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ALERT MEMORANDUM

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

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 the U.S. debt capital markets. It must be emphasized, however, that the House and Senate bills are likely to go through many additional changes before a single agreed-upon bill becomes law, if ever.

— Both bills propose two separate limits on net interest expense deductions by U.S. issuers. 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 significantly affect planning and structuring for LBOs and financings generally.

- They would diminish the incentive to allocate the maximum amount of debt to the U.S. in a multinational structure. Acquisitions may be carried out with less leverage, or 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 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. However, preferred equity is not a desirable

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form of financing for companies with a significant non-U.S. investor base, because of U.S. withholding tax on dividends.

- 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 target).
- Because the leverage rule for net interest expense deductions applies on a group-wide basis, an acquisition or disposition of a company or line of business may affect the overall ratios of the global group, with effects for the group on unrelated existing debt of the parent or on existing debt of the target. Consequently, the relative amount of debt in non-U.S. target companies is likely to become a significant part of the calculation in an acquisition, and may result in more post-acquisition liability management transactions in order to restructure the group's debt in a tax-efficient manner.

— In more detail:

- One proposal is a general "thin capitalization" rule similar to rules adopted in the UK and Germany. The other is a limit based on relative groupwide leverage. The "worst of" the two rules will apply.
- *First Rule. 30% Earnings Thin Cap 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.
  - 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 can be expected to affect multinationals with significant non-U.S. operations but largely spare companies that have mostly domestic operations.
  - 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 provision 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.

— The tax reform bills would make 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 would be imposed on the earnings of foreign subsidiaries, effectively "unlocking" the trapped cash held offshore by U.S. multinationals. On a going-forward basis, dividends from those foreign subsidiaries generally would be exempt from U.S. tax. The rules taxing loans by foreign subsidiaries to U.S. affiliates would be repealed.
  - As a result, U.S. multinationals with cash held offshore will be free to use that cash, and newly generated cash, to pay down debt; to make acquisitions or other investments with no or lower leverage; and to fund on-going operations. They may consequently issue less debt and/or tender for existing debt, particularly in light of the proposed limitations on net interest expense deductions.
  - U.S. borrowers would be able to pledge all of the stock or assets of their foreign subsidiaries to secure loans.

— The bills also impose tax on outbound payments to foreign affiliates.

  - The House bill includes a 20% excise tax on outbound payments from domestic corporations (and branches) to foreign affiliates (excluding certain securities, commodities and service transactions, as well as interest and certain other payments). The tax would apply starting in 2019. Taxpayers can elect to avoid the excise tax by instead treating these outbound payments as "effectively connected income" to the foreign recipient, which would be currently taxable in the United States with a limited foreign tax credit offset allowed. The excise tax seems designed as a club to force taxpayers to make the effectively connected income election.
  - The Senate bill provides for a minimum tax of 10% on the amount by which deductible payments to foreign affiliates exceed taxable income (determined without taking into account credits (including foreign tax credits) other than the research and development credit, and certain other adjustments). The Senate rule does not explicitly exclude payments of interest or other payments in connection with financial transactions. It would, however, exclude cost of goods sold from the scope of deductible payments subject to the rule.

— U.S. issuers of debt trading at a premium will continue to have a tax incentive to redeem or refinance their debt before tax reform legislation takes effect, in order to reduce current taxes at a 35% rate rather than future taxes at a 20% rate.

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