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CFC Guarantees and Pledges Still Relevant After Tax Reform

WRITTEN BY

Steven D. Bortnick | J. Bradley Boericke

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At this point, private equity firms are very conscious that debt of their U.S. acquisition vehicles or portfolio companies cannot be guaranteed by controlled foreign corporations (CFCs), nor can more than 65 percent[1] of the stock of such CFCs be pledged to support the debt of U.S. shareholders of the CFCs without triggering tax consequences under Section 956 of the Code. While tax reform did not eliminate these rules, certain provisions affect the application of the rules and may, in certain circumstances, raise the question of whether it still is necessary to plan around them.

Background on CFCs and CFC Guarantees/Pledges

A CFC is a foreign corporation where more than 50 percent of the corporation's stock (determined by vote or value) is owned by one or more U.S. persons (including U.S. partnerships), each of which owns 10 percent or more of the stock (determined by vote or value). Certain indirect stock ownership and stock attribution rules apply in determining whether a U.S. person owns 10 percent or more of the stock and whether U.S. persons collectively own more than 50 percent of the stock of the foreign corporation.

If a corporation is considered a CFC, each U.S. shareholder (*i.e.*, each U.S. person owning 10 percent or more of the CFC's stock) must include in income, similar to a deemed dividend, certain income of the CFC, known as Subpart F income. Subpart F income generally includes specific types of income that Congress considered easy to shift outside the United States, including passive income, insurance income and certain sales and services income earned outside the United States, but involving related parties.

In addition, the investment of earnings by a CFC in U.S. property also gives rise to an income inclusion for U.S. shareholders. This rule provides a backstop to the Subpart F rules (*i.e.*, if earnings escape inclusion in income as Subpart F income, U.S. shareholders are taxed on the earnings if earnings of the CFC effectively come back to the United States through investment in U.S. property). U.S. property includes the investment by a CFC in debt of a U.S. shareholder of the CFC. If the CFC guarantees the debt of a U.S. shareholder, or the U.S. shareholder pledges more than 66 2/3 percent of the stock of the CFC, the CFC will be deemed to have invested in the debt of the U.S. shareholder, resulting in the requirement to include the income of the CFC up to the amount of earnings and profits of the CFC (or if less, the amount of the debt).

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The Rules Are Still in Effect

The House of Representatives tax reform proposal would have eliminated the income inclusion under Section 956 for domestic corporations. Unfortunately, this was not enacted into law, and the rules continue to apply to corporations as well as individuals.

More Corporations Will Be CFCs After Tax Reform

Tax reform revised various rules in a way that will result in a dramatic increase in the number of CFCs. These changes include:

- The 10 percent threshold for determining if a person is a U.S. shareholder now is determined by vote or value (previously, the determination was based solely on vote).
- Stock now may be attributed from foreign persons to U.S. persons in determining if the 10 percent and 50 percent thresholds are satisfied.

  For example: If a foreign parent owns all of the stock of each of a foreign subsidiary and a U.S. subsidiary, the U.S. subsidiary is deemed to own all of the stock of the foreign subsidiary, and the foreign subsidiary is a CFC of which the U.S. subsidiary is its U.S. shareholder.

- The rule requiring a CFC to be a CFC for 30 days during a year was eliminated.

Global Intangible Low Taxed Income (GILTI) Does Not Eliminate the Issue

Tax reform dramatically expanded the reach of the rules for U.S. shareholders of CFCs. In addition to significantly expanding the class of foreign corporations that will be treated as CFCs, the new provisions require U.S. shareholders to include in income not only Subpart F income, but also their share of a CFC's GILTI. Essentially, all income of a CFC in excess of a 10 percent return on the CFC's basis in tangible personal property is GILTI, with certain exceptions. These exceptions include income that avoids treatment as Subpart F income because it is subject to tax in the foreign country at a rate at least 90 percent of the U.S. tax rate (High-Taxed Income). However, for a CFC involved in a service business without a significant investment in equipment, almost all income that does not fall into one of the exceptions will be GILTI.

In light of GILTI, the natural question is whether we should worry about the rules regarding investment in U.S. property. The authors suggest that we should. Ignoring these rules will subject income of a CFC that is not considered GILTI — such as income equal to the return on tangible personal property, High-Taxed Income and certain other types of income — to current taxation at regular tax rates.

Moreover, Treasury has not yet issued regulations clarifying that the GILTI provisions trump Section 956 inclusions. Although the statutory language suggests that this is the case, there is no detailed rule clarifying this, and some commentators have indicated that the opposite is at least a plausible reading. If (while not expected) Treasury were to determine that 956 inclusions take priority over GILTI inclusions, then this would subject the income to significantly higher tax rates in the hands of corporations.

Notably, the determination of a U.S. shareholder's share of Subpart F income or GILTI is not determined in the

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same manner as a U.S. shareholder's 956 inclusion. Moreover, after tax reform, especially the change in the constructive stock ownership rules that now allow stock of a foreign person to be attributed to U.S. persons, many more entities will be treated as CFCs. These two factors may result in U.S. shareholders having income inclusions under Section 956 in cases where they otherwise would avoid GILTI.

Non-Tax Rationale for the Status Quo

It is also worth bearing in mind that providing guarantees and grants of collateral by foreign subsidiaries can be expensive and time consuming. Creditors in U.S.-led credit facilities or debt issuances have generally accepted that they do not need this additional credit support (and are unlikely to take advantage of it in a default scenario), and can be adequately protected through limitations on the incurrence of indebtedness by the foreign subsidiaries. Accordingly, even in circumstances where the new tax law may reduce the impact of having CFC income included under Section 956, consideration should be given to the overall costs relative to the expected benefits to creditors.

Pepper Perspective

Tax reform did not change the rule that requires U.S. shareholders to take into income their share of the earnings of a CFC invested in U.S. property — including by reason of a CFC's guarantee of debt, or the pledge of the CFC's stock to secure the debt — of a U.S. shareholder. Changes in the definition of a U.S. shareholder and CFC, and the expansion of the constructive ownership rules, will create significantly more CFCs than under pre-tax reform rules. Although the GILTI rules will subject the income of many CFCs to taxation in the hands of their U.S. shareholders, certain exceptions, including the exception for High-Taxed Income and the return on tangible property, may present limited opportunities for deferral of a CFC's income, unless 956 were to apply. Additionally, differences in the calculations of a GILTI and Section 956 inclusion could result in larger inclusions under Section 956 than under GILTI. In light of the tax reform changes, U.S. borrowers should reconsider existing financing structures to ensure that they continue to avoid Section 956 concerns. Non-tax reasons, including the fact that lenders have been living with restrictions on CFC guarantees and stock pledges for many years, reinforce the conclusion that U.S. borrowers should continue to restrict the use of CFC guarantees and stock pledges to secure their debt.

Endnote

[1] The actual threshold is 66 2/3 percent, but, to avoid a foot fault, it is typical to limit the pledge of CFC stock to 65 percent.

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