The Debrief

Proposed Tax Changes Make Foreign Subsidiaries a More Powerful Financing Tool for Distressed Companies

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On October 31, 2018, the Internal Revenue Service and Treasury Department issued proposed regulations with guidance on Section 956 of the Internal Revenue Code in light of the Tax Cuts and Jobs Act. The proposed regulations seek to ease existing "controlled foreign corporation" deemed dividend rules that have historically limited the ability of foreign subsidiaries to provide credit support to their U.S. corporate parents. The tax impact of the proposed regulations—and the opportunities they present for structuring new investments—is discussed in more detail in the Debevoise Update available here. In this Debrief, we wanted to highlight how these changes may unlock value for troubled U.S. companies with foreign subsidiaries.

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Distressed issuers have long taken advantage of so-called "FSHCOs" (foreign subsidiary holding companies) to indirectly tap a source of traditionally unencumbered value: foreign subsidiaries. FSCHOs traditionally do not guarantee the debt of their parents and are generally treated like foreign subsidiaries under the financing documents that permit them. Debt issued by a FSHCO is structurally senior to the debt of the FSHCO's parent with respect to the value of the FSHCO's equity in the foreign subsidiaries. Because of this structural seniority, distressed companies have used FSHCOs to issue new debt that is effectively senior to their existing debt to the extent of that value.

Under the proposed regulations, U.S. corporations will be able to pledge more than 65 percent of the equity of their foreign subsidiaries (or FSHCOs), and lenders to the U.S. corporate parent will be able to obtain guarantees from those subsidiaries, subject to the local law restrictions. This capability will, predictably, lead to increased lender interest in foreign credit support for new deals in the market. It will also offer a potentially valuable new tool for distressed companies engaged in liability management, particularly those operating under financing agreements that were negotiated before the proposed rule change. Rather than using (or creating) FSHCOs to get an indirect benefit, look for issuers and investors to take advantage of this new ability to offer direct guarantees and pledges when trying to manage maturities, reduce leverage in exchange transactions, or tap new sources of liquidity.

Of course, every situation is different, and no source of untapped value is without its own unique issues and challenges. Foreign pledges and guarantees routinely raise a host of questions, ranging from covenant compliance, to bespoke local law concerns, to fraudulent conveyance risks—all of which point to the importance of a careful cost-benefit analysis for these transactions. Nonetheless, it seems clear that the IRS has opened the door to distressed companies, and their sponsors and investors, to leverage foreign subsidiaries in new and creative ways.

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