ALERT MEMORANDUM

Tax Cuts & Jobs Act: Considerations for Equity 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 equity 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.

1. **General Observations**

— The proposed 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.

— The changes in the proposed bill are likely to affect the value of U.S. companies' stock, but the effect will differ depending on the company, taking into account the company's effective tax rate, leverage profile, tax assets (including NOLs), international presence and offshore cash, among other things.

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
wmcrae@cgsh.com

2. **Unlocking Trapped Cash**

— The tax reform bill 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 The rules taxing loans by foreign subsidiaries to U.S. affiliates would be repealed.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 dividends or carry out stock buybacks, as well as to pay down debt; to make acquisitions or other investments; and to fund on-going operations.

3. **Significant Reduction in Headline Tax Rates**

— For corporations:

- The bills would lower the U.S. 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.

— However:

- There are significant limitations on interest deductions (discussed immediately below).
- Many other tax preferences would be eliminated.
- The reduction in tax rates will mechanically reduce the value of any tax assets owned by U.S. companies (e.g., NOLs). Other changes are made to the rules for NOLs that affect when they can be used.
- A new excise tax may substantially increase tax costs for some companies.

— The effect of the reduction in corporate tax rates may be greatest for companies that currently have relatively high effective tax rates.

4. **Limitations on Net Interest Expense Deductions**

— The bills propose two separate limits on net interest expense deductions. One 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.

— 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 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 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 may make equity financings more attractive than debt financings in some cases.
- 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 deductions 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-US operations but largely spare companies that have mostly domestic operations.

5. **Base Erosion Provisions Affecting Outbound Payments**

— Both the House and Senate bills 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 rule only applies to groups with aggregate outbound payments subject to the rule exceeding $100 million.

— 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.

— Both the House and the Senate rules could dramatically affect the taxes imposed on a multinational group, and would need to be taken into account in evaluating integration plans and tax synergies. Companies with significant IP held outside the United States (and that pay royalties to foreign affiliates to use that IP) may be especially hard hit.

…

CLEARY GOTTLIEB