

Tax Reform Bill May Eliminate Need to Limit Credit Support Attributable to CFCs for US Corporate Borrowers

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Under current law, the direct or indirect pledge of the assets of a “controlled foreign corporation” (a “CFC”) as collateral security for, among other things, a borrowing of a US person is treated as an investment in US property under section 956 of the Internal Revenue Code of 1986, as amended (the “Code”), and triggers a deemed dividend to the US shareholders of the CFC in an amount equal, in general, to the lesser of the principal amount of the loan and the total untaxed earnings and profits of the CFC (a “Deemed Dividend”).

Per a safe harbor in the applicable regulations, a pledge of less than 66⅔% of the voting stock of a CFC is not treated as an indirect pledge of the assets of a CFC. Current market practice for bank finance and other lending transactions involving US borrowers that have foreign subsidiaries that are CFCs seeks to balance the need on the part of lenders to obtain the maximum credit support possible against the desire on the part of US borrowers to avoid a Deemed Dividend by (1) treating CFCs and CFC holding companies (“CFC Holdcos”) as “Excluded Subsidiaries” and thus as subsidiaries that are not required to, among other things, guarantee any loans incurred by a US borrower pursuant to the credit documents, (2) treating any assets owned directly or indirectly by a CFC or CFC Holdco as “Excluded Assets” and thus as assets that are not required to be pledged as collateral security for a US borrowing and (3) limiting any pledge of the voting stock of a CFC or CFC Holdco to not more than 65% of the voting stock of such subsidiary (collectively, the “CFC Credit Support Limitations”).

Section 4002 of the Tax Cuts and Jobs Act Would Change the Deemed Dividend Calculus

Section 4002 of H.R. 1, the Tax Cuts and Jobs Act (the “TCJA”), introduced on November 2, 2017, would limit the application of the deemed dividend rules under section 956 of the Code to US shareholders of a CFC that are not corporations. As such, a guarantee by, or a pledge of the stock or assets of, a CFC to support a borrowing of a US person **would not** trigger a Deemed Dividend to the US shareholders of a CFC that are corporations. The deemed dividend rules, however, would continue to apply to non-corporate US shareholders of a CFC. The legislation contemplates that the treatment of corporations that are partners in a partnership would be addressed in regulations to be promulgated by the Treasury Department. It is unclear, however, how these regulations, if promulgated, would treat corporate partners of a partnership for purposes of the deemed dividend rules. The amendments to Section 956 contemplated by Section 4002 of the TCJA are proposed to be effective for taxable years of a foreign corporation beginning after December 31, 2017.

Next Steps

It is unclear at this point whether the TCJA will be enacted or, if so, whether section 4002 of the TCJA would be enacted in its current form. Nevertheless, in light of the possibility that a Deemed Dividend inclusion may no longer be an issue for US corporate borrowers, financing parties that are currently negotiating loans and other financing arrangements involving a US borrower may want to consider including provisions in the credit documents which would cause the CFC Credit Support Limitations to fall away with respect to US corporate borrowers in the event Section 4002 of the TCJA or a provision substantially similar to Section 4002 of the TCJA becomes law.

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