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Tax Reform Impacts Lenders and Borrowers

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New Tax Rules Will Impact Both Lenders and Borrowers in Lending and Leveraged Finance Transactions

On December 22, 2017, the President signed into law tax legislation commonly referred to as the Tax Cuts and Jobs Act (the "Act"), the most sweeping overhaul of the Internal Revenue Code in more than 30 years. The Act makes significant changes to tax rules that affect lending and leveraged finance transactions. Both borrowers and lenders will want to be acquainted with these changes to understand how they impact such issues as credit support, structuring and placement of debt, interest deductibility, and the negotiation and drafting of provisions around such topics as prepayments and permitted tax distributions, on both a go-forward basis and in existing credit arrangements.[1]

Reduction in Tax Rates

One of the cornerstones of the Act is the permanent reduction of the corporate income tax rate from 35 percent to a flat 21 percent. The Act also reduces the top individual tax rate from 39.6 percent to 37 percent and provides for an effective reduction in the tax rate on pass-through "qualified business income" received by non-corporate taxpayers in the form of an up-to 20 percent deduction, both of which will be effective through 2025.

New Limitations on Deductibility of Interest

The Act disallows a deduction for net interest expense in excess of 30 percent of adjusted taxable income, which is calculated on a consolidated group basis and computed using tax principles similar to EBITDA for years before 2022 and EBIT for years 2022 and after. Any disallowed net business interest expense can be carried forward indefinitely. Taxpayers with average annual gross receipts for a three-year period of $25 million or less are generally exempt from these rules. Interest on existing debt will not be grandfathered and therefore will be subject to these new limitations.

Loss of interest deductibility may result in leveraged companies facing an immediate increase in taxable income, although the impact of that may be mitigated by the reduction in tax rates. We expect that borrowers and issuers will seek out debt with lower rates of interest, even if that also means less favorable borrowing conditions, or even non-debt alternatives such as preferred stock. Leveraged companies will also want to reconsider their global capital structure and may pursue measures such as paying off debt held by U.S. entities (which will be made easier by new tax rules permitting cash to be returned to the U.S. tax-free from foreign subsidiaries) and moving debt offshore to foreign affiliates.

Impacts on Multinational Groups

Prior to the Act, active business income earned by a U.S. multinational enterprise's foreign subsidiary generally was not subject to U.S. income tax unless and until those earnings were repatriated back to the United States by way of a taxable distribution. This delay is believed to have resulted in many U.S. multinational enterprises ("MNEs") deferring the repatriation of offshore earnings. Section 956 of the Internal Revenue Code was designed to prevent foreign subsidiaries in MNEs from making their offshore earnings available for use by U.S. affiliates without actually having to declare a taxable dividend. Under these rules, the United States will generally consider the amount of any untaxed earnings of a foreign subsidiary that are invested in certain types of United States property as though distributed to the foreign subsidiary's U.S. parent as a dividend. Specifically, these rules treat a loan of any untaxed foreign subsidiary's earnings to its U.S. parent or U.S. affiliate as a deemed distribution, along with certain pledges of the stock of, or guarantee by, the foreign subsidiary of their debt.

The Act does not repeal Section 956, which means that U.S. borrowers with foreign affiliates must continue to be mindful of these rules when agreeing to a collateral package. However, some of the changes brought about by the Act may soften the impact of Section 956 on leveraged multinational groups. For example, deemed dividends to U.S. corporate shareholders that result from pledges of, and guarantees by, foreign subsidiaries triggering Section 956 will now be taxed at 21 percent rather than 35 percent. Significantly, under the Act, a U.S. corporate shareholder can now receive tax-free, by way of a "dividends received deduction" or "DRD," any foreign-source dividend paid from a foreign corporation of which it owns 10% or more (subject to a one-year holding period requirement). This effectively means that unless the earnings of a foreign corporation are taxed in the U.S. when earned under Subpart F or under new rules regarding "global intangible low-taxed income" or GILTI, such earnings will be permanently exempt from U.S. taxation if distributed to a 10% or greater corporate shareholder. This change will make it easier for leveraged U.S. corporations to repatriate cash from foreign affiliates to pay off U.S.-level debt and will also make it easier for companies to place debt offshore in a foreign affiliate and distribute the proceeds of that debt tax-free to U.S. affiliates. (Note that the benefit of the DRD is only available to corporate shareholders and not to pass-through entities or individuals, who will generally continue to be taxed on the repatriation of foreign earnings.)

The DRD does not come without cost, however. The Act requires that all U.S. shareholders owning 10% or more of a foreign corporation pay a one-time "transition" tax on their pro rata share of the foreign corporation's undistributed earnings and profits, measured as of November 2, 2017 or December 31, 2017 (whichever is higher). The transition tax, which is payable over eight years, is imposed at a rate of either 8 percent or 15.5 percent, depending on the amount of cash and other property held by the foreign corporation, and can be partially offset by foreign tax credits. As a result of the transition tax, the pool of "previously taxed income" held offshore by a foreign subsidiary will be increased, which will lessen the amount that would otherwise have to be taken into income under Section 956 from such foreign subsidiary's pledge or guarantee of a U.S. obligation. (Note again that while the benefit of the DRD is available only to corporate shareholders, the transition tax must be paid by all shareholders, whether corporate or non-corporate, owning 10% or more of a foreign corporation that has at least one 10% U.S. corporate shareholder.)

In addition to affecting collateral packages, these changes may also impact how borrowers and lenders negotiate mandatory prepayment provisions. Typically, borrowers have not been required to apply excess cash flow or proceeds from asset sales to prepayment where such application would require a taxable repatriation of proceeds from a foreign affiliate. The DRD generally now eliminates any U.S. federal income tax cost of repatriation for corporate U.S. shareholders. As a result, lenders may ask borrowers to repatriate foreign proceeds to make prepayments, although the parties will still have to consider state income tax and/or non-U.S. withholding taxes that could be triggered by repatriation or other restrictions on distributions. Corporate borrowers may in fact want to repatriate cash from foreign subsidiaries to pay down principal given the limitations on interest deductibility and the fact that this can now be done tax-free.

Changes to CFC Rules Will Cause More Foreign Entities to Be CFCs

The Act makes changes to rules relating to "controlled foreign corporations" or "CFCs" in a manner that will cause some entities that before the Act were not CFCs to become CFCs (in some cases retroactively). For some multinational groups, this may result in additional Subpart F income to U.S. shareholders and may also have the effect of shrinking the base of credit support available to U.S. borrowers in the group (at least without adverse U.S. tax consequences).

Specifically, in a change that will affect foreign-parented groups, the Act revises the attribution rules used in determining the extent to which a CFC is considered owned by U.S. shareholders, such that ownership by a foreign parent of a foreign corporation's stock will be attributed downward to any U.S. entity also owned by that foreign parent. As a result of this change, in a multinational group with a foreign parent, a foreign subsidiary that is more than 50 percent owned by the foreign parent will be treated as a CFC if the foreign parent also owns more than 50 percent of the value of the stock of a U.S. subsidiary (that is, the U.S. subsidiary will be treated as constructively owning more than 50 percent of the foreign subsidiary through attribution from the foreign parent). This change is retroactive to the first day of the last taxable year of the foreign corporation that begins before January 1, 2018 (which means it is effective as of January 1, 2017 for calendar year taxpayers). It is important to note that the fact that a foreign entity becomes a CFC as a result of this change does not necessarily mean U.S. persons within the multinational group will face additional U.S. tax liability; under Section 951(a)(2), only a "United States shareholder" that directly or indirectly owns stock in a CFC is required to include in gross income its share of the CFC's Subpart F income. Thus, only if the U.S. subsidiary also directly or indirectly owned stock in the foreign subsidiary, or if the foreign parent had any 10% or greater "United States shareholders," would a pledge of, or guarantee by, such CFC give rise to a deemed dividend under Section 956.

The Act also changes the definition of a "United States shareholder" to include U.S. persons who own 10% or more of the vote <u>or value</u> of a foreign corporation (rather than just vote).

Tax Distribution Provisions Likely Will Change

Borrowers organized as pass-through entities for U.S. tax purposes frequently negotiate to receive exceptions from restricted payment covenants to permit payments to direct and indirect owners for purposes of enabling such owners to pay income taxes attributable to their distributive share of the borrower's income ("permitted tax distributions"). Prior to the changes made under the Act, the maximum marginal corporate income tax rate (35%) and the maximum marginal individual income tax rate (39.6%) were close enough to each other that lenders generally were willing to calculate permitted tax distributions by reference to either rate (and applicable state rates) and were not concerned that a single rate was used to approximate the deemed tax liability for all owners. Similarly, lenders generally allowed for permitted tax distributions because the sum of the permitted tax distributions made to the borrower's direct and indirect owners approximated what the borrower would have had to pay in income tax if it had been structured as a taxable corporation rather than a pass-through entity for tax purposes.

Now that the corporate tax rate is 21 percent and the maximum individual tax rate is 37 percent, a permitted tax distribution that assumes the highest combined marginal tax rate applicable to an individual could provide for tax distributions materially higher than necessary to reasonably approximate the actual tax liability of the borrower's owners if some of those owners are corporations (or tax-exempt entities) and will result in an amount of permitted tax distributions exceeding what the borrower would have paid in entity-level income taxes had the borrower been a corporation. Other changes made under the Act further complicate the exercise. For example, after the Act, individuals are now significantly limited in their ability to deduct state and local taxes for federal income tax purposes, while corporations continue to be entitled to take a full deduction for these taxes, thus further reducing their effective tax rates on operating income below those applicable to individuals. Additionally, non-corporate owners of pass-through borrowers may be entitled to a deduction of up to 20 percent for "qualified business income," but the availability of that deduction (and the amount of the deduction) is dependent on the facts and circumstances surrounding the business. A final wrinkle presented by changes under the Act is the impact of the transition tax on permitted tax distributions. Because the transition tax is permitted to be paid over an eight year period and at a very reduced rate of tax, a permitted tax distribution provision that does not specifically address the treatment of the tax liability arising from the transition tax might permit tax distributions greatly in excess of what is needed to actually cover tax liability from the transition tax and would permit an immediate one-time payment in the current year to cover a liability that likely will be paid over a longer period of time.

We expect these changes will cause lenders and borrowers to revisit how tax distribution provisions are negotiated and drafted, the result of which may be that lenders are able to offer better terms to corporations than to pass-through entities, and borrowers may find the corporate form more attractive for this and other reasons.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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[1] Unless otherwise indicated, this discussion is limited to United States federal income tax consequences only. Any Section references herein are to the U.S. Internal Revenue Code of 1986, as amended.