ALERT MEMORANDUM

Tax Cuts & Jobs Act: Considerations for Equity Capital Markets

January 25, 2018

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

The TCJA introduces significant changes to the U.S. tax system. This memorandum sets forth a few key observations about the TCJA that may be relevant to equity capital markets.

If you have any questions concerning this memorandum, please reach out to your regular firm contact or the following authors

NEW YORK

Erika Nijenhuis
+1 212 225 2980
enijenhuis@cgsh.com

Yaron Reich
+1 212 225 2540
yreich@cgsh.com

1. Effects on Valuation of Companies

The TCJA will have significant effects on corporate valuation, due principally to a new lower corporate tax rate and a "participation exemption" for distributions to U.S. companies from foreign subsidiaries, on the one hand, and to new minimum tax rules on foreign profits from intangibles and services and cross-border intercompany transactions, and new limitations on the utilization of net operating losses ("NOLs") and the deduction for net interest expense, on the other hand.

— In the near-term, the TCJA is likely to affect the stock value of U.S. companies and non-U.S. companies with significant U.S. operations, but the nature of that effect will differ depending on the company. The lower corporate rate will decrease the value of deferred tax assets and liabilities, adversely affecting those companies with substantial NOLs or other assets which were originally measured against the old rate. Moreover, companies subject to a one-time repatriation tax will report a substantial charge on their balance sheet, unless the company has already reported a deferred tax liability for those earnings. Conversely, companies with an international presence or substantial offshore cash will benefit from the fact that they are now able to repatriate foreign earnings without subjecting themselves to U.S. tax.

— In the longer term, the TCJA is likely to affect different industries differently. Analysts will need to revise their models for evaluating companies, and new analysis will be needed to determine the optimal corporate structure or strategy in a given situation.

— Determining how a specific company is affected by tax reform will depend increasingly on the amount that company discloses about its internal structures, arrangements, and tax attributes, which will in turn depend both on the company's particular circumstances and on securities regulation which continues to evolve. Companies are already providing disclosure in capital markets issuances and other public statements

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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 new base erosion and anti-abuse tax ("BEAT") that imposes a minimum tax on U.S. companies that make significant interest or royalty payments to foreign affiliates, or purchase depreciable property from them; 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.

— New rules that require U.S. shareholders to pay a reduced rate of tax on "global intangible low-taxed income" ("GILTI"), may apply to non-intangible and non-low-taxed items because the rules are broadly drafted. The GILTI rules will potentially adversely affect financial services companies and service providers with significant offshore IP, or other income that is in excess of a deemed return on recently acquired hard assets.

— The strategies that issuers adopt will be complicated by any perceived instability in the new rules. In particular, some key provisions, such as the interest expense limitation and the BEAT, 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. **Effect of TCJA on M&A Transactions**

Several parts of the TCJA have the potential to significantly change which M&A structures and strategies are optimal in a given situation:

- In addition to the impacts that the bill will have on the value of corporations as currently structured, the bill also makes it harder to perform corporate valuation accurately on the basis of publicly available information, due to several rules which depend on information which may not be available, such as the BEAT. Additional diligence will be required in order to determine the extent to which particular companies are subject to these rules and how they affect its valuation.
- Changes made by companies to their debt profile in response to the new "thin capitalization" rules (limitations on interest expense deductibility) may affect which form a particular M&A transaction should take. For example, if the thin capitalization rules raise the cost of financings for a company that incurs debt to make an acquisition, the after-tax cost of financing a leveraged buyout would increase.

- New rules allowing taxpayers to immediately expense the cost of "qualified property" in the year of purchase will increase the incentive to acquire depreciable tangible property (including used property) and may create incentives to structure acquisitions as asset purchases or deemed asset purchases (such as stock purchases with a section 338 or 336 election or conversion of a corporate target to an LLC prior to purchase), during the 5 to 10 year period that this rule is in effect. However, in determining the benefit of selling assets vs. selling stock, the relative value of immediate expensing for the purchaser will still need to be balanced against potential additional tax on sellers.
- Complex international provisions, including the BEAT and GILTI, described above, may affect both the operational structure of multinational groups and the use of shareholder debt to finance U.S. acquisitions by non-U.S. entities.
- The trapped cash rules and reduction in the U.S. corporate tax rate might lead to more interest in acquisitions of U.S. targets by both U.S. and non-U.S. acquirors. Conversely, these changes would make inversion transactions (where a U.S. company combines with a non-U.S. company in order to escape the U.S. tax net) less attractive.
- More targeted rules aimed at discouraging inversions will likely also reduce the incentive to invert. Under the TCJA, dividends from any non-U.S. companies that complete inversion transactions after the enactment of the TCJA will not be eligible for the preferential U.S. tax rate applicable to qualified dividends from non-U.S. corporations.

3. **Potential Shifts to the Relative Attractiveness of Equity and Debt**

— Multiple factors will bear on how a company views the relative advantages of issuing debt and equity.

— The thin capitalization rule's limitations on deductibility of interest expense will diminish the advantages of debt relative to equity as a form of financing.

— Possible alternatives that may be available, depending on the company, may include leasing assets rather than acquiring them on a debt-financed basis; preferred equity or preferred partnership interests, if the company's investor base is primarily domestic; or short-term debt.

— Conversely, the difference between the tax rate on dividends received by holders eligible for the dividends received deduction and interest has narrowed. Prior to the TCJA, dividends eligible for the dividends received deduction were taxed at an effective rate of about one-third of the 35% corporate tax rate. While the effective tax rate for such dividends has not changed, it is now about one-half of the 21% corporate tax rate. As a result, payments of interest are generally less tax disadvantaged, relative to dividends, than they were under pre-TCJA law.

— Moreover, there are many non-tax reasons why companies issue debt, including that it is typically less costly than equity; there is a well-established investor base and market practice; and investors may prefer to have creditor remedies.

4. **Considerations Relevant to Convertible Debt**

— There may be increased interest by highly leveraged companies in convertible debt, as companies that are at risk of being subject to the thin capitalization rule 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 more coupon/lower conversion premium vs. higher coupon/lower 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.

5. **Unlocking Trapped Cash:**

— The TCJA makes dramatic changes to the tax rules applicable to U.S. multinationals with substantial offshore earnings that would end the "trapped cash" effect.

— A one-time transition tax is imposed on the undistributed earnings of foreign subsidiaries generally as of the end of 2017. The immediate impact on a particular company's financial statements of this one-time tax will depend on whether the company accounted for an eventual tax on these earnings.

- It is possible that companies will raise cash to pay the tax, but since the installments are back-loaded and interest-free, this may be unlikely.

— In the longer term, U.S. multinationals with cash held offshore will be free to use that cash. We expect that companies will use the repatriated cash for various purposes in addition to funding ongoing operations, though the primary use remains to be seen.

- History suggests that paying dividends and buying back shares will be popular uses for the cash.
- Repatriated cash may result in an increase in M&A activities, which may in turn result in more opportunities for arbitrage.
- Repatriated cash may fund near-term liability management transactions, which may be followed by fewer capital markets issuances, particularly in light of the limitation on net interest expense deductions.

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