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IRS Issues Proposed Section 956 Regulations Relating to Foreign Subsidiary Guarantees and Stock Pledges

The Internal Revenue Service recently issued proposed regulations under Section 956 of the Internal Revenue Code (IRC) that may allow foreign subsidiaries of U.S. multinational corporate borrowers to provide additional credit support to lenders without resulting in adverse U.S. federal income tax consequences. Although the proposed regulations may be relied upon by taxpayers for taxable years beginning after Dec. 31, 2017, detailed analysis should be conducted prior to eliminating or modifying the standard limitations on foreign subsidiary pledges and guarantees from credit agreements.

Background

Section 956 of the IRC was largely intended to prevent avoidance of U.S. taxation through indirect repatriation of the earnings and profits of a controlled foreign corporation (CFC), including through direct loans to U.S. parent companies and indirect pledges or guarantees by CFCs in support of parent companies' debt. Accordingly, credit agreements of U.S. multinational borrowers typically preclude CFCs from becoming guarantors and limit pledges of stock of a CFC to stock representing no more than 66 2/3 percent of voting power.

The 2017 Tax Cuts and Jobs Act (TCJA) enacted a participation exemption system such that dividends from certain foreign subsidiaries to their U.S. corporate owners would be largely exempt from U.S. federal income tax. Although an earlier version of the tax reform law would have also excluded U.S. corporate owners from application of Section 956, it was dropped in the final bill. As a result, the TCJA resulted in a mismatch between actual distributions and deemed distributions for U.S. corporate owners – actual distributions would be generally exempt from U.S. federal income tax but deemed distributions under Section 956 would continue to be subject to U.S. federal income tax. The proposed regulations address this inconsistency by providing that any inclusions under Section 956 would be entitled to the same deduction as if such inclusions were actually distributed to the U.S. corporate shareholders.

While these regulations are in proposed form, they provide that a taxpayer may rely upon them for taxable years of a CFC beginning after Dec. 31, 2017, provided that the U.S. shareholders of the CFC consistently apply the proposed regulations with respect to all CFCs in which they are U.S. shareholders.

Implication

The proposed regulations may now provide U.S. multinational corporate borrowers additional flexibility in pledging the stock of their foreign subsidiaries and/or causing their foreign subsidiaries to become guarantors without resulting in adverse U.S. federal income tax consequences. However, careful analysis should be conducted on a case-by-case basis to determine whether it would be advisable to do so, taking into account the potential for future changes to the tax laws, other non-U.S. tax considerations and local legal limitations. For example, the foregoing would not apply to borrowers that are not corporations (e.g., partnerships or REITs), and there may be circumstances in which there could still be adverse U.S. federal income tax consequences for U.S. multinational corporate borrowers under Section 956 or other sections of the IRC. In addition, existing credit agreements should be reviewed to determine the impact, if any, of the proposed regulations on credit support provisions.

For further information, please contact a member of the firm's Tax Practice.

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