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New Code Sec. 245A and Pledges of CFC Stock

By Donald P. Board • Wood LLP

Many readers of The M&A Tax Report spend a lot of time working with the corporate "deal lawyers" who make mergers and acquisitions happen. But what about those *other* corporate lawyers down the hall, the ones with the extremely tidy offices who do the debt financings? Lawyers who focus on loan work may call a tax specialist with occasional questions about withholding or COD income, but that is often about as far as it goes.

Recent changes to the tax rules governing controlled foreign corporations (CFCs) could provide opportunities for more frequent consultations. On October 31, 2018, the IRS issued proposed regulations (Proposed Regulations) intended to harmonize the "deemed dividend" provisions of Code Sec. 956 with the "participation exemption" established by new Code Sec. 245A. In most—but not all—cases, the Proposed Regulations will eliminate the adverse tax consequences that U.S. corporations have historically suffered if they pledge two-thirds or more of the voting shares of a foreign subsidiary or get the sub to guarantee their obligations.

Secured lenders want all the collateral they can get their hands on, so they should welcome the Proposed Regulations. U.S. corporate borrowers with CFCs may see it a bit differently, because the new rules will make it harder for them to resist lenders' demands. Borrowers may also feel uneasy because the new regime is subject, as usual, to complicated exceptions that have to be ruled out on a case-by-case basis.

Lenders, who don't have anything to lose, can be expected to press hard for all-inclusive pledges of CFC shares. Their legal advisors—those buttoned-up loan lawyers down the hall—may be called on to explain to nervous borrowers and their advisors why, under their particular facts, the proposed pledge is perfectly safe. If that happens, the loan lawyers will start calling their tax people.

Background: Foreign Deferral

For the first 50 years of the corporate income tax, the United States made no attempt to tax the non-U.S. earnings of foreign corporations.

This initially seems unremarkable. Why would the United States try to tax Qantas on the profits it earns flying koalas from Brisbane to Bangkok?

However, this restrained approach produced anomalous results when the foreign corporation was largely owned and controlled by a U.S. corporate parent. If the U.S. corporation had earned the foreign income *directly* by operating a branch in Australia, that profit would have been immediately subject to U.S. tax. But the corporation could make its foreign income disappear from the U.S. corporate tax base by simply incorporating the branch outside the United States.

The exclusion was not supposed to be permanent. The foreign income would eventually be taxed, most likely when the U.S. parent received dividends or other distributions derived from the sub's offshore earnings. However, if the subsidiary was operating in a relatively low-tax jurisdiction, there was a powerful incentive for the parent to defer U.S. tax by instructing the sub to minimize its taxable distributions.

Subpart F

By 1962, the use of foreign subsidiaries to avoid U.S. tax had become so widespread that tax policy-makers were considering whether U.S. corporations should simply be required to report their foreign subsidiaries' income on a current basis. In the end, however, Congress decided to target deferral only in what it regarded as abusive situations. The result was Subpart F [Code Secs. 951–965], which provides complicated rules for determining whether a "United States shareholder" (U.S. shareholder) must report foreign income earned by a controlled foreign corporation *before* that income is actually distributed.

A U.S. person is a U.S. shareholder of a foreign corporation if that person owns (directly, indirectly, or constructively) at least 10 percent of the total combined voting power of all classes of the foreign corporation's stock. [Code Sec. 951(b).] A foreign corporation is a CFC only if U.S. shareholders own (directly, indirectly, or constructively) more than 50 percent of: (1) the total combined voting power of the foreign corporation; or (2) the total value of the foreign corporation's stock. [Code Sec. 957(a).]

Taxing Subpart F Income

Under these definitions, a U.S. corporation with a foreign subsidiary should generally be classified as a U.S. shareholder of a CFC. Historically, the U.S. parent has had to contend with two rules that could force it to pay tax on a portion of the subsidiary's undistributed non-U.S. earnings and profits.

The first is Code Sec. 951(a)(1)(A), which requires the U.S. parent to include its *pro rata* share of the CFC's "subpart F income." Subpart F income generally consists of income of a type that is readily shifted to tax haven jurisdictions. A classic example would be income from stocks and bonds, which can be relocated to a foreign corporation with the stroke of a pen. [*See* Code Sec. 954(a)(1) and (c) (foreign personal holding company income).]

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Other examples involve transactions between related parties. Suppose that a U.S. parent sells a widget to its CFC in the Cayman Islands for $2. If the CFC turns around and resells the widget to a customer in Turkey for $3.50, the arrangement will shift $1.50 in profit from the United States to the tax haven.

This profit is potentially classified as "foreign base company sales income," which is another form of Subpart F income. [*See* Code Sec. 954(a)(2) and (d).] If so, the U.S. parent corporation will have to pay U.S. tax on the $1.50 earned by the CFC, even without a dividend or other taxable distribution.

Taxing Investments in U.S. Property

What about a CFC's legitimate foreign earnings—*i.e.*, its profits that do not fall into any of the categories of abusive Subpart F income? In general, Congress was willing to let the U.S. parent corporation defer tax on the CFC's on-the-level foreign earnings until they were actually distributed. However, the drafters of Subpart F recognized that a CFC might postpone paying taxable dividends, perhaps indefinitely, if it could find other ways to "repatriate" its earning and profits for the benefit of its U.S. shareholders.

Congress addressed non-dividend repatriations in Code Sec. 951(a)(1)(B). A U.S. shareholder is required to report as income its appropriate share (determined under Code Sec. 956) of any increases in the amount of the CFC's earnings and profits that are invested in "United States property" (U.S. property). This term is defined broadly to mean tangible personal property located in the United States, stock of domestic corporations, obligations of U.S. persons, and certain types of intellectual property developed or acquired by the CFC for use in the United States. [Code Sec. 956(c)(1).]

This is followed in Code Sec. 956(c)(2) by a much longer list of exceptions, which undo much of the general language of Code Sec. 956(c)(1). Notably, it turns out that a CFC's investment in the stock or obligations of a domestic corporation is generally *not* an investment in U.S. property. For Code Sec. 956 to apply, the investee domestic corporation must be: (1) a U.S. shareholder of the CFC; or (2) a corporation that is at least 25-percent controlled by the CFC's U.S. shareholders as a group. [*See* Code Sec. 956(c)(2)(F).]

This is the kind of upside-down drafting that gives the Code a bad name. For our purposes, however, the key point is that a foreign subsidiary's direct or indirect loan to its U.S. parent *does* count as an investment in U.S. property. Hence, the door is open to requiring the U.S. parent to report the loan proceeds as income pursuant to Code Sec. 951(a)(1)(B).

Foreign Credit Support

What if a CFC does not actually make the loan, but instead guarantees a *third party's* advance to the U.S. parent? Or what if the CFC grants a security interest in its assets to secure the U.S. parent's obligations to a third-party lender? To keep these potential loopholes tightly shut, Code Sec. 956(d) declares that a CFC shall, under regulations prescribed by the Treasury, be considered as holding an obligation of a U.S. person if the CFC "is a pledgor or guarantor of such obligation."

Perhaps Congress expected the required regulations to qualify this broad statutory language. But Reg. §1.956-2(c)(1) simply rephrases Code Sec. 956(d). Any obligation of a U.S. person "with respect to which a controlled foreign corporation is a pledgor or guarantor" is considered to be U.S. property held by the CFC.

In for a Penny, In for a Pound?

If this language is taken at face value, the implications can be harsh. Suppose that a U.S. parent corporation has borrowed $100, and that one of its CFCs gives the lender a *limited* guaranty. If the parent doesn't pay the full $100, the CFC must pay the lender $7.50 or, if less, the amount of the shortfall.

There is an obvious sense in which the CFC *is* a guarantor of the U.S. parent's $100 obligation. Yet the CFC's exposure is limited to $7.50, so many people would probably describe the CFC as the guarantor of just a $7.50 "portion" of the obligation. That sounds sensible, but no such refinement appears in the "plain language" of Code Sec. 956(d) or Reg. §1.956-2(c)(1).

Under Reg. §1.956-1(e)(2), the amount that must be taken into account with respect to any pledge or guaranty described in Reg.

§1.956-2(c)(1) is "the unpaid principal amount … of the obligation with respect to which the controlled foreign corporation is a pledgor or guarantor." The unqualified use of "unpaid principal amount" suggests that the regulations mean what they literally say. In that case, the CFC's $7.50 guaranty would require the U.S. parent to report the full $100 as income, assuming the CFC has sufficient E&P.

Multiple Guarantors

If that's not enough zeros, consider the Subpart F debacle recounted in *SIH Partners LLP* [150 TC No. 3, Dec. 61,108 (Jan. 18, 2018)]. There, the U.S. parent corporation borrowed $1.485 *billion* from Merrill Lynch, backed by guaranties from 39 of its subsidiaries. Unfortunately, two of the subs were CFCs, and they were sitting on hundreds of millions of dollars of E&P.

From a commercial-law perspective, each of the 39 subsidiaries was on the hook for the entire $1.485 billion. However, they all had rights to *contribution* from their fellow guarantors. One could therefore argue that each sub was *really* guaranteeing only its *pro rata* share of the U.S. parent's massive debt.

The IRS didn't see it that way. It treated the two CFCs as *both* investing the full $1.485 billion in U.S. property when they guaranteed their parent's obligation to Merrill Lynch. Based on the amount of the CFCs' available E&P, the parent was required to include over $375 million in income pursuant to Code Sec. 951(a)(1)(B).

In the Tax Court, the U.S. parent pointed out that literal application of the Code and regulations could produce results that were not only disproportionate, but arguably absurd. Suppose, for example, that the U.S. parent had provided guaranties from a *dozen* CFCs, each packing at least $1.485 billion of earnings and profits. Under the IRS's approach, the U.S. parent would have had to report *$17.82 billion* in income in connection with the $1.485 billion loan.

The IRS has itself noted that literal application of the Code and regulations to multiple guaranties can produce "strange results." [FSA 200216022 (Jan. 8, 2002).] In 2015, the Treasury reported that it was considering amending the regulations to limit the U.S. parent's aggregate inclusion to the unpaid principal amount of the obligation. [*See* Notice of Proposed Rulemaking, 80 FR 53062 (Sept. 2, 2015).] However, no action was taken on this sensible proposal.

In *SIH Partners*, the Tax Court upheld the IRS's decision to apply Code Sec. 956(d) literally. In its appeal, now pending before the Third Circuit, the U.S. parent is contending that the regulations are invalid. The regulations have been on the books for 55 years, so invalidation would be a surprising result.

The U.S. parent argues that the Treasury failed to engage in reasoned decision-making, because the regulations simply rephrased Code Sec. 956(d) and made no attempt to rule out strange results. The regulations were therefore arbitrary and capricious when adopted in 1964. [*Cf. Motor Vehicle Mfrs. Ass'n of the U.S. v. State Farm Mut. Auto Ins. Co.*, SCt, 463 US 29 (1983).] In that case, they are unenforceable under Section 706(2)(A) of the Administrative Procedure Act. We'll see.

Indirect Pledges

The regulations apply to certain forms of *indirect* credit support. A CFC is treated as if it had granted a security interest in its assets if those assets "serve at any time, even though indirectly, as security for the performance of an obligation of a United States person." The regulations state that this includes a *pledge of stock* in a CFC, provided that the pledged shares represent at least 66 ⅔ percent of the combined voting power of the CFC's voting shares. [Reg. §1.956-2(c)(2).]

This is why, since the early 1960s, U.S. parent corporations have preferred not to pledge *any* shares of their foreign subsidiaries, if they could avoid doing so. When lenders have insisted, U.S. parents have uniformly refused to pledge shares representing the forbidden two-thirds of the sub's total voting power. In fact, the furthest most borrowers will go is 65 percent, just to be safe.

Over the decades, lenders have come to accept borrowers' tax-based objections to pledges of CFC shares. It is considered bad form for a lender to even *ask* a U.S. borrower for a pledge that might force it to report profits that were supposed to be safely stashed offshore. With the enactment of Code Sec. 245A, that is going to change.

Code Sec. 245A

Code Sec. 245A exempts the foreign-source portion of certain foreign dividends from U.S. tax. This raises an immediate policy question under Subpart F. If Code Sec. 245A would exempt an *actual* CFC dividend from tax, should a U.S. shareholder have to report income under Code Sec. 956 if the CFC engages in a transaction that is a *substitute* for a dividend?

Both the Senate and the House versions of the bills that eventuated in the TCJA would have made Code Sec. 956 inapplicable to U.S. corporations qualifying for the new participation exemption. For reasons that remain obscure, however, the version that became law made no effort to coordinate Code Secs. 245A and 956. This left it up to the Department of the Treasury and the IRS to figure out how to bring these provisions into alignment.

To understand where the Proposed Regulations are coming from, we need to take a closer look at the participation exemption. Code Sec. 245A(a) states the basic rule:

> In the case of any dividend received from a specified 10-percent owned foreign corporation by a domestic corporation which is a United States shareholder with respect to such foreign corporation, there shall be allowed as a deduction an amount equal to the foreign-source portion of such dividend.

Several structural points should be noted at the outset. First, the so-called "participation exemption" is actually a form of dividends-received deduction. Second, it applies solely for the benefit of domestic *corporations*. Third, as noted in the legislative history, this actually refers only to domestic *C corporations*. [*See* Joint Committee on Taxation General Explanation of Public Law 115-97 (JCS-1-18), December 2018, at 349.]

To qualify for the new DRD, a domestic corporation must be a U.S. shareholder with respect to the payor of the dividend. That concept is familiar from Subpart F, but it is worth pointing out that Code Sec. 245A does *not* require the payor to be a CFC. "Specified 10-percent owned foreign corporation" just means the corporation with respect to which the domestic corporation is a U.S. shareholder. [*See* Code Sec. 245A(b)(1).]

A domestic corporation cannot claim the DRD unless it has held the shares of the payor for more than 365 days during the 731-day period beginning 365 days before the shares became ex-dividend with respect to the dividend. [*See* Code Secs. 246(c)(1)(A) and 246(c)(5)(A).] A day counts for holding-period purposes only if the domestic corporation was a U.S. shareholder on that date. [*See* Code Sec. 246(c)(1)(B).]

Foreign-Source Portion

Code Sec. 245A applies only to the "foreign-source portion" of a dividend. This is determined by multiplying the full amount of the dividend by an allocation factor equal to: (1) the foreign corporation's undistributed *foreign* earnings; divided by (2) the foreign corporation's *total* undistributed earnings. [Code Sec. 245A(c)(1).]

Even though the payor of the dividend is a foreign corporation, its "earnings" correspond to its earnings and profits determined using U.S. tax principles. [*See* Code Sec. 245A(c)(2).] This is hardly an exercise in tax comity, but it's standard operating procedure under the Code. [*See* Reg. §1.964-1(a)(1) (foreign corporation's E&P is "computed for all Federal income tax purposes substantially as if such corporation were a domestic corporation").]

The foreign corporation's total undistributed earnings are determined as of the end of the taxable year, with no reduction for dividends paid during the year. [Code Sec. 245A(c)(2).] "Undistributed foreign earnings" means all of the corporation's undistributed earnings except: (1) amounts subject to U.S. tax as income effectively connected with the conduct of a trade or business within the United States [*cf.* Code Sec. 245(a)(5)(A)]; and (2) dividends received from a domestic corporation at least 80 percent of whose stock (by vote and value) is owned by the foreign corporation [*cf.* Code Sec. 245(a)(5)(B)].

Suppose that a U.S. parent corporation receives a $10 million dividend from a foreign subsidiary that has $50 million in total E&P. Further suppose that $20 million of that amount derives from income effectively connected to a trade or business conducted by the sub in the United States. That means that the sub has $30 million of undistributed foreign earnings (*i.e.*, $50 million minus $20 million). The allocation factor works out to 60 percent (*i.e.*, $30 million

divided by $50 million), so the foreign-source portion of the $10 million dividend that is deductible under Code Sec. 245A(a) is $6 million.

Hybrid Dividends

Code Sec. 245A(e)(1) prevents a domestic corporation from claiming the DRD for a hybrid dividend. A "hybrid dividend" means any amount received from a CFC that would ordinarily be deductible under Code Sec. 245A(a), but for which the CFC received a deduction (or other tax benefit) under the tax law of a foreign country or possession of the United States. [Code Sec. 245A(e)(4).]

The analysis can go off in a different—but still taxable—direction when a domestic corporation has multiple tiers of subsidiaries that are classified as CFCs. If a lower-tier CFC pays a hybrid dividend to an upper-tier CFC, the dividend is treated as *Subpart F income* to the upper-tier CFC. The domestic corporation must report its *pro rata* share of this income in accordance with Code Sec. 951(a)(1)(A). [*See* Code Sec. 245A(e)(2).]

The Proposed Regulations

The preamble to the Proposed Regulations summarizes their purpose with admirable clarity:

> The proposed regulations exclude corporate U.S. shareholders from the application of section 956 to the extent necessary to maintain symmetry between the taxation of actual repatriations and the taxation of effective repatriations. In general, under section 245A and the proposed regulations, respectively, neither an actual dividend to a corporate U.S. shareholder, nor such a shareholder's amount determined under section 956, will result in additional U.S. tax.

Let's take a quick look at how the Proposed Regulations implement this program. Then we will take a moment to consider the Treasury's authority to issue the new rules.

Mechanics

Proposed Reg. §1.956-1(a)(2)(i) gives effect to Code Sec. 245A by modifying the amount reportable under Code Sec. 951(a)(1)(B). The starting point is the amount that would be determined under Code Sec. 956 with respect to a U.S. shareholder for the taxable year of a CFC in the absence of the Proposed Regulations (the "tentative Code Sec. 956 amount"). The amount now reportable under Code Sec. 956(a)(1)(B) is: (1) the tentative Code Sec. 956 amount; *minus* (2) the amount of the deduction under Code Sec. 245A that the shareholder would be allowed if the shareholder were to receive an actual distribution from the CFC equal to the tentative Code Sec. 956 amount.

As we have seen, determining how Code Sec. 245A applies to an *actual* distribution can be less than completely straightforward. These difficulties carry over to the question of how Code Sec. 245A would apply to a *hypothetical* distribution. To keep things interesting, Proposed Reg. §1.956-1(a)(2)(ii) adds special rules to deal with indirect ownership of shares and other complications.

The analysis of any particular proposed pledge or guaranty involving a CFC will depend on the specific facts and how they interact with the Code and regulations. Perhaps the most important point for tax advisors is that some kind of analysis *will* be necessary. It might be a good idea to communicate this to their corporate colleagues, who may have heard only that Code Sec. 956's restrictions on pledges and guaranties "have been repealed."

Quo Warranto?

Judged from a policy perspective, the Proposed Regulations are eminently sensible. Whatever one thinks of new Code Sec. 245A, the corporate DRD for the foreign-source portion of foreign dividends is now the law. It makes no sense to apply Code Sec. 956 to transactions that are, at worst, simply substitutes for a tax-free distribution of a CFC's foreign earnings.

But even if the Proposed Regulations are substantively unobjectionable, what are we to make of them in "process" terms? Congress enacted Code Sec. 245A without making conforming changes to Code Sec. 956. In fact, based on the legislative history, one might even argue that Congress *rejected* proposals to conform Code Sec. 956 to the new DRD.

We should recall, however, that Congress enacted the TCJA in a blind rush. Consequently, there is an even-greater-than-usual element of

fiction in claiming that it "rejected" proposals that did not find their way into the final bill. Viewing the process realistically, we might conclude instead that Congress *wanted* to conform Code Sec. 956 to new Code Sec. 245A, but simply ran out of time to figure out which proposal to adopt.

Even if we accept this charitable interpretation of the legislative history, can the Treasury correct Congress's failure to act by issuing regulations that "turn off" a major provision of Code Sec. 956? Taxpayers, of course, are unlikely to object to this administrative amendment of the Code. But imagine what the reaction would be like if the shoe were on the other foot.

When the Treasury or the IRS tries to plug some obviously unintended loophole in the Code, the *amici* pour forth from their well-funded redoubts to warn the courts about the imminent peril to The Rule of Law. If we do not uphold the sanctity of the statutory text against the encroachments of unelected administrators, the Republic will slide into tyranny. If there is something wrong with the Code, Congress—and *only* Congress—can correct it.

The Treasury evidently feels a bit uneasy on this score. The preamble to the Proposed Regulations spends several pages describing previous administrative expansions and contractions of Subpart F in response to changes in the Code. This history makes administrative sense, but those modifications did not involve anything on the scale of what the Proposed Regulations do to Code Sec. 956(d).

The preamble also points to Code Sec. 956(e). This provision, added in 1993, says that the Secretary shall prescribe such regulations as may be necessary "to carry out the purposes of this section." That includes "regulations to prevent the avoidance of the provisions of this section through reorganizations or otherwise."

The Treasury does not read Code Sec. 956(e) as simply authorizing anti-avoidance rules. The preamble emphasizes the mandate to adopt regulations to "carry out the purposes of this section." Everything therefore depends on how one frames the purposes of Code Sec. 956.

Fearless Symmetry

According to the preamble to the Proposed Regulations, the purpose of Code Sec. 956 is:

> to create symmetry between the taxation of actual repatriations and the taxation of effective repatriations, by subjecting effective repatriations to tax in the same manner as actual repatriations.

If we accept this abstract formulation, the Treasury should be able to respond to a change in the Code affecting the taxation of CFC dividends (*i.e.*, "actual repatriations") by modifying the scope of Code Sec. 956. The Treasury might even claim that it has a *duty* to issue regulations to promote symmetry. After all, Code Sec. 956(e) says that the Secretary "shall" prescribe regulations to carry out the purposes of the statute.

The Treasury cannot use regulations to amend the statutory text. [*See C.S. Koshland*, SCt, 36-1 USTC ¶9294, 298 US 441, 447, 56 SCt 767.] Nor may it *add* "something which is not there" [*V. Calamaro*, SCt, 57-2 USTC ¶9750, 354 US 351, 359, 77 SCt 1138]. The Treasury's bold action in the Proposed Regulations may reflect its intuition that it has more leeway to legislate if: (1) it is *subtracting* from the Code something that is there; and (2) it is doing so in response to a new Congressional enactment.

Congress does not hesitate to delegate quasi-legislative authority to the Treasury when it feels like it. An outstanding example is the Code's treatment of consolidated returns in Code Secs. 1501–1504. Congress provided some basic definitions, but otherwise left it up to the Treasury to prescribe whatever rules it "may deem necessary" to regulate affiliated groups of corporations filing consolidated returns. [Code Sec. 1502.]

Congress provided little or no substantive guidance regarding what the regulations should say. In fact, it specifically noted that the Treasury could prescribe rules "that are different from the provisions of chapter 1 that would apply if such corporations filed separate returns." [*Id.*] Read literally, that's a blank check.

Consolidated returns are an extreme case, but Congress frequently inserts references to implementing regulations into specific Code provisions. In 2006, the Tax Section of the New York State Bar Association observed that there are more than 550 provisions of the Code that include grants of authority to issue regulations. [*See* N.Y. State Bar Ass'n Tax Section, *Report on Legislative Grants of Regulatory Authority* 2–3 (2006).]

These targeted authorizations are *in addition to* Code Sec. 7805(a), which directs the Treasury to issue "all needful rules and regulations for the enforcement of this title." The original Code Sec. 956 regulations were issued in 1964 under the aegis of this general provision. The special grant of authority in Code Sec. 956(e) wasn't adopted under 1993.

Code Sec. 7805(a) authorizes "all rules and regulations as may be necessary by reason of *any alteration of law* in relation to internal revenue." [Emphasis supplied.] This is arguably more relevant than the specific grants of regulatory authority in Code Secs. 245A(g) and 956(e). The Proposed Regulations trim back Code Sec. 956 to accommodate new Code Sec. 245A, which is undeniably "an alteration of law in relation to internal revenue."

Conclusion

Lenders are going to like the Proposed Regulations. The danger is that they—as well as borrowers—will mistake the new rules for wholesale repeal of the regulations that historically restricted CFC stock pledges and guaranties. Tax advisors need to point out that it's not as simple as that.

One way to communicate this would be to emphasize that the Proposed Regulations are completely driven by the TCJA's changes to how U.S. corporations are taxed on the receipt of foreign dividends. This explains why the Proposed Regulations do nothing for individuals and trusts. And it at least reminds us that the Treasury has not yet decided how the rules should apply to partnerships or LLCs that have domestic corporations among their members.

Even when the U.S. shareholder is a U.S. corporation, lenders and borrowers should not assume that the Proposed Regulations will apply. It depends on whether the U.S. corporation would be taxed on a *foreign dividend* corresponding to the amount otherwise calculated under Code Sec. 956. At that point, somebody needs to call in a tax advisor to check on how Code Sec. 245A would apply to an actual distribution under the circumstances at hand.

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