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Structuring U.S. Debt Facilities In Light Of New IRS Rules

WRITTEN BY

Joan C. Arnold | J. Bradley Boericke

Until recently, the structuring of debt facilities for U.S. borrowers with foreign subsidiaries has been largely driven by IRS interpretations of section 956 of the Internal Revenue Code, which gave rise to significant tax inefficiencies if foreign subsidiaries were to guarantee or provide other collateral support for the debt of a U.S. borrower. As a result of these rules, it has been generally accepted between borrowers and creditors in the U.S. debt markets that credit and collateral support will stop “at the border.”

However, in October 2018, the IRS issued a proposed rule that eliminates the negative tax results of foreign guarantees and collateral support in almost all cases where the borrower is a C corporation. Accordingly, going forward, lenders and borrowers will need to take a more general cost-benefit approach to foreign guarantees and collateral support.

Background

In broad strokes, section 956 of the Internal Revenue Code provides that the investment of earnings by a “controlled foreign corporation” (CFC) in U.S. property gives rise to a pro rata income inclusion for the U.S. shareholders of that CFC who own 10 percent or more. This is based on the principle that certain investments by a CFC of its earnings in U.S. property are “substantially the equivalent of a dividend” and should trigger the same U.S. tax consequences. Debt of a U.S. company constitutes U.S. property for purposes of this rule — for example, an intercompany loan to the U.S. shareholder of the CFC is precisely the sort of investment that has substantially the equivalent effect as a dividend and is intended to be captured by the rule. A direct guarantee of the debt or grant of collateral to secure the debt has a similar effect and is an investment in U.S. property for purposes of section 956.

The result is that a guarantee or provision of collateral support by a CFC in respect of debt of a U.S. parent company results in some or all of the earnings and profits of the CFC being included in the taxable income of the U.S. parent. This is often referred to as a “deemed dividend” from the CFC to the U.S. parent.

This was generally recognized to be a bad result, and it has been long-standing market practice for the collateral support for U.S. debt facilities of virtually all types to “stop at the border.” Material U.S. subsidiaries would provide guarantees and grant collateral, as and to the extent appropriate to the underwriting of the credit, but foreign subsidiaries would not. Furthermore, a pledge of more than two thirds of the voting equity interests of a CFC was interpreted to give rise to the same concern, and, therefore, pledges of only 65 percent of the voting equity interests of first-tier foreign subsidiaries would be provided.

In some cases, the extent of the foreign operations or business needs of the borrower group would lead to structures that avoided this constraint. In particular, some or all of a debt package could be structured with a foreign subsidiary as the borrower. This debt could be supported by guarantees and collateral from any company in the group, without triggering any deemed dividends. When debt facilities were structured to include both a U.S. borrower loan (supported by only U.S. subsidiaries) and a foreign borrower loan (supported by both U.S. and foreign subsidiaries), there was often a "collateral adjustment mechanism" by which the recovery rates would be equalized over the two facilities in the event of insolvency.

New Proposed Rule

In October 2018, the IRS issued a proposed regulation that dis-applies section 956 in most situations where the borrower is a C corporation.

The proposed regulation is an outgrowth of the Tax Cut and Jobs Act enacted in December 2017. Among other things, the Tax Cut and Jobs Act established a deduction, with respect to dividends received from 10 percent or more owned foreign corporations, in an amount equal to the foreign-source portion of such dividends, subject to certain exceptions (referred to as the "dividends received deduction"). Since the entire premise of the section 956 rules is that certain investments by CFCs in U.S. property are "substantially the equivalent of a dividend," the IRS concluded that it would be inconsistent with the intent of section 956 to treat "deemed dividends" under the section as subject to taxation, when an actual dividend would not be. Accordingly, the proposed regulations provide that the amount of income otherwise determined under section 956 as includable as taxable income of a U.S. taxpayer will be reduced to the extent that the U.S. taxpayer would be allowed a "dividends received deduction" if the U.S. taxpayer had received a distribution of the amount.

In almost all cases, this means that there would no longer be any "deemed dividend" resulting from the provision of guarantees or other collateral support by CFCs in relation to debt of their U.S. shareholder. However, there are certain circumstances in which there are still section 956 concerns. For example, to the extent the CFC has taxable income from operations it carries out in the United States, or it has dividends from U.S. corporations, dividends it pays to its 10 percent U.S. shareholders would not be part of the dividend received deduction and thus would still be section 956 inclusions. However, it would be unusual for those facts to exist, as taxpayers work to avoid such structures. In addition, in order to use the dividend received deduction, and thus to qualify for the exemption for section 956, the 10 percent U.S. shareholders need to meet a minimum holding period of the CFC's stock. If a CFC does not meet the holding period at the time of the potential investment in U.S. property, there is a risk there will be a section 956 inclusion because the U.S. shareholder may dispose of the stock before the holding period is met. For this reason, it is reasonable to exclude from the security package for the U.S. debt the guarantees and pledges of the CFCs that have not yet met the holding period requirement. This would include after acquired (or formed) CFCs; they can become a part of the package once the holding period is satisfied.

Because the proposed regulation is geared to tie the section 956 inclusion to the dividend received deduction, which is only available to C corporations, the proposed regulation does not apply to individuals, S corporations, regulated investment companies, real estate investment trusts, entities taxed as partnerships (including multimember U.S. limited liability companies), and corporations that receive "hybrid dividends " because these entities do not qualify for the dividend received deduction. The proposed regulation also would not apply when the borrower is a single member LLC (a disregarded entity) whose sole member is one of the foregoing types of

entities. Investments in U.S. property by CFCs owned by those entities remain fully subject to the section 956 rules.

The notice of proposed rulemaking provides that taxpayers may rely on the proposed regulation for taxable years of a CFC beginning on or after December 31, 2017, provided they apply the proposed regulation with respect to all of their CFCs.

It is noted that some taxpayers have used section 956 affirmatively to assist in foreign tax credit planning with respect to the taxes paid by the CFCs. Thus, there may be a challenge to the validity of the proposed regulation, but there has not been a public outpouring of such a response, and the IRS has considerable authority to write regulations under section 956 to implement the goals of the section. While it is unclear when, or if, the regulation will be made final, most taxpayers are comfortable that they can rely on the proposed regulation until, or if, it is revised.

Impact on Structuring Debt Facilities

Existing Credit Agreements With Material Adverse Tax Effect Criterion

While it is accepted market practice to exclude foreign subsidiaries from any requirements to provide subsidiary guarantees or collateral under debt facilities for U.S. borrowers, some facilities limit that exclusion to cases where the provision of the guarantee or grant of collateral would trigger material adverse tax consequences. In light of the proposed rule, the exclusion of foreign subsidiaries may no longer be supported under such a standard. Where debt facilities include such a standard, the relevant parties should evaluate whether additional steps are required to be taken or if amendments or waivers might be appropriate. Administrative agents should be particularly attentive to wording that places the determination of material adverse tax consequences in their discretion.

New Framework for Negotiation

Going forward, creditors and debtors will need to negotiate over the inclusion or exclusion of guarantees and collateral from foreign subsidiaries on a basis other than the rules previously in effect under section 956.

To a certain extent, this sort of negotiation was already commonplace, in that most facilities did not tie the exclusion of foreign subsidiaries to cases where there would actually be an adverse tax result. Indeed, it has been fairly commonplace to exclude foreign collateral even when owned by a U.S. debtor. This is broadly justified by the relative expense of obtaining guarantees and collateral in multiple non-U.S. jurisdictions, on the one hand, and the precedent shaped by section 956 showing that creditors were willing to live without that extra degree of protection.

In significant part, the willingness of creditors to live without foreign guarantees and collateral was supported by contractual protections, such as limitations on the incurrence of other debt by the foreign subsidiaries (since, absent guarantees by such foreign subsidiaries, debt incurred by those subsidiaries would be structurally senior to the U.S. debt to the extent of the assets and income of those foreign subsidiaries). In the credit agreement markets (including the Term Loan B market), it is also widespread to place limitations on the transfer of value, such as loans or investments from the credit parties (borrowers and guarantors), to non-credit parties. Absent the constraints of the section 956 rules, borrowers may, in some cases, find it to their advantage to improve their

operational flexibility by allowing foreign subsidiaries to be credit parties.

To the extent that borrowers and creditors are engaged in cost-benefit analyses over the provision of guarantees and collateral by foreign subsidiaries, it is clear that not all jurisdictions are created equal in terms of the costs of giving guarantees or granting collateral (or giving particular types of collateral), and the relative benefits to creditors generally of holding such rights. In some jurisdictions, there are legal limitations on the ability of subsidiaries to guarantee debt of a parent company. Realistic consideration should also be given to the nature of the particular creditors involved in the financing and their practical institutional ability to manage a multijurisdictional enforcement process.

Additional Considerations

It is important to check the state tax impact of the guarantee or pledge of collateral. How the states will handle the dis-application of section 956 is to be determined.

While the proposed regulation permits a taxpayer to rely on the new rule now, there is some concern that it may not be finalized in its current form. Thus, when borrowers are agreeing to guarantees or collateral support from CFCs that they would not have accepted otherwise, they should include a caveat that if the proposed regulation is finalized in a manner that would not preclude a section 956 inclusion, the guarantees or pledges of stock will be unwound.

Also, because of the holding period that is required for the dividend received deduction to apply, the credit agreement should provide that future acquired or formed CFCs would not be part of the collateral package until the time period is met.