ALERT MEMORANDUM

Tax Cuts & Jobs Act: Considerations for U.S. Issuers of Debt

November 14, 2017

On November 2, 2017, the much anticipated Tax Cuts & Jobs Act was introduced in the U.S. House of Representatives. The bill was amended several times before being approved by the House Ways & Means Committee on November 9.

On November 9, the U.S. Senate introduced its own version of the bill which, while having many similarities, is also significantly different (although the Senate's version is reflected only in a description, not legislative text).

This memorandum sets forth a few key observations about the proposed bills that may be relevant to U.S. issuers of debt. It must be emphasized, however, that the House and Senate bills are likely to go through many additional changes before a single agreed-upon version becomes law, if ever.

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

Bill McRae
+1 212 225 2188
wmacrae@cgsh.com

1. **Key Benefits for U.S. Corporations**

— The bills would lower the US corporate tax rate to 20%, with corresponding changes to the deduction for dividends received from U.S. corporations. Under the House bill the rate reduction would be effective starting in 2018. The Senate bill would delay this for one year and have the rate reduction effective starting in 2019.

— The corporate alternative minimum tax would be eliminated.

— U.S. taxpayers would be able to immediately deduct 100% of the cost of certain qualified property acquired and placed in service before January 1, 2023.

- The short life of the rule would create an incentive to acquire assets eligible for immediate expensing within the next 5 years.

- "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.

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

— Both bills propose two separate limits on net interest expense deductions. In each bill, the "worst of" the two rules will apply.

— The proposals would apply to any debt outstanding on Jan. 1, 2018. There is no grandfathering.

— These rules, combined with the proposal to reduce the U.S. corporate tax rate to 20%, would diminish the incentive to allocate the maximum amount of debt to the U.S. in a multinational structure. The rules may increase the after-tax cost of financings by U.S. companies, and may make preferred equity financings more attractive than debt financings in some cases.

— *First Rule. 30% Earnings Limit.* The first rule limits the deduction for net business interest expense to 30% of adjusted taxable income (similar to EBITDA in the House bill and EBIT in the Senate bill). Disallowed interest expense can be carried forward, for 5 years in the House bill and indefinitely in the Senate bill.

- This 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 allow "excess" adjusted taxable income to tier up. The location of debt financing among partnerships or non-consolidated companies may affect deductibility.

— *Second Rule. Limit Based on Groupwide Leverage.* The other new rule is intended to limit the net interest expense deductions of companies that are overleveraged in the United States compared to the company's global operations. The net interest expense deduction of U.S. borrowers would be capped at 110% of the U.S. share of the group's overall EBITDA (in the House bill) or the group's global leverage ratio (in the Senate bill).

- This rule is a blunt instrument. It may deny U.S. interest expense deductions if U.S. operations have higher leverage as a result of different capital needs for different types of business inside and outside the United States. The rule could also affect groups with low overall leverage, if that leverage is unevenly distributed between the group's U.S. and global operations – there is no de minimis exception. The House version of the rule may deny U.S. interest expense deductions even if the U.S. and global operations have similar leverage, because of differences in U.S. and non-U.S. interest rates.

3. **Limits on Deductibility of Net Operating Losses (NOLs)**

— Carrybacks of NOLs would be repealed, while carryforwards would become indefinite (with an inflation adjustment, in the House bill). The carryback and carryforward rules would apply only to NOLs that arise in taxable years beginning *after* December 31, 2017.

— A company would be able to deduct NOLs only to the extent of 90% of the company's taxable income under the proposal, consistent with the rules under the existing AMT. Since this rule applies in the AMT context under current law this means that, in many cases, the effective tax rate for the use of NOL carryovers is not changing materially.

- The 90% restriction would apply to taxable years beginning after December 31, 2017.
  - Under the House bill (but not the Senate bill), unlike the repeal of NOL carrybacks discussed above, the 90% restriction would *not grandfather preexisting NOLs*. Consequently, companies with substantial existing losses to carryforward would still pay some federal income tax in future years.
- To the extent you have existing NOLs, this rule – together with the reduced 20% corporate tax rate – could significantly reduce the benefit of those NOLs.

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