Published on *The National Law Review* https://natlawreview.com

May the Stars Align: Finding Symmetry in International Tax Reform

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While U.S. corporations largely have been viewed as the big winners of tax reform under the Tax Cuts and Jobs Act (TCJA or Act), they were left to contend with the asymmetry the Act created, particularly with respect to international tax reform. The Act largely overhauled the U.S. international tax regime, but existing, related provisions within the Internal Revenue Code (Code) were left untouched. Recently released proposed regulations under Section 956 of the Code (Proposed Regulations) appear to be an effort to restore symmetry to one area of the tax law impacted by international tax reform – the controlled foreign corporation (CFC) deemed dividend rules.

Controlled Foreign Corporation Defined

A foreign corporation will be a CFC if "United States Shareholders" own, or are considered to own, more than (a) 50 percent of the total combined voting power of all classes of stock of such corporation entitled to vote or (b) the total value of the stock of such corporation on any day during the taxable year of such foreign corporation. As a result of the TCJA's passage, certain rules determining stock ownership for purposes of classifying an entity as a CFC were expanded. Specifically, the term "United States Shareholder" now includes any "United States Person" (as defined for U.S. federal income tax purposes) that owns directly or indirectly 10% of the voting power or value of the outstanding stock of the foreign corporation (and not merely voting power, as was the case prior to tax reform). Also, certain attribution rules were expanded to cause stock owned by a foreign entity to be attributed to a United States Person. Consequently, many entities that were not previously considered to be CFCs now fall under this definition as of January 1, 2018 (click here for more).

The Deemed Dividend Issue

While a full discussion of the CFC and "subpart F" regime is outside the scope of this article, United States Shareholders of a CFC generally are required to include (1) certain passive income from the CFC ("subpart F income") and (2) certain amounts equal to the CFC's investment in "United States property," which includes the obligations of a United States Person if the CFC is a guarantor or pledgor with respect thereto. Of particular importance to financing transactions is that this rule

extends to “indirect pledges and guarantees” where the assets of the CFC serve as support for the obligations of a United States Person. The only clear guidance in the “indirect” pledge and guarantee rules demonstrating what would cause a deemed dividend where the assets of the CFC serve as collateral support relates to a pledge of CFC stock. Specifically, a pledge of sixty-six and two thirds percent (66 2/3 %) or more of the voting power of the CFC in support of the obligation is treated as an indirect pledge of the assets of the CFC, triggering a deemed dividend. Accordingly, where relevant, most U.S. borrowers have specific carve outs from collateral packages, not just prohibiting a foreign subsidiary from guaranteeing the borrower’s debt obligations, but also limiting pledges of its stock in support of such obligation to sixty-five percent (65%) or sixty-six percent (66%). We currently are following efforts by Republicans in the U.S. House of Representatives (“House Republicans”) to eliminate or curtail the new downward attribution rules, which, if successful, materially would alter the treatment of CFCs under the TCJA.

A more complicated scenario exists where a CFC is not merely guaranteeing a borrower’s obligation, but is a co-borrower along with a United States Person. There, given the lack of clarity in the rules, great care must be taken to ensure that the CFC is not supporting the U.S. facility. This impacts indemnity and certain operational provisions within typical agreements and often has significant commercial consequences, at times leading borrowers to restructure the transaction in order to limit the risk of a deemed dividend. However, alternatives may be hard to come by that could access the CFC’s borrowing power without creating the risk of a deemed dividend. For example, back-to-back borrowings from a bank to the CFC and the CFC to the U.S. parent typically are avoided, as most practitioners would agree this would constitute prohibited indirect support under the indirect guarantee and pledge rules.

While the deemed dividend is first and foremost a potential tax on the borrower in a debt financing, the tax on noncash income potentially could impact cash flow to such a degree that it impedes the borrower’s ability to repay its debt obligations. Thus, in the first instance , a lender typically will align itself with the borrower and agree to the requisite collateral limitations. However, the lender has a stake in drafting the limitations as narrowly as possible in order to maximize its access to collateral, which also protects its investment. As a result, lenders tend to agree on the clear parameters on guarantees and pledges, but typically are more hesitant about potentially noncommercial restrictions that may be required with a CFC co-borrower, for instance.

TCJA and the Creation of Asymmetry

The TCJA created a “participation exemption” in furtherance of a territorial tax system for U.S. corporations. Under new Section 245A of the Code, actual dividends received by a U.S. corporate shareholder from its CFC subsidiary generally are exempt from tax due to a new, equal and offsetting dividends received deduction. Such a deduction was not available prior to the enactment of the TCJA. However, the CFC regime largely was untouched, which surprised many in the tax community. The CFC regime was intended to tax income that was held offshore in circumstances where (1) the United States Shareholder was benefitting from that income, including in the form of credit support and (2) repatriation in the form of a dividend would trigger a tax. In a territorial corporate tax regime, this makes little sense, at least for corporations. Moreover, despite the proposed repeal of Section 956 being included in both the House and Senate bills, such Section ultimately was left intact (likely because it is a revenue raiser. The puzzling result is that U.S. corporate shareholders now would receive actual dividends from a CFC virtually free of tax, but still must pay tax on deemed dividends under Section 956.

Finding Symmetry

The Proposed Regulations attempt to align the treatment of deemed dividend inclusions under Section 956 with that of actual dividends. To that end, the proposed rules provide that there is no deemed dividend under Section 956 to the extent the United States Shareholder would not be taxed on an actual dividend from a CFC. Significantly, taxpayers may rely on the proposed regulations for taxable years beginning after December 31, 2017. Therefore, going forward, we are likely to see a significant reduction in provisions designed to prevent income inclusion. At this stage, the restrictions may remain in place, possibly with an additional prerequisite in new or amended credit agreements that the absence of Section 956 targeted restrictions creates material adverse tax risk; in other words, a CFC can serve as a guarantor so long as there is no United States shareholder that would be taxed on a deemed dividend.

The Proposed Regulations also address certain practical concerns regarding the expanded definition of a "controlled foreign corporation." As we discuss, the expanded attribution rules may cause certain corporations to be CFCs even where no United States Shareholder would be required to include amounts in income as a result. For example, under prior law, a foreign subsidiary of a foreign parent that also had a U.S. corporate subsidiary but no direct or indirect United States Shareholders would not be considered to be a CFC. Now, as a result of the expanded attribution rules (not taking into account recent House Republican efforts, noted above), the U.S. subsidiary is attributed the parent's ownership of the foreign subsidiary's stock and, as a result, the foreign subsidiary now is considered to be a CFC – even if there is no United States Shareholder who would be subject to income inclusion and tax. Where there is no such income inclusion, there would be no commercial reason to exclude the new CFC from collateral provisions. However, these types of "springing" CFCs still might be so excluded by operation of pre-tax reform agreements that contained provisions automatically excluding subsidiaries that become CFCs without any action by the parties. Conversely, foreign corporations that are now considered CFCs due to the newly expanded definition of United States Shareholder (as discussed above) may not be excluded, triggering unplanned inclusion in the absence of amendments. To the extent the deemed dividend inclusion no longer is law for U.S. corporate borrowers as a result of the Proposed Regulations, there is no need to amend agreements to address foreign subsidiaries becoming CFCs.

Note that this relief does not extend to borrowers that are not U.S. corporations or treated as corporations for U.S. federal tax purposes. While the universe of non-corporate taxpayers subject to Section 956 is narrow, we expect typical restrictions to remain in place for non-corporate borrowers – and such borrowers still must contend with "springing" CFC issues under the new definitions.

Conclusion

The Proposed Regulations are a welcome development for U.S. corporations with subsidiaries that are CFCs, particularly after tax reform failed to repeal any part of Section 956. While the proposed regulations provide welcome relief, it remains to be seen whether the CFC regime will continue to be overhauled in order to eliminate inconsistencies with the TCJA's international provisions. On the one hand, U.S. corporations largely were viewed as the primary beneficiaries of tax reform, which brought complex new international rules that ultimately treat non-corporate taxpayers less favorably. (Click here and **here** for a discussion of the disproportionate impact of the so-called GILTI tax to non-corporate taxpayers.) Thus, it is possible that further relief would be limited in order to prevent exacerbating this perceived imbalance. Conversely, it is possible that further corporate relief becomes the focus of this administration, which would see the subpart F regime being scaled back for U.S. corporations. We will continue to monitor developments in this area, including efforts by House Republicans to eliminate or limit the scope of the newly expanded attribution rules.

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National Law Review, Volume VIII, Number 355

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