Proposed Regulations Provide Greater Flexibility in Obtaining Credit Support from Foreign Subsidiaries

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On October 31, 2018, the Treasury Department issued proposed regulations that fundamentally change the way that U.S. corporate borrowers can use controlled foreign corporations ("foreign subsidiaries") to obtain better credit terms.

Under the old rules under Section 956, a U.S. corporation could obtain very little credit support from its' foreign subsidiaries. This is because a guarantee or pledge of assets by a foreign subsidiary on U.S. corporate debt was viewed as an investment in U.S. real property by that foreign subsidiary, giving rise to a "deemed dividend" that was taxable in the U.S. under the old "Subpart F" income regime. Case law and IRS rulings have made it clear that this "deemed dividend" is not actually a dividend under the tax rules and, therefore, is not eligible for the preferred rate of tax on qualified dividends, among other matters.

As a result of this limitation, the standard credit practice became that a U.S. corporate borrower would typically pledge no more than 65% of the voting stock of a first-tier foreign subsidiary. The foreign subsidiary would never serve as a guarantor on the U.S. debt or pledge any of its assets. Most debt documents contained standard boilerplate language restricting foreign subsidiary collateral in order to avoid the issue altogether, and missing it has resulted in eye-popping legal malpractice cases.

The tax legislation passed last December moved away from the Subpart F income regime and created a "participation exemption" system that generally allows a U.S. corporation to receive dividends from a foreign subsidiary tax-free by providing an offsetting dividend received deduction. Based on the initial language in the statute, it was doubtful that this dividend received deduction applied to deemed dividends based on the well-established case law excluding deemed dividends from actual dividend treatment.

The proposed regulations clarified that the dividend received deduction does in fact apply to deemed dividends resulting from a pledge or guarantee by a foreign subsidiary on U.S. corporate debt. While the soundness of this about-face may be questioned, it is now possible for U.S. corporate borrowers to include foreign subsidiaries in the loan process in order to obtain better credit terms. Subject to limitations imposed by other countries, foreign subsidiaries should now be able to assist their U.S. corporate parents obtain financing by guaranteeing debt or pledging their assets or stock without fear of triggering U.S. tax.

Significant limitations and restrictions remain so careful consultation is necessary in order to successfully navigate these complex rules. For instance, the proposed regulations only apply to corporations and not partnerships, disregarded entities, or individuals – another result that is seemingly inconsistent with past practice. Interest deduction limitation rules remain in place, so careful analysis is needed in order to determine the optimal placement of debt within the corporate structure. Finally, this new rule only applies if a U.S. corporation has owned a foreign subsidiary for more than 365 days during a 731 day period ending on the last day of the tax year. This could result in newly acquired foreign subsidiaries being treated differently from foreign subsidiaries during the credit process.

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