Final IRS Regulations Modify the Deemed Dividend Rule

On May 23, 2019, the Internal Revenue Service (IRS) issued Final Regulations under Section 956 of the Internal Revenue Code of 1986 generally adopting the Proposed Regulations that were released on October 31, 2018. The Final Regulations are intended to eliminate a disparity caused by the Tax Cuts and Jobs Act (TCJA) in the tax treatment of actual dividends and deemed dividends, in each case, made or deemed made, by controlled foreign corporations (CFC)1 to U.S. shareholders2 meeting certain ownership and holding period requirements. The Final Regulations align the tax treatment of deemed dividends with that of actual dividends and allow U.S. shareholders to better avoid the adverse tax impacts triggered when a CFC provides credit support to its U.S. parent.

Section 956 Background

For more than 50 years, Section 956 has loomed large in the context of corporate finance transactions through its restriction on the ability of U.S. borrowers to use overseas assets or revenues of CFCs as additional credit support in transactions. Section 956 was based on the notion that U.S. shareholders were implicitly receiving the benefit of CFC earnings by having their CFCs provide credit support for their debt obligations. Due to this, Section 956 originated with the intention to prevent avoidance of U.S. taxation through indirect repatriation of CFC earnings to the U.S. where the actual representation of such earnings through a dividend would have given rise to U.S. income tax.

Under Section 956, any of the following types of CFC credit support would trigger a deemed dividend: (1) a guaranty by a CFC; (2) a lien or security interest on assets of a CFC; or (3) a pledge of two-thirds or more of the voting stock of the CFC. The amount of the taxable deemed dividend is, generally, the lesser of (1) the total principal amount of the debt obligation that is supported by the CFC, and (2) the amount of such CFC's earnings and profits that previously have not been taxed in the United States. If a foreign subsidiary or affiliate of a U.S. shareholder provides credit support for such U.S. shareholder but does not constitute a CFC, the deemed dividend rule is not applicable.

[1] A CFC is defined as any foreign corporation in which a U.S. Shareholder owns, directly or indirectly, on any day during the taxable year of the foreign corporation, (i) more than 50 percent of the total combined voting power of all classes of voting stock or (ii) more than 50 percent of the total value of the stock in the CFC. 26 U.S.C. § 957.

[2] A U.S. shareholder is one that owns at least 10 percent of the voting stock or value of a CFC. 26 U.S.C. § 951.

To avoid triggering a deemed dividend under Section 956 and the adverse tax consequences that follow, U.S. borrowers have typically been unwilling to allow their CFCs to provide any collateral and would only get credit support through a pledge of 65 percent of the CFC's stock (which has limited value because it ranks behind all of the secured and unsecured creditors of the CFC, and then only entitles the lender to 65 percent of whatever is left over after all such creditors have been paid).

The Tax Cuts and Jobs Act of 2017

In December of 2017, Congress enacted the TCJA which created a mismatch in the tax treatment of actual dividends and deemed dividends. This mismatch was due to Section 245A of the TCJA, which provides for a "participation exemption." The participation exemption provides that if a U.S. shareholder meeting the ownership and holding period requirements receives a dividend from a CFC, the U.S. shareholder is entitled to a "dividends received" deduction equal to the amount of the dividend actually received. The practical result of the participation exemption is that a CFC can make actual dividends to a U.S. shareholder meeting the ownership and holding period requirements without such U.S. shareholder being subject to U.S. income tax.

Contrary to expectations at the time, the TCJA did not repeal Section 956, effectively breaking the parity of the tax treatment between actual dividends and deemed dividends. Because deemed dividends are not actual dividends, the participation exemption under Section 245A did not apply. This created a dichotomy where a CFC could make an actual dividend to a U.S. shareholder without adverse U.S. income tax consequences, but a deemed dividend to the same U.S. shareholder from the same CFC would trigger adverse U.S. income tax consequences.

Final Regulations

On May 23, 2019, the IRS issued the Final Regulations. The Final Regulations align the tax treatment of deemed dividends under Section 956 with the participation exemption created under Section 245A of the TCJA. As a result, there will no longer be a U.S. income tax impediment to a CFC providing credit support to a U.S. shareholder meeting the ownership and holding period requirements. The Final Regulations provide, generally, that a U.S. shareholder may take a "dividends received" deduction for deemed dividends by a CFC to the U.S. shareholder to the extent the U.S. shareholder would be entitled to a "dividends received" deduction for actual dividends from a CFC to the U.S. shareholder under Section 245A.

245A Requirements for Participation Exemption

In order for a U.S. shareholder to qualify for a "dividends received" deduction in connection with receipt of a deemed dividend from a CFC, the U.S. shareholder must meet the participation exception requirements set forth in Section 245A. Section 245A only provides deductions to U.S. corporations meeting certain ownership and holding period requirements. Other U.S. shareholders, such as individuals, most partnerships (including limited liability companies taxed as partnerships), real estate investment trusts, and regulated investment companies will continue to be taxed on Section 956 inclusions. One technical change the Final Regulations made to the Proposed Regulations involves the applicability of the Final Regulations to domestic partnerships owned by U.S. corporations. The Final Regulations provide that a U.S. partnership borrower owned directly (or indirectly through other partnerships) by one or more U.S. corporations can reduce the amount of any deemed dividend from a CFC under Section 956 to the same extent each such U.S. corporate parent would be entitled to a deduction under Section 245A if such amounts were actually distributed by such CFC to each such U.S. corporate parent.

Under Section 245A, a U.S. shareholder must have owned at least 10 percent of a CFC for at least 365 days during a 731 day period that begins on the date that is 365 days before the last day of the applicable taxable year in which the foreign subsidiary is a CFC. The 10 percent ownership requirement is calculated by reference to either the total combined voting power of all classes of voting stock of the CFC or to the total value of the CFC stock. A CFC acquired by a U.S. shareholder with acquisition financing should be able to provide credit support for such acquisition financing without incurring adverse U.S. income tax consequences so long as such U.S. shareholder retains ownership for the 365–day period following the acquisition. In this circumstance, the 731-day period would start 365 days before the last day of the CFC's taxable year in which the CFC provided credit support.

Effective Date of Final Regulations

The Final Regulations apply to taxable years of a CFC beginning 60 days on or after the date of publication in the Federal Register, and to taxable years of a U.S. shareholder in which or with which such CFC's taxable years end. Since the Final Regulations were published on May 23, 2019, the rules are effective for CFC taxable years beginning on or after July 22, 2019. The Preamble states that U.S. shareholders may rely on the Proposed Regulations for taxable years of a CFC beginning after December 31, 2017, so long as the U.S. shareholder and any related persons consistently apply the Proposed Regulations with respect to all CFCs.

Other Considerations

Now that the Final Regulations have been released and the uncertainty around what would be included has been eased, market practice will likely shift towards a more expansive inclusion of CFC credit support. In most cases, CFCs will be able to guarantee debt and pledge their assets, and U.S. shareholders will be able to pledge 100 percent of CFC stock, in each case, without any adverse U.S. income tax effects under Section 956. However, there are still a few circumstances in which credit support from CFCs may trigger deemed dividends or otherwise invite adverse tax consequences.

The TCJA contains anti-hybrid provisions intended to prevent transactions from being structured to take advantage of different taxing regimes to achieve a favorable tax outcome. Accordingly, "hybrid dividends" received by a U.S. shareholder are subject to taxation as a deemed dividend. A "hybrid dividend" is, generally, a dividend from a CFC to a U.S. shareholder for which the foreign corporation received a tax deduction or other tax benefit from a foreign jurisdiction. Also, in some non-U.S. jurisdictions, a CFC that guarantees debt of its U.S. corporate parent may be deemed to receive a guarantee fee from the U.S. corporate parent, which could be subject to tax in that non-U.S. jurisdiction.

Aside from tax consequences, there remain many issues to be considered before spending the time and money necessary to obtain enforceable foreign guaranties and foreign collateral, including, without limitation, licensing for lenders in foreign jurisdiction; ability of U.S. lenders to take foreign collateral and obtain foreign guarantees in non-U.S. jurisdictions; recognition of U.S. choice of law provisions and enforcement of U.S. judgments, in each case, in non-U.S. jurisdictions; ability of agents or trustees, on behalf of lender groups, to hold collateral and exercise rights and remedies after default; withholding tax implications on interest and fees paid by foreign subsidiaries; thin capitalization rules limiting deductibility of tax on interest incurred on debt of a foreign borrower that is guaranteed by related parties; remedies available to lenders in a non-U.S. insolvency proceeding; and non-U.S. laws governing anti-money laundering, anti-discrimination, privacy and data protection. Lenders seeking CFC credit support for a U.S. corporate borrower's debt obligations should conduct a cost/benefit analysis in consultation with their U.S. counsel and experienced local foreign counsel. Similarly, before a CFC agrees to provide credit support, the U.S. corporate parent should consult with domestic and local foreign counsel to identify any potential issues with providing such credit support.

If you have questions about the Final Regulations and how it impacts your business, contact Bill Gardner.