ALERT MEMORANDUM

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

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. financial institutions. 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.

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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.

— *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.
- The rules look to *net* business interest (so business interest income can offset business interest expense), but interest income equivalents (*e.g.*, lease income) are not covered.

— *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 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.

— 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

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.

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.
- In 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.

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

— Both the House and Senate bills impose tax on outbound payments to foreign affiliates.

- The rules do not allow for netting of inbound and outbound payments, which could be very significant for financial institutions.

— The House bill includes a 20% excise tax on outbound payments from domestic corporations (and branches) to foreign affiliates. The tax would apply starting in 2019.

- The rule would exclude outbound payments in connection with service and commodities transactions and payments of interest, as well as any payments in connection with the acquisition of securities. The securities exclusion would not take into account, for example, periodic payments on notional principal contracts.
- 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 election would allow the foreign recipient to be taxed at a rate of 20% of the net profits (based on the profitability for the group of the specific product line) and, potentially, a branch profits tax of 30% (as reduced by applicable tax treaties).

- The rule only applies to groups with aggregate outbound payments subject to the rule exceeding $100 million.

- This controversial proposal, which is intended to address transfer pricing concerns, subjects to U.S. taxation income that is generally viewed as attributable – economically and under international tax principles – to foreign tax jurisdictions. This may result in double taxation, and, if the election is made, may not be eligible for relief under treaties.

- The rule was somewhat of a surprise (although it is in some way a variation on the "Border Adjustment Tax" that was included in the Republicans' 2016 blueprint for tax reform).

— 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 and low-income housing credits) other than the research and development credit, and certain other adjustments).

- The rule would apply to corporations (including S corporations) and REITs with at least $500 million in annual gross receipts and for which deductible payments to foreign affiliates represent at least 4% of total deductions. Foreign corporations and foreign REITs would be subject to the rule if their ECI meets the gross receipts test.

- 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.

— The Senate bill would also disallow deductions for interest and royalty payments to foreign affiliates that are hybrid payments or made to hybrid entities.

5. **Base Erosion – Low-taxed Intangibles Income**.

— Under the House bill, U.S. shareholders of CFCs would be subject to tax on a current basis on 50% of a CFC's returns in excess of a certain threshold which is keyed off the CFC's depreciable assets (resulting in a 10% rate).

— Under the Senate bill, subpart F income would include a new category of "global intangible low-taxed income" taxed at 62.5% of the usual rate (*i.e.*, a 12.5% rate).

— These rules most likely are intended to capture CFCs that earn high returns on assets consisting of intangibles or that have assets that are not depreciable or that have already been significantly depreciated.

— Under each rule, an 80% foreign tax credit would be available (subject to some limitations). As a result, a CFC would need to pay tax at an effective rate of 12.5% (under the House bill) or 15.6% (under the Senate bill) in order to avoid triggering tax under this rule.

6. **Shift to a Territorial System**. Both bills would adopt a territorial system of international taxation, effective January 1, 2018. It would likely result in the repatriation of significant amounts of offshore cash to U.S. corporates.

— A one-time transition tax would be imposed on the earnings of foreign subsidiaries (in the House bill, at a rate of 12% on liquid asset, and 5% on illiquid assets; and in the Senate bill at rates of 10% and 5%), effectively "unlocking" the trapped cash held offshore by U.S. multinationals. Taxpayers can generally elect to pay the tax over 8 years.

  • This deemed repatriation provision would treat a financial institution's offshore securities book as liquid assets subject to the higher rate of tax, even though they are held in connection with an active business.

— Under the new system, the dividends received by a U.S. corporation from its 10%-or-greater-owned foreign subsidiaries would generally be exempt from tax (if attributable to foreign source income).

  • This participation exemption is intended to make U.S.-parented companies more competitive internationally, and to encourage these companies to bring offshore cash back into the U.S. It will make managing a U.S. corporation's foreign tax position even more important than it has been to date.

— The bill would repeal current law section 956 with respect to U.S. corporate shareholders (*i.e.*, the rule which requires a U.S. shareholder of a CFC to currently include in income the earnings of the CFC reinvested in United States property).

— There are a few notes of caution however:

  • This is not a full participation exemption. Dividends received by non-corporate taxpayers as well as dividends from subsidiaries in which the U.S. taxpayer does not own 10% of the voting power will be fully taxable (with potential for foreign tax credit relief). In addition, gain from the sale of shares of foreign companies is generally not exempt from tax (though the Senate bill would provide a potential exemption for a portion of such gains from the sale of a CFC). There may be a significant benefit to selling foreign assets and deriving exempt dividends as compared to selling foreign shares.

7. **Deferred Compensation (Senate bill only)**.

— The Senate bill (but not the House bill) would significantly limit the flexibility of non-qualified deferred compensation (*e.g.*, such as equity options) as a tax-efficient form of compensation for management. This may significantly impact the incentive structure granted to management teams in connection with acquisitions.

— Performance vesting does not allow for deferral. Non-qualified deferred compensation would be included in income immediately upon vesting, with only service-based conditions (which would not include a non-compete) respected as vesting conditions that prevent immediate income inclusion. Performance-based conditions (*e.g.*, return thresholds or the occurrence of an IPO or qualifying exit) would not be treated as vesting conditions for this purpose.

— The rule would not apply to compensation in the form of property that is subject to section 83 (*e.g.*, restricted stock), but would otherwise cover deferred equity compensation (*e.g.*, options, SARs, RSUs or other deferred payments). The rule would not change the treatment of the grant of profits interests.

— The proposal would require all preexisting deferred compensation to be included in income by 2026 or the year it vests, whichever is later.

— The good news is that the bill would eliminate current law sections 409A and 457A, with related benefits of simplicity.

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