CLEARY GOTTLIEB

ALERT MEMORANDUM

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

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On December 22, 2017, the President signed into law the 2017 U.S. tax reform bill formerly known as the Tax Cuts & Jobs Act (the "TCJA"). Most of the TCJA's provisions take effect 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 non-U.S. financial institutions. The two most significant provisions for many financial institutions are likely to be new limit on interest expense deductions and the new rules for outbound payments.

1. **Reduction in Corporate Tax Rate**

— The TCJA lowers the US corporate tax rate 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— The corporate alternative minimum tax is repealed.

2. **Limits on Net Interest Expense Deductions**

— The TCJA imposes a new limit on net business interest expense deductions for U.S. companies.

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

— The rule limits the deduction for net business interest expense to 30% of adjusted taxable income. "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

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"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 may affect the relative attractiveness of debt financings for a financial institution's customers, and may encourage multinationals to borrow or issue bonds from non-U.S. affiliates rather than from U.S. affiliates. It may raise the cost of financings for higher-leveraged companies, including capital intensive companies, recently acquired companies and companies in a growth mode funded by debt.
- It 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.

3. **Base Erosion: Payments to Foreign Affiliates**

— The TCJA imposes a minimum tax (called the "BEAT") on a U.S. company's taxable income after adding back certain "base erosion payments."

— 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 U.S. after November 9, 2017), certain payments for services, and certain payments pursuant to derivatives that are marked to market for tax purposes (generally by banks or swap dealers). Deductible payments are also excluded to the extent they are subject to U.S. withholding tax.

- The rules do not allow for netting of inbound and outbound payments, which could be very significant for financial institutions.
- There are no exclusions for interest or other payments in connection with financial transactions other than derivatives. Moreover, there is an unfavorable rule that treats any interest expense that is non-deductible under the limit described in "Limits on Net Interest Expense Deductions" above as paid to unrelated parties for purposes of the minimum tax, which maximizes the deductible interest that is treated as paid to related parties and therefore subject to the minimum tax.
- The rule also treats payments made by a U.S. subsidiary to a U.S. branch, for example interest on a loan from the U.S. branch, as within the scope of the rule. This results in double taxation.

— 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.

- 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. banks and registered securities dealers: 6% in 2018, 11% in 2019 through 2025 and 13.5% in 2026 and later years. However, the base erosion tax does not apply to most payments in connection with derivatives which are marked to market.
- In calculating tax liability at the regular corporate rate, certain credits are not taken into account, with the effect that the credits can mitigate the amount of minimum tax paid. In 2018 through 2025, 80% of low-income housing and energy credits are excluded, and in 2026 and later years, all credits are excluded.

— The minimum tax 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 U.S. banks and securities dealers). Foreign corporations are subject to the rule if their ECI meets the gross receipts and 3%/2% tests.

— This rule does not take into account the special circumstances of regulated financial institutions, including the constraints on a financial institution's ability to manage its capital structure, in particular regulatory requirements affecting the amount, form and terms of any intercompany debt such as internal TLAC issued by U.S. intermediate holding companies to their non-U.S. affiliates. Other similar proposals made in recent years have included carve-outs or special rules for regulated financial institutions.

— The TCJA also disallows deductions for interest and royalty payments to foreign affiliates that are hybrid payments or made to hybrid entities.

4. **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.

— A company may use NOLs to offset a maximum of 80% of the company's taxable income for taxable years beginning after December 31, 2017 (with unused NOLs carried forward into future years).

— To the extent a non-U.S. financial institution has existing U.S. NOLs, the reduced 21% corporate tax rate could significantly reduce the benefit of those NOLs, and therefore reduce the value of the institution's deferred tax assets.

5. **Timing Issues**

— The TCJA requires most accrual-method taxpayers to take items of income into account for tax purposes no later than the time it is 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.

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