Tax Reform Advisory: Provisions Impacting Debt Financing

January 18, 2018

On December 22, 2017, the President signed into law H.R. 1, informally known as the "Tax Cuts and Jobs Act" (the "Act"), implementing sweeping changes to the United States tax regimes generally applicable to businesses. Most provisions of the Act take effect as of January 1, 2018, and generally apply to tax years beginning after 2017. Certain highlights of the Act that may be relevant to debt financing transactions are discussed below.

Limits and Elections for Interest Deductions. The Act limits the deductibility of business interest for every business, regardless of its form, to 30% percent of adjusted taxable income (defined similarly to "EBITDA" for taxable years beginning before January 1, 2022, and "EBIT" thereafter). This limitation does not apply to: (1) taxpayers that are not part of a controlled group with more than $25 million of gross receipts (measured as an average over a three-year period); and (2) real property trades or businesses that elect out of the limitation.

Commercial Observations:

- This limitation applies to net interest expense associated with third party and related party debt. Interest expense on certain cross-border related party debt may be limited under the new base erosion minimum tax described below.
- The eventual transition to EBIT as the metric for measuring adjusted taxable income will result in a further reduction in allowable interest deductions for many businesses.
- This limitation only applies to "business interest" and does not apply to "investment interest", which remains subject to a separate set of limitations (generally limited to offsetting investment income).
- Borrowers will be incentivized by these new limitations to keep their interest expense below the allowable 30% threshold and may prefer equity capitalization as an alternative to debt above that level. In the partnership context, preferred equity may become a more attractive financing alternative since income can be allocated to a preferred equity holder without being subject to any 30% limitation.

Changes to Individual and Corporate Tax Rates. The corporate tax rate is reduced to a flat 21%, with lower rates available for certain foreign export income (FDII) and income earned through foreign subsidiaries (GILTI). The highest individual income tax rate is reduced from 39.6% to 37%. As described below, a new deduction available to individuals for certain pass-through business income further reduces the effective maximum tax rate on income qualifying for the deduction to 29.6%.

Qualified Business Income Deduction. Individuals, trusts, and estates may be eligible for a 20% deduction on certain qualified business income, subject to limitations. The two principal limitations on the availability of this deduction are: (1) a limit imposed on certain services businesses; and (2) a limit based upon the wages paid by the business and the unadjusted cost basis of the depreciable tangible property of the business. Both of these limits are phased in for taxpayers with taxable income of $157,500 individually (or $315,000 for a joint filers).These limits do not apply to REIT dividends.

Commercial Observations:

- Multinational groups may now wish to increase borrowing offshore if they have entities and operations in higher tax jurisdictions.
- The rate differential between corporations (21%) and pass-through entities (29.6% or 37% depending on the availability of the qualified business income deduction) may put more pressure on the negotiation of permitted payments for tax distributions in the case of pass-through borrowers. Under prior law, the delta between corporate (35%) and individual (39.6%) tax rates was relatively modest. As a result, allowing tax distributions as permitted payments for pass-through borrowers in loan documents was viewed as roughly equivalent to a corporate borrower paying corporate level tax. As the rate differential between corporations and flow-through entities increases, lenders may rethink this approach to permitted payments for tax distributions.In addition, the rate differential between corporations and flow-through entities further increases when state income taxes are considered.For federal income tax purposes, corporations will continue to be able to deduct state income taxes, but partners or members in flow-through entities generally will not be able to do so beyond a $10,000 cap.
- Given the reduction in individual rates and the potential availability of the qualified business income deduction, many existing loan documents may provide permitted payments for tax distributions that significantly exceed the actual cash needed by members and partners to satisfy their tax liabilities. It is not uncommon for tax distribution provisions to be based on a hypothetical calculation of taxable income that is measured by the highest rate applicable to an individual resident in an enumerated jurisdiction (e.g., New York, New York). In the case of a flow-through borrower that is entitled to the pass-through deduction, tax distribution provisions in existing agreements could be overstated.

The Act includes several significant changes to the United States international tax system. Certain of these changes will impact borrowers that have international operations and subsidiaries. Below is summary of certain key international provisions that may impact debt financing transactions.

New Dividends Received Deduction. The Act moves the United States to a so-called territorial system of international taxation, under which no US federal income tax is imposed on the operations of foreign corporate subsidiaries even when the profits are repatriated back to the United States in the form of dividends.

Transition Rule for Existing E&P. To transition existing offshore earnings into the new territorial regime, US shareholders are subject to a mandatory immediate inclusion of all accumulated earnings and profits (E&P) of a "specified foreign corporation" into gross income for the current taxable year. A special partial dividends received deduction (not limited to domestic corporations) is available. A number of special elections are available to US shareholders subject to a section 965 inclusion.

Retention of Section 956. Contrary to the approach in the House and Senate bills, the Act retains the rules treating credit support from a controlled foreign corporation ("CFC") as an investment in US property for federal income tax purposes creating a deemed dividend to the U.S. borrower (a "Section 956 Deemed Dividend"). However, such deemed dividends are not eligible for the new dividends received deduction.

New Tax on Low-Taxed Income of CFCs. The Act adds a new tax on "global intangible low-taxed income" (GILTI). The GILTI tax operates in a manner similar to subpart F requiring US shareholders of a CFC with GILTI income to include their proportionate shares of such income on a current basis.

Base Erosion Minimum Tax. The Act imposes a new base erosion minimum tax (BEAT) of 10% (5% for 2018) on the modified taxable income of an applicable taxpayer which is calculated by adding back to the taxpayers income any deductions for payments made to related foreign parties and any depreciation claimed for assets purchased from such persons (as well as NOL carryovers attributable to such payments made in prior years). The BEAT only applies to taxpayers with gross income exceeding $500 million.

New Deduction for Foreign Derived Income of Domestic Corporations. The Act add a new deduction equal to 37.5% of a domestic corporation's foreign derived intangible income (FDII) which effectively reduces the tax rate on such income to 13.125%.

Commercial Observations:

- The retention of Section 956 means that the provisions in loan documents prohibiting guarantees from certain foreign corporations (CFCs) and limiting pledges of stock in such corporations to 2/3rds of voting shares (such provisions, the "Credit Support Limitations") will still be relevant going forward.
- As it relates to corporate borrowing groups, the retention of the Section 956 Deemed Dividend rules is peculiar as under the new dividends received deduction described above such corporate groups generally will be able to make actual cash distributions from such foreign subsidiaries on a tax free basis.While the Credit Support Limitations will remain relevant, there may be increased focus on requirements in lending documents that corporate borrowers make actual distributions from their CFC subsidiaries on a periodic basis so long as they can do so in a tax efficient manner.
- The transition rule for existing E&P will require taxpayers to pay tax on all of their deferred earnings in CFCs as the United States transitions to a new hybrid territorial system of international taxation.In addition, with respect to CFCs located in low-tax jurisdictions, the new GILTI tax generally will result in a reduction of deferred earnings in such CFCs.As a result, the deferred offshore earnings of most multinational groups will be greatly reduced if not eliminated (at least in the short-term).Since the Section 956 Deemed Dividend is paid

out of a CFC's deferred earnings, the practical impact of those rules on a borrower group may be greatly diminished under the new international taxing regime. As part of the credit support negotiation it may be appropriate to analyze the actual detriment to each US borrower of providing full credit support from its CFCs.

- The permitted payment provisions related to tax distributions will need to be examined with the new international tax provisions in mind.For example, the transition rule for existing E&P will result in income inclusions flowing up through flow-through entities that own CFC subsidiaries. Such inclusions will come through at reduced tax rates under the new provision (8% or 15.5% depending on whether the CFC invested its deferred earnings in business assets (8%) or passive assets (15.5%)) and the associated tax liabilities may, at the election of the taxpayer, be paid over a period of years.Existing tax distribution provisions may allow for current tax distributions associated with such inclusions that would be well in excess of the actual cash tax liability of the respective members or partners of the flow-through borrower entity.

A Note Regarding the Bipartisan Budget Act of 2015

The Bipartisan Budget Act of 2015 included new provisions addressing tax audit procedures for partnerships (the "Revised Partnership Audit Rules"), that are generally applicable to taxable years beginning after December 31, 2017. The Revised Partnership Audit Rules introduces many important changes to the procedures governing partnership audits that are beyond the scope of this summary. However, in relevant part, for taxable years subject to the Revised Partnership Audit Rules tax adjustments, deficiencies or liabilities (including interest and penalty) associated with a partnership audit (generally referred to as "imputed underpayments" under the Revised Partnership Audit Rules) are imposed at the partnership level instead of on the individual partners as was the case under prior law. Certain partnerships (depending on the composition of the partners of the entity) may be able to elect out of these rules. In addition, an election (a "Push-Out Election") may be available to push any imputed underpayments imposed at the partnership level under these rules out to the partners of the partnership. Although initially limited in application, recently issued proposed Treasury Regulations expand the availability of the Push-Out Election by providing that the election may be available to certain partnerships that have other flow-through entities as partners (e.g., tiered partnerships).

Commercial Observations:

- Under the Revised Partnership Audit Rules, adjustments of taxable income (including penalty and interest) resulting from partnership audits of taxable years beginning after December 31, 2017, will be imposed at the partnership level instead of at the partner level. The application of these rules to a partnership borrower will place more emphasis on potential income tax exposures of such a borrower – similar to a C corporation borrower. A partnership borrower, however, may be reliant (at least in part) on current and/or former partners funding any such liability imposed at the partnership level. As a result, lenders will be interested in whether the Revised Partnership Audit Rules apply to a borrower treated as a partnership for federal income tax purposes. Lenders may seek an undertaking in the loan documents from such borrowers to elect out of the Revised Partnership Audit Rules or to make a Push-Out Election, in each case, to the extent available.

Additional detail regarding the above items and further discussion of other elements of the Act is available in the following Client Advisories.

- Corporate and General Business Provisions
- Exempt Organizations
- International Provisions
- Private Client & Trust
- Real Estate Industry

If you have any questions or concerns, we invite you to reach out directly to any member of our Capital Markets and Tax Groups.

**Mr. Razza is an accountant and not an attorney.*