount equal to the tentative section 956 amount. Special rules apply to corporate U.S. shareholders that indirectly own CFCs, and the Proposed Regulations provide three examples that address both direct and indirect corporate U.S. shareholders of a CFC. Section 956 will continue to apply without modification to individuals, real estate investment trusts, and regulated investment companies that own an interest in a CFC.

While the impact of the Proposed Regulations on lending practices remains to be seen, Treasury expects that, due to the broad applicability of Section 245A, "in many cases a corporate U.S. shareholder will not have a section 956 inclusion as a result of a CFC holding U.S. property under the proposed regulations." As a result of the Proposed Regulations, a U.S. corporate borrower that meets the requirements of Section 245A with respect to dividends received from a CFC will be able to pledge 100% of the voting and non-voting stock of its CFC (and provide a guarantee and pledge by its CFCs) in support of its U.S. borrowing without adverse tax consequences under Section 956. Treasury expects the new rules to "significantly reduce the complexities, costs and compliance burdens for corporate U.S. shareholders of CFCs" by reducing the need for corporate U.S. shareholders to carefully monitor the application of Section 956 to their loans, guarantees, and pledges. U.S. borrowers will still need to ensure that dividends received from a CFC would otherwise be eligible for the deduction under Section 245A before agreeing to make pledges and guarantees that trigger Section 956; in particular, Section 245A has a holding period requirement and does not apply to certain "hybrid" dividends, among other limitations. In addition, although the Proposed Regulations should generally eliminate any U.S. tax impediment to having the assets of CFCs secure the obligations of their U.S. corporate shareholders, any local law requirements associated with such security arrangements and the cost thereof will need to be considered as well as the risk of future changes in the U.S. tax rules.

The Proposed Regulations will apply to taxable years of a CFC beginning on or after the date the Proposed Regulations are published as final regulations in the *Federal Register* and to taxable years of a corporate U.S. shareholder in which or with which such taxable years of the CFC end. Prior to finalization, taxpayers can rely on the Proposed Regulations for any taxable year of a CFC beginning after December 31, 2017, and for taxable years of a U.S. shareholder in which or with which such taxable years of the CFC end, provided that the taxpayer (and any U.S. persons related to such taxpayer within the meaning of Sections 267 or 707) apply the Proposed Regulations consistently with respect to all CFCs in which they are U.S. shareholders. The IRS has requested comments on the Proposed Regulations, particularly as to the application of the Proposed Regulations to

U.S. shareholders that are domestic partnerships with partners that are a combination of U.S. corporations, U.S. individuals or other persons.

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[1] References herein to the "Code" are to the Internal Revenue Code of 1986, as amended, and any section references herein are to the corresponding section of the Code.