CROSS-BORDER FINANCE ALERT

IRS Regs Would Eliminate Section 956 Tax Risk for Guarantees and Pledges Prevalent in Cross-Border Financing

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Potentially adverse and unanticipated tax consequences under Section 956 of the Internal Revenue Code of 1986, as amended (the Code) are familiar concerns to U.S. borrowers and their counsel in cross-border financing transactions. Section 956 was enacted as an anti-abuse measure to tax a controlled foreign corporation's (CFC) investment of earnings in U.S. property in the same manner as if it had distributed those earnings to the U.S. In the context of cross-border financings, guarantee and certain pledge arrangements by CFCs in support of a borrowing by a U.S. borrower would be considered as such an investment and therefore such arrangements have customarily been strictly limited to minimize the risk of adverse tax consequences.

Recent tax reforms enacted by the Tax Cuts and Jobs Act (the Act) include a new participation exemption for the taxation of certain foreign income under Section 245A of the Code. This exemption gives corporate U.S. shareholders a deduction to offset any repatriated dividend income received from a specified 10% (or greater) owned foreign corporation in an amount equal to the foreign-source portion of such dividend, subject to certain limitations. The Act, however, did not provide a similar elimination of tax consequences for "effective repatriation" or "deemed dividends" that are the purview of Section 956.

On October 31, 2018, the Internal Revenue Service and the Department of the Treasury issued proposed regulations (the Proposed Regulations) to rectify this disparity between the tax treatment of foreign income that is actually repatriated as opposed to "effectively repatriated". The Proposed Regulations rectified this disparity by providing that the amount that would be considered an "effective repatriation" under Section 956 would be allowed a deduction under Section 245A as if the corporate U.S. shareholder had received an actual dividend. Section 956 will continue to apply without modification to U.S. shareholders other than corporate U.S. shareholders, such as individuals, regulated investment companies and real estate investment trusts.

IRS and Treasury predict that the Proposed Regulations will effectively eliminate the effects of Section 956 to corporate U.S. shareholders and the risk of adverse tax consequences caused by guarantee and pledge arrangements by CFCs used in support of borrowing transactions by U.S. borrowers in cross-border financings.

As a result, the Proposed Regulations could result in lenders insisting on including CFCs in collateral packages. While that may increase the burden on borrowers (by way of increased spending on fees for local counsel in multiple jurisdictions, for example), the borrowers may also benefit by way of improved interest rates attributable to better credit quality and less complex loan documents.

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