ALERT MEMORANDUM

Tax Cuts & Jobs Act: Considerations for U.S. Debt Capital Markets

January 25, 2018

On December 22, 2017, the President signed into law the 2017 U.S. tax reform bill known as the Tax Cuts & Jobs Act (the "TCJA"). Most of the TCJA's provisions took effect January 1, 2018.

This memorandum sets forth some key observations about the TCJA that are likely to affect the U.S. debt capital markets. The principal relevant changes adopted by the TCJA are a new "thin capitalization" rule that limits interest expense deductions for leveraged issuers, and a new minimum tax (the "base erosion and anti-abuse" or "BEAT" rule) that may be imposed on deductions for interest expense paid to foreign affiliates.

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1. Summary

— In the near-term, we expect the TCJA to affect companies' financial statements and related disclosure. We also expect companies to engage in more liability management transactions in order to restructure their outstanding debt.

— In the long-term, we expect new patterns to emerge with respect to how much debt companies operating in the United States issue, where they issue it, and in some cases, what type of debt they issue. The United States has long been an attractive location to issue debt because of its comparatively high tax rate and lack of formulaic limitations on interest expense deductions. The thin capitalization and BEAT rules, and the new 21% corporate tax rate, will diminish the incentive to allocate the maximum amount of debt to the United States in a multinational structure.

- Financing may be shifted to non-U.S. borrowers if the interest expense deductions are more cost-effective there. Consequently, U.S. multinationals, or non-U.S. multinationals with significant U.S. operations, may issue more debt out of European or other non-U.S. affiliates.
- The interest expense limitations may increase the after-tax cost of financings by some U.S. companies, particularly inverted companies, recently acquired U.S. targets of foreign acquirors, and private equity portfolio companies. Determining the effect on a company of the new thin capitalization ("thin cap") rule

will be complicated by the need to account for differences between financial statements earnings and adjusted taxable income. Additional diligence on the effect of the thin cap and BEAT rules, and where relevant the new international tax rules, may be warranted.

- The new rules may increase interest in leasing transactions or convertible bonds on the part of some issuers. Companies may also revisit their hedging strategies for debt issuances.
- Acquisitions may be carried out with less leverage, and U.S.-headed groups may be limited in their ability to borrow at the parent company level to finance foreign acquisitions, unless the borrowing is then on-loaned to the foreign acquiring entity / target.

— The strategies that issuers adopt will be complicated by potential instability in the new rules. In particular, some key provisions, such as the interest expense limitation and the base erosion tax, apply different rules in a few years. There may also be future changes in the law, either to fix problems or to rethink policy issues in a different political climate.

2. Immediate impact of the TCJA

— In addition to enacting the thin cap and BEAT rules, the TCJA also reduces the corporate tax rate from 35 percent to 21 percent; makes significant modifications to the deductions available to businesses, including immediate expensing for investments in certain types of tangible assets; exempts future foreign earnings from tax when repatriated to the United States under a new participation exemption, but imposes a new minimum tax on foreign earnings from intangibles and services ("GILTI"); and imposes a one-time transition tax on offshore earnings, after which those earnings can be repatriated free of U.S. federal tax.

— Companies are already providing disclosure in capital markets issuances and other public statements regarding the impact of tax reform, including both the effect of specific provisions and the general potential for tax reform to affect the company's financials or, in some cases, in the markets in which it operates.

- Many of the public statements made to date have addressed the adverse impact of the new lower corporate tax rate on the value of deferred tax assets. Some disclosure has also addressed the cost of the repatriation tax on offshore earnings. These can be expected to be one-time events. Some disclosure has addressed the effect of the BEAT; as discussed below, companies can be expected to restructure their operations to eliminate or minimize the effect of the BEAT going forward.
- Pursuant to recent SEC guidance, public companies will be required to provide information in their 10-Ks for 2017 regarding the effect of the TCJA if the company's analysis is complete or a reasonable estimate can be provided, and to update their reporting when more definitive information is available. We understand that many companies are still assessing the effect of the TCJA, and therefore that only preliminary information is likely to be available for some time.
- Guidance has not (yet?) been issued on how much detail companies must provide on a going-forward basis about the effect of the TCJA. The application of some critical provisions of the TCJA, including the BEAT and the new international tax rules for U.S. multinationals, are likely to be difficult to estimate absent company disclosure, so that increased diligence may be necessary if companies do not provide detailed disclosure.

3. Effects on Investment Grade Companies vs. Highly Leveraged Companies

— *Thin Cap Rules*. For investment grade issuers, the thin cap rule may have a limited immediate effect, because those companies are more likely to have sufficient "adjusted taxable income" that the cap will not apply.

- Under the new thin cap rule, net business interest expense can be deducted only to the extent of 30% of "adjusted taxable income," which is similar to EBITDA. Excess deductions can be carried forward indefinitely. The rule applies to any debt outstanding on January 1, 2018. There is no grandfathering of existing debt.
- Starting in 2022, however, adjusted taxable income will be similar to EBIT (rather than EBITDA). The thin cap rules will affect more companies, consequently, particularly those with significant depreciation or amortization.
  - For example, for a company with 100 of adjusted taxable income equal to EBITDA, and 40 of depreciation, the thin cap limit on interest expense deductions would be 30 through 2021. Starting in 2022, it would be 18. Companies therefore may want to take advantage of the immediate expensing permitted under the TCJA for certain types of tangible assets to accelerate such investments to pre-2022 years when depreciation is not taken into account in measuring adjusted taxable income for thin cap purposes.
  - Any analysis of the effect of the thin cap rule must take into account significant differences between measures of earnings compared to adjusted taxable income. For a summary of some important differences, see the table on the next page.

— *BEAT*. The BEAT is a minimum tax similar to the alternative minimum tax. The tax due equals the excess of (a) a minimum tax rate applied to a corporation's taxable income after adding back deductible payments made to foreign affiliates over (b) the corporation's tax liability at the regular corporate rate. The minimum tax rate is 5% in 2018, 10% in 2019 through 2025, and 12.5% in 2026 and later years. Increased rates apply to U.S. affiliated groups that include banks or securities dealers.

- Interest paid by a U.S. affiliate to a foreign affiliate is potentially subject to the BEAT, as are other deductible payments like royalties. Consequently, the BEAT may lead companies to issue more external debt from U.S. subsidiaries, as discussed below.

— *M&A transactions.* In deciding how to fund M&A transactions and spin-offs, the ground rules for evaluating both existing and acquisition financing have changed. Companies will need to consider the debt profiles of both companies under the thin cap rules, and how to structure intercompany debt under the BEAT rule. For example, the acquisition of a highly leveraged target, or the sale of a low-leveraged business with steady earnings, may increase the risk that the thin cap rules will apply. It is more likely that acquisition debt will be partly or wholly incurred outside the United States in order to avoid being disallowed under the thin cap rules, and more likely that U.S. targets (or their U.S. acquirer entities) will issue debt to the market, in order to avoid the BEAT minimum tax on related party interest.

— *Leveraged issuers.* More heavily leveraged companies are naturally more likely to be affected adversely by the thin cap rule.

- Inverted companies, U.S. companies recently acquired by foreign acquirors and private equity portfolio companies are most likely to be affected.
- While companies can carry forward the amount of interest deductions that are disallowed, they are not allowed to carry deductions back.

— In evaluating the impact of disallowed interest expense deductions, it is important to note that the cost of a disallowed deduction will be less when measured under the new corporate tax rate.

Thin capitalization rule ***Summary of differences between GAAP earnings and "adjusted taxable income"***		
	GAAP	***Tax***
Consolidation	Based on worldwide earnings Earnings of subsidiary included in full if hold controlling financial interest (generally 50% threshold); ratable share of earnings included if equity method applies (generally 20-50% ownership)	Based on US group's earnings (plus earnings for foreign "check the box" entities, and net GILTI income). US subsidiary earnings included in full, only if 80% owned by group.
Depreciation	Slower	Faster; immediate expensing for certain types of assets through 2022
Stock-based compensation	Deduct at time of grant	Deduct when exercised, or later (results in later timing, and generally higher amount for deduction)
Tax-exempt income. net interest income	Included in earnings	Not included
Portfolio investments, derivatives	Marked to market, unless hedge accounting applies	Generally accrue income and expense

— It is conceivable that preferences for different types of debt will shift. For example, if highly leveraged companies were to borrow more, or less, in the form of loans as opposed to other types of debt, that could affect the syndicated loan market and investments in collateralized loan obligations.

4. Incentive to Issue Debt

— For companies that are not subject to the thin cap rule, there may be an incentive to borrow domestically in order to invest abroad through a controlled foreign corporation, since the participation exemption means that dividends from the foreign subsidiary will not be subject to U.S. income tax.

— It may be unlikely that companies will borrow to fund the repatriation tax imposed for the 2017 or 2018 taxable year (likely to be the 2018 taxable year in many cases), because the tax can be paid on an interest-free and back-loaded basis over 8 years.

5. Incentive to Reduce Debt

— Cash held abroad that can now be repatriated free of additional U.S. federal tax may be used for various purposes. One such purpose could be to redeem outstanding debt (or to let existing debt run off and not issue new debt).

— Issuers of hybrid debt or other long-term debt with a tax call based on the loss of interest expense deductions may be able to exercise those calls.

- The call would be highly advantageous if the debt is trading at a premium and the call is at par or a small premium.
- The ability to make this call depends on the language of the particular provision and on the ability of the company to establish that the loss of interest expense deductions applies now or will apply in the near term.

— Companies affected by the interest expense limitation may engage in an increased number of liability management transactions in the near term, for example, tender offers and exchange offers. While the deduction for repurchase premium in such transactions may itself be subject to the thin cap limitation, it may still be preferable to accelerate that expense into a pre-2022 year when the cap will be higher, particularly if the issuer can take advantage of the near-term favorable rules for expensing investments. Companies with additional 2018 income as a result of the repatriation tax may also have an incentive to accelerate interest expense into that year.

6. Incentive to Restructure Debt

— The thin cap rule may encourage U.S. companies to change the type of debt they issue.

- Highly leveraged companies may evaluate the trade-offs between high-yield bonds and convertible debt differently. (See the discussion below.)
- Companies may rethink the benefits of owning debt-financed tangible property rather than leasing it, since leasing deductions are not subject to the thin cap limitation. Because the business terms of leases may not be simply financings in disguise in order to be treated as leases for tax purposes, companies will need to evaluate the relative costs and benefits of different commercial terms vs. tax deductions.
- Companies subject to the thin cap rule may consider financing through preferred stock or preferred partnership interests. Preferred equity is not a desirable form of financing for companies with a significant non-U.S. investor base, however, because of U.S. withholding tax on dividends and U.S. net income tax on partnership earnings. Moreover, for corporate investors the tax rate differential between dividends and interest has narrowed substantially, so that there may also be less appetite for preferred stock on the part of U.S. investors.
- Companies may be more likely to issue short-term debt. Again, there will be a trade-off between commercial risks (that short-term rates will rise) vs. tax deductions.

— The thin cap rule may encourage U.S. companies to change the country from which the debt is issued.

- Companies, particularly U.S. multinationals with offshore cash needs, will be more likely to consider shifting their borrowing offshore to foreign subsidiaries (or entering into back-to-back financings), if the foreign subsidiaries can use the deduction and the effective tax savings is greater than in the U.S.
- Moving debt to subsidiaries can trigger foreign withholding tax costs or local laws restricting debt pushdown, so this strategy will also require analysis of local law.

— The legal entity of the issuer will matter for purposes of the thin cap rule:

- While the rule is expected to apply on a U.S. consolidated group-wide basis for domestic corporations, partnerships are evaluated on a separate entity basis, with rules to avoid double counting and to allow "excess" adjusted taxable income to tier up. Consequently, the deductibility of interest expense may be different depending on whether the debt is incurred by a partnership or its partners.

- It may be possible to manage the thin cap rule through the use of subsidiaries that are not part of a tax consolidated group. For example, if the earnings of the tax consolidated group are volatile, there may be an advantage to issuing debt out of a non-consolidated subsidiary with steady earnings.

— The BEAT may encourage U.S. subsidiaries of non-U.S. companies to finance their borrowings directly from the market rather than from a foreign affiliate.

- Inverted companies with significant outbound payments made by their U.S. affiliates are particularly likely to be affected by this, as well as by new “hybrid transaction” rules denying interest expense deductions for debt of a U.S. borrower where the foreign recipient is exempt from tax on the interest due to a different characterization of the interest payments or the tax status of the recipient for foreign tax purposes.
- For legal and commercial reasons, the foreign parent of a U.S. subsidiary may guarantee the external debt of the subsidiary. For U.S. tax purposes, it typically will be necessary to establish that the U.S. subsidiary could have borrowed on comparable terms without the guarantee, in order to ensure that the subsidiary can deduct interest on the debt. In such cases, it may be useful to obtain confirmation from a bank that the subsidiary could have done so, as was the case in connection with the repatriation tax holiday of 2005.
- The BEAT may have a particularly significant effect on foreign financial institutions with U.S. operations, because their U.S. operations typically rely significantly on shareholder funding, often because of regulatory requirements. Financial institutions subject to the BEAT may therefore reconsider both their funding structures and the manner in which they comply with the regulatory rules that they are subject to, to avoid being subject to punitive taxes for complying with their legal obligations.

7. Considerations Relevant to Convertible Debt

— Companies that are subject to the thin cap rule, or are at risk of being subject to it, may evaluate the trade-offs between issuing convertible debt vs. high-yield bonds differently.

— The lower coupon on a convertible bond would be less costly on an after-tax basis than the higher coupon on a high-yield bond. This must be weighed against the commercial consequences of giving investors a conversion right.

— Issuers of convertible debt may weigh the merits of higher coupon/lower conversion premium vs. lower coupon/higher conversion premium differently if the coupon is non-deductible.

— Call spread deals may be affected.

- A “call spread” transaction refers to the issuance of convertible debt, hedged by the purchase of a call option with terms similar to the option embedded in the bond, and the sale of a call option or warrant that economically converts the entire transaction to a convertible bond with a higher conversion premium. For tax purposes, U.S. issuers often “integrate” the bond and the purchased bond hedge into a synthetic non-convertible discount bond.
- Issuers for whom the interest expense deduction is a gating item may be less interested in call spread transactions, or may price them with less costly bond hedges if additional discount attributable to a higher premium for the bond hedge would not be deductible.
- Issuers that don’t expect to be able to deduct the tax discount may choose to enter into call spreads without integration in order to avoid the additional complexities that an integrated transaction requires, for example more complicated documentation for the bond hedge.

8. Considerations Relevant to Credit Agreements

— U.S. tax rules (section 956) have long driven the manner in which credit support from foreign subsidiaries of U.S. borrowers is structured. Typically, foreign subsidiaries do not provide a guarantee of the U.S. parent's debt, and only a limited amount of a foreign subsidiary's stock can be pledged as credit support.

- While section 956 remains in place, the manner in which it interacts with other parts of the tax rules have changed, and those new interactions may lead to differences in the way credit agreements are structured.
- As described above, it may become more common for foreign subsidiaries of U.S. multinationals to become direct borrowers under a credit agreement. That can be expected to lead to changes to credit agreement documentation, since there are different commercial consequences to a subsidiary borrowing than a top-company borrowing.
- Issuers may be less willing to take the risk of failing to comply with section 956, because the consequences of failing (a deemed fully taxable distribution from the relevant foreign subsidiary) are now much worse than simply paying a dividend from a foreign subsidiary, since an actual dividend would be tax-free.
- On the other hand, a U.S. company that has paid substantial repatriation tax on its offshore earnings may now be able to provide credit support from its foreign subsidiaries without incremental U.S. tax, until it exhausts its pool of "previously taxed income."

9. Hedging with Derivatives

— It is possible that interest rate swaps may be used to stay under the thin cap limit.

- The thin cap rule applies to interest but does not by its terms take into account swaps or other hedges.
- A company that wants to issue fixed rate debt and hedge it into a floating rate can make a tax election to integrate the debt and swap into a synthetic debt instrument with a lower rate, at least initially. The thin cap rule would take into account interest at the all-in floating rate, not the higher fixed rate.
- Conversely, a company that wants to issue floating rate debt and hedge it into a fixed rate should not integrate the hedge, and may want to take steps to limit the risk that the IRS can force integration under anti-abuse principles.
- If floating rates become higher than the fixed rate on the debt or hedge, however, this strategy could become costly. Companies will need to evaluate the risks involved.

— Companies subject to the BEAT may wish to consider establishing an internal Treasury center to centralize their derivatives hedging transactions in the U.S., because the BEAT generally does not apply to intercompany derivatives entered into by "dealers" (for tax purposes) in derivatives.

10. Effect on Investors; Book/Tax Conformity

— Any changes to the amount and types of debt issued will obviously affect investors, as will any liability management transactions.

— A new rule that may have a more direct effect on investors is a book/tax conformity rule that will accelerate taxable income for some investors in some debt instruments. The rule applies to accrual method taxpayers that have typical financial statements – that is, taxable institutional investors like mutual funds and insurance companies. The book-tax conformity rule requires those investors to accrue based on book rather than tax if book accruals are higher and the income is within the scope of the new rule. This rule applies to debt, including outstanding debt, starting January 1, 2018, except that there is a one-year delay for debt issued with "original issue discount" ("OID").

- The scope of the new rule is uncertain, and likely to remain so until the IRS issues guidance. Among the possible applications of the new rule are to:
  - Debt issued with OID including mortgage-backed securities, and debt with stepped coupons or other multiple interest rate provisions
  - Debt issued below par but without OID (that is, debt with de minimis OID)
  - Debt acquired in the secondary market at a discount or premium
  - Structured notes and other debt instruments with complex payment terms
  - Debt with put and/or call rights
  - Debt with interest rate adjustment provisions, including registration rights, gross-ups, and credit ratings-linked adjustments
  - Foreign currency-denominated debt
  - Convertible bonds and other hybrid instruments
  - Liability management transactions where book and tax treatment diverge
- We do not believe that the book/tax conformity rule requires investors that mark investments to market for book purposes to do so for tax purposes. More generally, apart from debt issued with OID, it may be unlikely that the new rule will apply to most debt with conventional fixed income terms.
- Because different investors may use different methods to accrue income for financial statement purposes, there is not likely to be a single answer for all investors.
- If the book/tax conformity rule applies, investors will take more taxable income into account in earlier years to the extent that book income exceeds the taxable income that would otherwise accrue. It is not clear whether or how investors may reduce their taxable income in later years when taxable income exceeds book income.

11. Repos, Securities Loans, and Derivatives

— Repurchase premium on repos, and interest on cash collateral for securities loans and derivatives, is considered interest expense for U.S. tax purposes. Consequently, those payments are potentially subject to the thin cap rules or the BEAT. There is less clarity as to whether substitute interest or dividends, or borrow fees, are subject to the BEAT.

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