

## Changes to deemed dividend rules bring good news for secured creditors

Prior to the issuance of the final regulations under Section 956 of the Internal Revenue Code of 1986, a dividend was deemed created when a U.S. borrower pledged, as security for its obligations, two-thirds or more of the voting stock in a foreign subsidiary considered to be a “controlled foreign corporation” (CFC) or if the CFC guaranteed or pledged its assets as security for the U.S. parent’s obligations. The U.S. parent was required to include in its U.S. taxable income the lesser of (i) the total principal amount of the loan that was supported by the foreign subsidiary credit support, and (ii) the amount of such foreign subsidiary’s earnings and profits that previously have not been taxed in the U.S.

To avoid this exposure, credit agreements with a U.S. borrower had been drafted to exclude CFCs as guarantors, to exclude the pledge of any assets of a CFC, and to limit any pledge of voting stock of a CFC to no more than 65% of the voting stock.

The purpose of the Section 956 deemed dividend rules was to prevent a U.S. parent from benefitting from the earnings of a CFC without paying the U.S. taxes that would result from an actual distribution of the earnings to the U.S. parent.

One of the changes included in the Tax Cuts and Jobs Act (**TCJA**) enacted in December 2017 was a participation exemption system effectively exempting from U.S. federal income taxation the foreign-sourced portion of dividends that were paid to a U.S. corporation by a foreign corporation with respect to which the U.S. corporation was a 10% or greater shareholder.

Since an actual dividend from a CFC to its U.S. corporate parent is now generally not subject to U.S. taxation under the TCJA provisions, draft versions of the TCJA also repealed the deemed dividend rules of Section 956 for U.S. corporations with CFCs that qualify for the new participation exemption. However, inexplicably, the final version of the TCJA failed to include such repeal and as result, the TCJA created a trap by retaining the rules under which a pledge or guarantee by a CFC in support of a debt of its U.S. corporate parent could result in deemed dividends subject to U.S. taxation, even though an actual dividend would not result in U.S. taxation.

To address this problem, in October 2018, the IRS published proposed regulations under Section 956 (the “**Proposed Regulations**”), which, in most situations, eliminated the deemed dividend that otherwise would have resulted from the U.S. Borrower’s pledge of the voting stock of a CFC or a

pledge of assets or guarantee by a CFC in support of the debt of its U.S. corporate parent. The Proposed Regulations reduced the amount to be included in taxable income as a result of Section 956 to the extent that an actual dividend paid by the CFC would not be subject to U.S. federal income tax as a result of the TCJA participation exemption system.

The Proposed Regulations included a provision that allowed taxpayers to rely on the Proposed Regulations for taxable years of a CFC beginning after 31 December 2017, and for taxable years of a U.S. shareholder in which or with which such taxable years of the CFC end, provided the taxpayer and U.S. persons who are related to the taxpayer consistently apply the Section 956 Regulations for all CFCs in which they are U.S. shareholders.

On May 23, 2019, the IRS issued final Section 956 Regulations consistent with the Proposed Regulations that apply to taxable years of a CFC beginning on or after July 22, 2019, and to taxable years of a U.S. shareholder in which or with which such taxable years of the CFC end.

CFCs of U.S. corporate borrowers will generally now be able to provide guarantees and 100% pledges in support of their US corporate parents’ debt without triggering adverse tax consequences for the U.S. parent. Lenders may ask that the agreed security principles in agreements with US borrowers reflect this change and require guarantees by CFCs and/or direct or indirect pledges of 100% of the voting stock of CFCs and possibly a pledge of the assets of CFCs.

However, care needs to be taken when considering this issue because the final Section 956 Regulations generally address only corporations eligible for the participation exemption system enacted under the TCJA and may not be applicable to other corporate forms such as limited liability companies.

This means that the pledge of more than 65% of the voting stock or the CFC pledges and guarantees still may result in adverse tax consequences, including in the following circumstances:

- If the U.S. borrower is not a corporation (except to the extent the borrower is a partnership for U.S. tax purposes and its partners are corporations that would be entitled to the participation exemption if the partnership received a distribution);
- If not all of the CFC's earnings are foreign source (e.g., CFC has income from a U.S. trade or business or from a U.S. subsidiary of the CFC);
- If the CFC has issued instruments which pay "hybrid dividends," i.e., for which the CFC receives a deduction or other tax benefit related to taxes imposed by a foreign country;
- If the U.S. borrower does not meet certain holding period requirements, e.g., has owned the CFC for fewer than 365 days over a specified period.

Non-tax considerations (such as local law issues) will still need to be considered in determining whether credit and/or collateral support from a foreign subsidiary are feasible.

Existing credit agreements should be reviewed to determine whether covenants which prohibit the pledge of more than 65% of the voting stock of the CFC and/or the pledge of assets or guarantees by CFCs only apply where the pledge or guarantee would result in adverse tax consequences to the borrower since such CFC pledges and guarantees may now be required.



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