ALERT MEMORANDUM

Tax Cuts & Jobs Act: Considerations for Non-U.S. Financial Institutions

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.

The TCJA introduces significant changes to the U.S. tax system that are likely to have a profound impact both on the economy as well as on non-U.S. financial institutions. This memorandum sets forth a few key observations.

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1. Summary

— Although in general the TCJA favorably improves the tax regime applicable to corporate taxpayers (including by reducing the corporate tax rate from 35% to 21%), it is likely to have a potentially significant adverse impact on many non-U.S. parented financial groups, principally as a result of the "BEAT" minimum tax, described below.

— *The BEAT.* The TCJA imposes a minimum tax (called the "BEAT", or Base Erosion and Anti-abuse Tax) on payments made by a U.S. corporation or U.S. branch to its non-U.S. affiliates. While there is considerable uncertainty regarding its scope, payments that are – or potentially are – subject to the BEAT include:

- Gross interest payments made to non-U.S. affiliates (including to a U.S. branch) on any intra-group debt, including subordinated debt required by regulators ("internal TLAC");
- Payments of separately-stated sales commissions and other service charges relating to securities, commodities and derivatives dealing and trading operations, although global dealing profits split arrangements are probably excluded (though the scope of the exclusion may depend on the terms of particular arrangements);
- Repo repurchase premium, interest payments on cash collateral posted under securities loans and derivatives transactions, as well as possibly payments of substitute interest and dividends, or securities borrow fees; and
- Payments to the group parent (or other non-U.S. affiliates) for group-wide expense allocations.

— Other changes effected by the TCJA that are likely to be relevant to non-U.S. financial institutions – including with respect to corporate tax rates, interest deductions, NOLs and timing of income – are described below.

2. BEAT: Minimum Tax on Payments to Foreign Affiliates

— The TCJA targets earnings stripping or base erosion by imposing a new minimum tax (called the "BEAT") on the taxable income of a corporate taxpayer, modified so as to deny deductions for "base erosion payments."

— Base erosion payments are deductible payments from U.S. corporations and U.S. branches of foreign corporations (including any branch deemed to exist as a result of a foreign corporation having "effectively connected income" (ECI)) to foreign affiliates, excluding (i) cost of goods sold (except for corporations that expatriate from the United States after November 9, 2017), (ii) certain payments for services representing cost reimbursement with no mark-up, (iii) certain payments pursuant to derivatives that are marked to market for tax purposes (generally by banks or swap dealers) and (iv) payments that are subject to U.S. withholding tax.

- The rules do not by their terms provide for netting of inbound and outbound payments, which could be very significant for financial institutions.
- There are no exclusions for interest, or for most other payments in connection with financial transactions, although there is an exception for most payments under derivatives that are marked to market. The scope of the derivatives exception is not clear, and thus, for example, it is uncertain whether and to what extent substitute interest and dividends, or securities borrow fees, are subject to the BEAT. Payments of interest on cash collateral posted under securities loans and derivatives transactions, as well as repo repurchase premium, are subject to the BEAT. Derivatives on master limited partnerships are likely not eligible for the derivatives exception.
- There is an unfavorable rule that treats any interest expense that is non-deductible under the limit described in "'Thin Cap' Limit on Net Interest Expense Deductions" below as paid to unrelated parties for purposes of the BEAT, which maximizes the deductible interest that is treated as paid to related parties and therefore subject to the BEAT. As discussed below, this rule is not expected to affect most non-U.S. financial institutions.
- The treatment of payments to and by a U.S. branch is unclear. Payments made by a U.S. subsidiary to a U.S. branch, for example interest on a loan from the U.S. branch, may be within the scope of the rule, which would result in double taxation. On the other hand, payments between a U.S. branch and other branches (as compared to affiliates) would seem to be excluded, except perhaps if and to the extent they are treated as regarded payments (*e.g.*, under a treaty and possibly as "excess interest" under Treasury regulations section 1.882-5).
- Payments of separately-stated sales commissions and other service charges relating to securities, commodities and derivatives dealing and trading operations, as well as head office expense allocation payments, may be subject to the rule. Payments made pursuant to global dealing profits split arrangements are probably excluded. The scope of the exclusion may depend on the terms of particular arrangements.

— The tax due equals the excess of (a) the minimum tax rate applied to the corporation's taxable income after adding back base erosion payments over (b) the corporation's tax liability at the regular corporate rate. Appendix A illustrates how the tax is calculated for a hypothetical multinational financial institution.

- *Rates*:
  - 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 a bank or registered securities dealer: 6% in 2018, 11% in 2019 through 2025, and 13.5% in 2026 and later years.

- *Tax Credits*: In calculating a corporation's tax liability at the regular corporate rate for purposes of the BEAT, tax credits are generally taken into account, thereby increasing the BEAT liability. However, in 2018 through 2025, research tax credits and 80% of low-income housing and energy credits are excluded from the calculation, with the effect that these credits can mitigate BEAT liability.
- *NOLs*: As demonstrated in Appendix A, the BEAT can have distortive effects on multinational businesses with NOLs.

— The BEAT applies to corporations with at least $500 million in annual gross receipts and for which base erosion payments represent at least 3% of total deductions (2% for a U.S. affiliated group that includes a bank or securities dealer). Aggregation rules apply to test related entities on a group-wide basis. Foreign corporations are subject to the rule if their ECI meets the gross receipts and 3% tests.

— There is significant uncertainty about how the BEAT will be applied in practice. Guidance from the Treasury Department and the Internal Revenue Service is needed to clarify many aspects of the BEAT.

— "*Hybrid" transactions and entities.* The TCJA also disallows deductions for interest and royalty payments to foreign affiliates where the foreign recipient is not subject to tax on the payments due to a different characterization of the payment or the recipient (as to its regarded or transparent tax status) by the foreign jurisdiction.

3. "Thin Cap" Limit on Net Interest Expense Deductions

— The TCJA imposes a new limit on net business interest expense deductions.

— The rule applies to any debt outstanding on January 1, 2018. There is no grandfathering.

— The rule limits the deduction for ***net*** business interest expense to 30% of adjusted taxable income.[1] "Adjusted taxable income" is similar to EBITDA for taxable years 2018 through 2021, and EBIT for 2022 and later years. Disallowed interest expense can be carried forward indefinitely.

- Because most banks and many other financial institutions have net interest income, this rule generally will not adversely affect them in their capacity as taxpayers. However, the rule by its terms applies only to "interest," which could affect some financial institutions with other types of financial services income from U.S. operations unless regulations expand the scope of that term.
- This rule, combined with the reduction in corporate tax rates to 21%, may affect the relative attractiveness of debt financings for a financial institution's customers.
  - Highly leveraged companies may evaluate the trade-offs between high-yield bonds and convertible debt differently.
  - 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

[1] The separate limitation on interest expense deductions based on a worldwide leverage test, which was included in prior versions of the TCJA, was not adopted.

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. There will be a trade-off between commercial risks (that short-term rates will rise) vs. tax deductions.
- Particularly in 2022 and later years, for companies with significant expenditures eligible for expensing, there may be little or no capacity for interest deductions, due to the change from EBITDA to EBIT. That change would apply to any debt instruments that exist at that time (there is no grandfathering), creating a cliff effect, and therefore well-advised U.S. borrowers will take into account the switch to EBIT in considering their current debt profile.
  - 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 (described below) to accelerate such investments to pre-2022 years when depreciation is not taken into account in measuring adjusted taxable income for purposes of this interest expense limitation.

— The thin cap rule is consistent with similar changes in law that have been enacted recently by some of our trading partners (*e.g.*, Germany, UK) as a result of the OECD Base Erosion and Profit Shifting (BEPS) project.

— 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. The location of debt financing among partnerships or non-consolidated companies may affect deductibility

4. Other Aspects of the TCJA Relevant for Non-U.S. Financial Institutions

— **Significant Reduction in Headline Tax Rates**

- *For corporations*:
  - The corporate tax rate is lowered to 21%, with corresponding changes to the deduction for dividends received from U.S. corporations. The rate reduction is effective starting in 2018.
  - The corporate alternative minimum tax is repealed.
  - The reduction in tax rates will mechanically reduce the value of any tax assets owned by U.S. companies (*e.g.*, value of deferred tax assets for NOLs).
- *For non-corporate taxpayers*: The TCJA also reduces the tax rate applicable to most income earned through partnerships and other tax-transparent entities, by providing for a deduction equal to 20% of certain business income earned by the non-corporate owners of such entities, subject to a cap based on the entity's wage expenses and asset make-up. The deduction expires after 2025, and does not apply to investment income, compensation, or income from services businesses.

— **Immediate Expensing of Certain Assets**

- U.S. taxpayers may immediately deduct 100% of the cost of certain qualified property acquired and placed in service before January 1, 2023.

- "Qualified property" is, generally, depreciable tangible property (including used property), and does not include shares in corporations, real estate, or intangibles such as goodwill and intellectual property. It also does not include property that is leased rather than purchased.
- Accelerated expensing is also allowed for property acquired and placed in service in 2023 and afterwards, with the percentage of cost that is immediately deductible stepping down annually until it reverts to the previously existing depreciation schedule for property placed in service after 2026 (or 2027, in the case of certain property with longer production periods).
- The short life of the rule will create an incentive to acquire assets eligible for immediate expensing within the next 5 to 10 years.

— **Limits on Deductibility of Net Operating Losses (NOLs)**

- Under the TCJA, carrybacks of NOLs are no longer allowed, while carryforwards become indefinite. The carryback and carryforward rules apply only to NOLs that arise in taxable years *ending after* December 31, 2017 – *i.e.*, they capture some 2017 NOLs for non-calendar year taxpayers.
- For taxable years beginning after December 31, 2017, a company may use NOLs to offset only up to 80% of the company's taxable income (with unused NOLs carried forward indefinitely into future years). This 80% cap applies to NOLs arising in taxable years beginning after December 31, 2017.
- To the extent a company has existing NOLs, the reduced 21% corporate tax rate could significantly reduce the benefit of those NOLs, and therefore reduce the value of its deferred tax assets.

— **Timing Issues**.

- The TCJA requires most accrual-method taxpayers to take items of income into account for tax purposes no later than the time they are included on the taxpayer's audited financial statements or annual reports, subject to certain exceptions (including an exception for mortgage servicing contracts). The rule generally takes effect beginning in 2018, but is delayed until 2019 for debt instruments with original issue discount.

— **Shift to a Territorial System**.

- The TCJA adopts a territorial system of international taxation, effective January 1, 2018. It will likely result in the repatriation of significant amounts of offshore cash to U.S.-based multinationals. For a summary of these rules, please see our "Alert Memo on Tax Cuts & Jobs Act: Considerations for Multinationals," available at www.clearygottlieb.com/2017taxreform.

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APPENDIX A

BEAT: Detailed Overview

The BEAT is payable only by U.S. corporations and branches (or deemed ECI branches) of non-U.S. corporations with average annual gross receipts of at least $500m and “base erosion payments” representing at least 3% of total deductions (2% for a U.S. affiliated group that includes a bank or securities dealer).

Base erosion payments are deductible payments from domestic corporations and branches to foreign affiliates, excluding:

- Cost of goods sold (except for corporations that expatriate from the United States after November 9, 2017);
- Certain payments for services representing reimbursement for costs with no mark-up;
- Certain payments pursuant to derivatives that are marked to market for tax purposes (generally by banks or swap dealers); and
- Deductible payments to the extent they are subject to U.S. withholding tax.

The BEAT equals the excess of (a) the minimum tax rate applied to the corporation’s “modified taxable income” over (b) the corporation’s tax liability at the regular corporate rate.

- The corporation’s modified taxable income equals taxable income after adding back base erosion payments and disregarding the “base erosion percentage” of any NOLs.
- The minimum tax rate is 5% in 2018, 10% in 2019 through 2025, and 12.5% in 2026 and later years. Increased rates (6%, 11%, and 13.5%, respectively) apply to U.S. affiliated groups that include a bank or securities dealer.
- The base erosion percentage equals the taxpayer’s deductions for base erosion payments divided by the taxpayer’s total deductions (with certain adjustments).
- In calculating tax liability at the regular corporate rate, tax credits are generally taken into account, thereby increasing the BEAT liability. However, in 2018 through 2025, research tax credits and 80% of low-income housing and energy credits are excluded from the calculation, with the effect that these credits can mitigate BEAT liability.

BEAT Example 1

Parent, a non-U.S. bank, conducts activities directly and through a U.S. broker-dealer (“DSub”) and a non-U.S. broker-dealer (“FSub”).

In 2019, DSub has gross income of 900, including 200 of interest income. DSub has subordinated debt owed to Parent, on which it incurs 150 of annual interest expense. DSub incurs 100 of deductions from payments to FSub connection with intercompany derivatives that are marked to market; these payments qualify for the derivatives exception from the BEAT. DSub pays 100 to Parent for various services, including an arm’s length profit spread. DSub incurs 500 of other deductions and does not have any NOLs or credits. DSub has net interest income, so its interest expense is not subject to limitation under the thin cap rule.

DSub’s total deductible expenses are 850 (150 interest to Parent + 100 paid to FSub in connection with derivatives + 100 paid to Parent for services + 500 of other expenses). DSub’s taxable income is 50 (900 minus 850).

DSub's 100 of payments to FSub in connection with derivatives are not base erosion payments, but its 150 of interest paid to Parent, as well as its 100 of payments for services, are or may be base erosion payments (total potential base erosion payments: 250).

DSub has 50 in net taxable income, so its tax liability at the regular corporate rate is 10.5 (21% of 50). DSub's modified taxable income is 300 (50 plus 250), and the minimum tax rate applied to the modified taxable income yields 33 (11% of 300). DSub's BEAT liability therefore is 22.5 (33 minus 10.5). DSub's total tax liability is 33 (10.5 of regular tax liability + 22.5 of BEAT liability), which is more than three times its regular tax liability.

BEAT Example 2: Credits

The facts are the same as BEAT Example 1, except that DSub has 10 in foreign tax credits available for use in 2019.

As in Example 1, DSub's pre-credit tax liability at the regular corporate rate is 10.5 and the minimum tax rate applied to DSub's modified taxable income is 33. Taking into account the foreign tax credits, DSub's tax liability at the regular corporate rate is 0.5. Thus, DSub's BEAT liability is 32.5 (33 minus 0.5). DSub's total tax liability is 33 (0.5 regular tax liability + 32.5 of BEAT liability). The BEAT thus effectively disallows DSub's foreign tax credits.

If the credits are low-income housing tax credits instead of foreign tax credits, 8 of the credits (80% of 10) are disregarded in calculating DSub's tax liability at the regular corporate rate. Thus, DSub's tax liability at the regular corporate rate increases to 8.5 (10.5 minus 2) and DSub's BEAT liability decreases to 24.5 (33 minus 8.5). DSub's total tax liability is 25 (0.5 regular tax liability + 24.5 BEAT liability).

BEAT Example 3: NOLs

The facts are the same as BEAT Example 1, except that DSub has 100 of NOL carryforwards.

DSub has no net taxable income after taking into account 50 of the NOL carryforwards.[2] Assuming DSub's base erosion percentage is 30%, 15 of the utilized NOLs (30% of 50) are disregarded in calculating DSub's modified taxable income, so only 35 of the NOLs (50 minus 15) are taken into account for that purpose. DSub's modified taxable income is 265 (300 per BEAT Example 1 minus 35), and the minimum tax rate applied to the modified taxable income yields 29.15 (11% of 265). DSub's BEAT liability, and its total tax liability, therefore is 29.15 (29.15 minus 0).

The NOLs reduce regular tax liability (i.e., the right side of the equation) in full, but are discounted by the base erosion percentage before they reduce modified taxable income (i.e., the left side of the equation). As a result, they can have a distortive effect on the BEAT calculation.

Moreover, even if NOLs were fully deductible from modified taxable income, the lower regular tax liability attributable to the utilization of the NOLs means that BEAT tax is far more likely to apply, even if there have been no changes to the amount of base erosion payments made or their relative percentage of total deductions.

[2] This is a simplifying assumption, as future NOLs can reduce only 80% of regular taxable income.