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Proposed Regulations Remove Tax Obstacles to Secure U.S. Domestic Corporate Borrowings

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On October 31, 2018 the Treasury Department released proposed regulations under section 956 of the Internal Revenue Code of 1986, as amended, that generally exempt U.S. domestic corporations from recognizing deemed dividends if a controlled foreign corporation (or CFC) invests in U.S. property or provides credit support for a U.S. domestic corporation's borrowing. The broad application of these rules has kept domestic borrowers from pledging more than 66 2/3 percent of CFC voting stock or from providing lenders with upstream guarantees or asset pledges. Significantly, while the proposed regulations relax the rules for domestic corporations, they do not change the deemed dividend rules that apply to individuals and other non-corporate borrowers, such as domestic operating partnerships owned by private investment funds.

Going forward, while domestic corporations are likely to pledge 100 percent of CFC equity, it may not be commercially feasible for a borrower to provide other forms of credit support from a foreign corporation. In this regard, there can be considerable financial and administrative costs to perfecting foreign security arrangements. Moreover, local law restrictions, such as financial assistance rules, may prevent a subsidiary from supporting a parent borrowing. Borrowers should review their credit agreements, which in some cases require borrowers to provide security from CFCs if changes in tax rules, like the proposed regulations, eliminate potential tax costs.

The preamble to the proposed regulations indicates that the deemed dividend rules should be relaxed to provide parity with the tax treatment of a domestic corporation that receives an actual dividend from a CFC. The Tax Cuts and Jobs Act, which became law in December of last year, can provide a 10 percent U.S. *corporate* shareholder of a CFC with a complete exemption from tax on dividends received from a CFC. Among other requirements, the U.S. corporate shareholder must hold the shares for a one year period that includes the dividend date, and the dividends paid to the domestic corporation must not afford the CFC a tax deduction or similar non-U.S. tax benefit under local law (Hybrid Dividends). These same rules are also conditions to the exemption for the deemed dividend rule. Before pledging 100 percent of the equity of a CFC (or providing other CFC credit support), a domestic corporate borrower should determine whether the CFC interests it holds produce Hybrid Dividends. Hybrid Dividends may arise from profit participating loans, convertible preferred equity certificates and similar instruments issued in many common holding company structures in Ireland and Luxembourg, among other jurisdictions.

Domestic corporate taxpayers can rely on the proposed regulations, even prior to promulgation in final form, for taxable years beginning after December 31, 2017.

For further information about how the issues described in this Alert may affect your interests, please contact your regular Ropes & Gray contact.

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