ALERT MEMORANDUM

Tax Cuts & Jobs Act: Considerations for Non-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).

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This memorandum sets forth a few key observations about the proposed bills that may be relevant to the non-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.

— The 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 thus may make preferred equity financings more attractive than debt financings in some cases. However, preferred equity is not a

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

- 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 overall effect of the proposed bill will be different for each company, and will depend on the company's effective tax rate, leverage profile, tax assets (including NOLs), international presence and offshore cash, among other things.

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