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Client Alert

Guaranties and Pledges by Foreign Subsidiaries: The Weakening of Section 956

March 25, 2019 – As a general rule, lenders are aggressive in searching through a debtor's assets to find credit support for their loans. However, there is a long standing carve out for credit support from foreign subsidiaries with respect to loans to U.S. borrowers. As a result of this carve out, in practice, lenders have generally been restricted from obtaining guaranties from foreign subsidiaries and pledges of more than 66 2/3% of the voting equity of foreign subsidiaries.

The carve out is based on Section 956 of the Internal Revenue Code and regulations thereunder. Section 956 applies to "controlled foreign corporations", as described in Section 957 (a "CFC"). It requires shareholders of a CFC to include in income the earnings of the CFC (even though undistributed to the shareholders) to the extent the CFC holds certain investments in U.S. property. A CFC that provides certain credit support for its U.S. shareholder's debt is considered to hold that debt as an investment in U.S. property.

Of course, the practical application of this rule depends on the facts and circumstances surrounding the loans. For example, where a CFC has de minimis earnings or annually distributes all its earnings, the impact of Section 956 is neutered. Thus, under these and similar circumstances lenders have taken guaranties from foreign subsidiaries.

In a similar vein, foreign subsidiaries can be treated under certain circumstances as disregarded or pass throughs for U.S. income tax purposes. In such cases, the foreign subsidiaries are not technically corporations and therefore not CFCs. Further, those subsidiaries are already treating any undistributed income as received by their U.S. owners. Thus, lenders have also taken guaranties from disregarded and pass through foreign subsidiaries.

The most recent tax reform act has further impacted this issue. First, it has expanded the scope of the term "CFC" by modifying certain ownership rules. Second, it has substantially altered how offshore earnings are taxed. Under the modified post tax reform rules, new section 245A provides that a U.S. corporation that owns 10% or more of a foreign corporation can receive a distribution of a foreign corporation's offshore earnings tax free. Generally, this new rule will discourage undistributed earnings, but there may be other limitations on the distribution of a foreign corporation's earnings to its U.S. owners, such as local withholding taxes. The obvious issue has become the treatment of undistributed foreign earnings that are nevertheless taxable (say under Section 956) under the new regime.

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Under recently proposed regulations, earnings included in income by U.S. shareholders of a CFC under section 956 are specifically covered by Section 245A and are not taxable. Typically, proposed regulations may not be relied upon until after they are adopted. In this case, however, the proposed regulations provide that they may be relied upon if consistently applied. Assuming a corporate debtor is agreeable to applying these new regulations, a lender to such a U.S. corporate debtor would be able to take guaranties from foreign subsidiaries and pledges of all the stock of such subsidiaries.

Section 956 remains a problem for (a) non corporate borrowers, and (b) those corporate borrowers who are unwilling to establish a borrowing structure that may need to be renegotiated if the proposed regulations are modified or revoked.

If you would like to discuss these new rules or any other tax topic, please reach out to Isaac Grossman or other members of our tax department.

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