Proposed Tax Regulations May Allow Foreign Assets to Serve as Credit Support

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Tax regulations proposed on October 31, 2018 may allow a US parent corporation to grant lenders guarantees and pledges by, and pledges of the shares of, its foreign subsidiaries without adverse US tax consequences. This may allow US multinationals to **achieve greater financing flexibility by offering foreign assets as collateral**. However, there are still hurdles to using foreign assets as collateral, and reliance on the regulations prior to their finalization comes with risks.

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Background. Prior to last year's US tax reform, a 10% or greater US shareholder of a controlled foreign corporation ("CFC") could generally defer US tax on the earnings of the CFC until the US shareholder received a dividend of those earnings. However, where the CFC guaranteed, or pledged its assets in favor of, the debt of its US shareholder, or where the US shareholder pledged two-thirds or more of the voting stock of the CFC as collateral for the US shareholder's debt, the earnings of the CFC were subject to US tax in the hands of its US shareholder as if they had been distributed (the "Guarantee and Pledge Rule").

Tax reform at the end of 2017 upended the deferral regime by requiring more of a CFC's income to be included currently by 10% or greater US shareholders. Tax reform also introduced a new rule (the "Dividend Exemption Rule") under which 10% or greater corporate US shareholders ("US Corporations") of a foreign corporation are generally allowed to receive distributions of foreign earnings free of US tax. Inexplicably, the tax reform legislation left in place the Guarantee and Pledge Rule, meaning that a US Corporation whose CFC had provided credit support would be taxed currently under the Guarantee and Pledge Rule to the extent of earnings that had otherwise escaped current US tax, despite the fact that an actual distribution of those earnings would have been free from US tax under the Dividend Exemption Rule. For this reason, **even after tax reform, US borrowers resisted allowing their foreign subsidiaries' assets to serve as credit support for the US borrower's debts.**

The new proposed regulations. The Proposed Regulations effectively turn off the Guarantee and Pledge Rule for US Corporations by treating the income that a US Corporation would have otherwise included under the Guarantee and Pledge Rule as a dividend covered by the Dividend Exemption Rule. Use of the Proposed Regulations is subject to certain restrictions:

- *US Corporations only*: Individuals and partnerships are still subject to current tax under the Guarantee and Pledge Rule. However, the IRS invites proposals for partnerships with US Corporation partners.

- *Holding period requirement*: US Corporations must own the CFC for more than 365 days over a 2 year period.

- *Consistent application*: US Corporations may rely on the Proposed Regulations for tax years of a CFC beginning after Dec. 31 2017, but only if the US Corporation and all related US persons consistently apply the Proposed Regulations.

Anticipated effects

- Lenders may **require a US parent corporation to offer foreign assets as credit support or pledge 100% of the stock of its foreign subsidiaries** (particularly in a restructuring or workout scenario).

- Although the Proposed Regulations can be relied upon immediately, their uncertain status should give borrowers **reason to be cautious** (and an argument to resist bank demands):

  - The Proposed Regulations **may not become final** or **may change significantly** before becoming final.

  - Taxpayers that wish to rely on the Proposed Regulations must make sure that all US persons related to them apply the Proposed Regulations consistently. This may be difficult to police, particularly for large groups, given the broad definition of relatedness.

- Borrowers must weigh potential lower borrowing costs from enhanced credit support against **change-in-law risk** and non-US **impediments to granting upstream guarantees and security interests in local assets**.

- Borrowers that rely on the Proposed Regulations must think ahead:

  - Borrowers that add foreign subsidiaries to their credit support should retain the **flexibility** to remove them if the tax law develops unfavorably.

- Borrowers acquiring or forming new foreign subsidiaries will want a **one-year delay** on their addition to the collateral package to meet the required holding period.

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