Milbank

January 29, 2018

CONTACT

Eschi Rahimi-Laridjani
Partner
+1-212-530-5141
erahimi-laridjani@milbank.com

Andrew R. Walker
Partner
+1-212-530-5624
awalker@milbank.com

Client Alert: The New Tax Cuts and Jobs Act—Implications for Loan Markets

On December 22, 2017, the President signed into law the Tax Cuts and Jobs Act (the "Act"). The Act makes very significant changes to the Internal Revenue Code. The Act generally provides lower tax rates for business income and moves towards a territorial approach to taxing foreign earnings of non-U.S. corporate subsidiaries.

Discussed below are some of the provisions most likely to have an impact on loan markets and market practice for syndicated loans. The discussion does not address state and local tax implications. It is not yet clear to what extent states and localities will conform to, or revise their own tax laws to respond to the federal changes.

The legislative process adopting the Act was unusually rapid for legislation adopting such fundamental changes to the U.S. tax system. The import (and legislative intent) of many of the relevant provisions is not clear in all respects and future technical corrections through legislation or regulatory guidance may change the law and conclusions below.

CORPORATE AND INDIVIDUAL TAX RATE REDUCTION

The Act lowers the maximum marginal rate for "C corporations" to 21% from a 35% rate under prior law. On the one hand, and subject to the potential countervailing impact of other changes described in the memorandum, this will improve the after-tax return of any business conducted in U.S. C corporation form. On the other hand, it will reduce the tax-effected benefit of tax "shield" from deductible items like interest and depreciation.

Under the U.S. tax system, in addition to income tax at the corporate level, shareholders are subject to income tax on dividends or gain from disposing of their equity in the C corporation. As a general matter, this will continue to be the case under the Act although income tax rates for non-corporate U.S. shareholders have also been somewhat reduced (to a maximum rate of 37%) for tax years prior to 2026. Further,

individuals can no longer deduct state and local income taxes except to a very limited extent.

Despite the double tax on C corporation income, the significantly lower tax rate applicable to C corporations under the Act compared to individuals may lead many businesses currently operating as pass-through entities to convert to C corporations. Debt documents for pass-through borrowers often restrict actions that would cause the borrower to be taxed as a C corporation. This may lead to requests for lender consent for those businesses considering a conversion.

PASS-THROUGH BUSINESS DEDUCTION AND EXCESS BUSINESS LOSS LIMITATIONS

U.S. taxpayers that are not C corporations do not qualify for the lower 21% corporate tax rate. However, depending on the business conducted, a borrower that is a U.S. taxpayer (or its partners, if the borrower is a partnership) may be entitled to a deduction that reduces its generally applicable tax rate with respect to that business income.

At a high level, for tax years through 2025, a partner in a partnership that conducts a qualified business generally may claim a deduction equal to 20% of the business income from that business, reducing its effective individual tax rate on the income. However, this deduction is generally capped based on the partner's share of the greater of (1) 50% of the W-2 wages paid by the business to its employees or (2) the sum of 25% of such W-2 wages and 2.5% of the unadjusted tax basis immediately after its acquisition of all qualified depreciable property used in the partnership business (whose depreciable life is not over).

The pass-through business deduction may affect how permitted tax distributions are calculated under a pass-through borrower's loan documents.

NEW NOL LIMITATIONS; REPEAL OF CORPORATE ALTERNATIVE MINIMUM TAX

Prior law permitted taxpayers to reduce taxable income by deducting net operating losses ("NOLs"), which could be carried back two years and carried forward 20 years. However, the alternative minimum tax effectively limited the benefit of NOLs by imposing an alternative minimum tax ("AMT"), at a 20% rate in the case of corporations, on alternative minimum taxable income. No more than 90% of a taxpayer's alternative minimum taxable income could be offset with NOLs. In effect, a 20% tax was imposed on the 10% of taxable income that could not be offset with available NOLs (which could be viewed as an effective 2% "toll charge" tax on the use of NOLs).

The Act generally eliminates the ability to carry back NOLs generated in taxable years ending after December 31, 2017, and allows such NOLs to be carried forward indefinitely. The Act also eliminates the corporate AMT, but provides that NOLs generated in taxable years beginning on or after January 1, 2018 can only offset up to 80% of taxable income (determined without regard to the deduction). Taxpayers are allowed to carry such NOLs forward indefinitely under the Act. The two-year carry-back and special NOL carry-forward provisions were repealed for post-2017 NOLs. At a 21% corporate rate, there is now effectively an approximately 4.2% toll charge on using recently generated NOLs. NOLs generated in tax years beginning before January 1, 2018 are not subject to the new 80% limitation on use. That, coupled with the elimination of the alternative minimum tax, makes historic NOLs significantly more valuable than new NOLs.

LIMITS ON DEDUCTIBILITY OF INTEREST

The Act limits the net interest expense deduction for most businesses, regardless of form, to 30% of adjusted taxable income ("ATI"). Disallowed interest can be carried forward. Net interest expense is the excess of "business interest expense" over "business interest income." The disallowance does not apply to "investment interest." It is not clear whether a C corporation can be treated as having "investment interest" for this purpose.

ATI generally is a business's taxable income computed without regard to non-business income, business interest income and expense, NOLs, the new pass-through business deduction (described above) and for tax years beginning before January 1, 2022, any deduction allowable for depreciation, amortization, or depletion. For tax years beginning in 2018 through 2021, the computation of ATI should approximately reflect a business' EBITDA. For tax years beginning after 2021, the inability to add back depreciation, amortization and depletion will generally result in lower ATI, with ATI approximating EBIT. This change may significantly decrease the maximum amount of business interest expense deductible annually.

Complex rules apply to vehicles treated as partnerships for federal income tax purposes, a detailed discussion of which is beyond the scope of this summary. The rules effectively apply the limitation at the partnership level in a manner that prevents a partner from taking into account ATI from other activities or partnerships in deducting the excess interest expense from the partnership. Thus, partners may be subject to more stringent limitations on interest than they would have been had they directly conducted the partnership activity.

The new limitation on interest deductibility will make it less attractive for some businesses to borrow. The limitation coupled with the reduction in the U.S. corporate income tax rate may result in a multi-national group of companies incurring more leverage outside the United States where interest deductions may provide more value. While the limitation on deductibility of interest may make borrowing in the U.S. less attractive, there are still good reasons for financings to be structured as debt rather than equity. U.S. source interest paid to foreign persons generally remains eligible for the portfolio interest exemption from U.S. withholding tax or zero withholding rates for foreign banks under an applicable tax treaty. An equivalent yield on an equity investment in a U.S. corporation would generally be considered a dividend subject to a 30% withholding tax if paid to a non-U.S. person. If the issuer is a pass-through entity, debt may be strongly preferred by both the issuer and the investors for a variety of reasons.

FUNDAMENTAL CHANGES TO THE INTERNATIONAL TAX REGIME

The Act fundamentally alters the architecture of the U.S. international tax regime for U.S. taxpayers. In the past, U.S. taxpayers generally could defer recognizing income earned in non-U.S. corporate subsidiaries until they actually realized dividend income or capital gains, subject to certain important exceptions such as the rules for passive foreign investment companies and some passive or mobile income of controlled foreign corporations ("CFCs") (generally, foreign corporations more than 50% owned by one or more U.S. 10% shareholders). However, income could be deemed to be repatriated in various circumstances, including when earnings were invested in certain U.S. property or a CFC provided credit support for a borrowing by a related U.S. person (resulting in "deemed dividends" under section 956). Borrowers who intended to permanently reinvest deferred earnings of the foreign subsidiary outside the United States generally were not required to reflect a deferred tax liability with respect to those assets for financial accounting purposes. Borrowers were therefore very sensitive to the risk that financing structures might trigger deemed dividends under section 956, converting what could effectively be considered tax exempt income into currently taxed income.

Under the new regime, a limited portion of the foreign earnings (relating to an assumed rate of return on depreciable tangible assets) of foreign subsidiaries is exempt from U.S. tax when earned and when repatriated as a dividend (under a "participation exemption") to a U.S. corporate owner. Certain passive or mobile "Subpart F income" earned by a foreign subsidiary that is a CFC continues to be taxed currently to the U.S. 10% shareholders of the CFC at regular U.S. rates as it is earned by the subsidiary whether or not distributed. Most other income (that formerly could be deferred offshore without U.S. taxation, often indefinitely) now is also taxed currently to U.S. 10% shareholders whether or not distributed, although for corporate taxpayers it is taxed at a significantly reduced rate. Importantly, the reduced rate does not apply to

non-corporate taxpayers, who have to pick up this income (whether or not distributed) at their maximum marginal tax rate.

As part of the transition to the new regime, the Act provides for a deemed repatriation of most previously untaxed earnings deferred offshore for a taxpayer's last tax year beginning before January 1, 2018 (the 2017 tax year for calendar year taxpayers). The Act allows a deduction for a portion of the amount deemed repatriated, resulting in effective tax rates on such amounts considerably lower than regular rates (especially for corporate taxpayers). The Act also permits taxpayers to pay the tax over a period of up to eight years. Deemed repatriation of untaxed foreign earnings for taxpayers that have reinvested the offshore earnings may strain liquidity and some taxpayers may need to borrow to finance payment of the tax or obtain lender consents to allow funds to be moved and used to pay the tax.

The Act also broadens application of the constructive ownership and attribution rules, resulting in certain foreign corporations being treated as CFCs for the first time. Effectively, shares in a foreign corporation owned by a foreign significant shareholder may now be deemed to be owned by a U.S. entity in which that foreign shareholder also owns a significant interest. While perhaps unintended, foreign subsidiaries of a foreign parent company may now be CFCs if the foreign parent also owns a U.S. subsidiary. The foreign subsidiary shares may be deemed owned by the U.S. subsidiary, causing the foreign subsidiary to be deemed more than 50% owned by a U.S. person and, therefore, to be considered a CFC.

SECTION 956

Section 956 provides for a deemed dividend from a CFC to its U.S. shareholders if, among other things, the foreign subsidiary provides certain credit support for U.S. borrowings. Historically, the section 956 deemed dividend rules have limited guarantees by, and pledges of the stock and assets of, CFCs owned by a U.S. borrower. Given the regime described above, which no longer permits deferral for non-subpart F income of CFCs owned by a U.S. taxpayer, it is not evident what policy purpose the section 956 "deemed dividend" rules would continue to serve. Indeed, the House and Senate Bills would have repealed the section 956 rules in the case of U.S. shareholders who were corporations. Somewhat surprisingly, however, the section 956 deemed dividend regime ultimately was not repealed by the Act.

Retaining section 956 may now have the effect of converting what would have been earnings that might have been repatriated tax-free to a corporate shareholder under the new participation exemption into fully taxable income. That said, given the Act provisions taxing on a current basis a broader amount of a CFC's income, the portion of the foreign earnings that would have otherwise been exempt from U.S. tax were it not

for section 956 may be a relatively small component of a CFC's earnings. The exempt portion is tied to an assumed normal (10%) rate of return on depreciable fixed assets and may therefore be limited in companies whose assets are primarily intangibles. Moreover, even if fully taxed, in the case of a corporate shareholder the applicable rate is now only 21%. However, for 10% U.S. shareholders of a CFC that are individuals rather than corporations, a deemed dividend inclusion would suffer up to a 37% federal income tax rate.

SOME PRELIMINARY CONCLUSIONS

The combination of a much lower corporate tax rate and the new limitations on the deductibility of interest may make debt financing a less tax advantageous form of financing for some U.S. taxpayers, although debt financing still has certain tax advantages over equity financing. Multi-national groups may rethink their financing structures now that the incentive to borrow in the United States rather than abroad due to much higher U.S. corporate rates has been reduced or eliminated.

As has been reported in the press, the change to corporate rates, the taxable deemed repatriation of deferred offshore earnings, the limitations on post-2017 NOLs and other provisions may result in significant financial accounting charges that will be reflected on financial balance sheets and earnings statements.

Tax planning under the new international tax regime may lead multi-national groups to substantially reorganize their corporate group structures in ways that may not be permitted under current debt covenants, requiring renegotiation of terms. The much broader attribution rules may also result in many foreign subsidiaries that were not CFCs prior to the Act becoming CFCs, which will give rise to additional tax considerations for borrowers, including sensitivities about triggering deemed dividends under section 956. In other cases, depending on how the debt covenants are drafted, subsidiaries that formerly were not excluded from the collateral and guarantee package as they did not pose section 956 concerns may have become "Excluded Subsidiaries" or "Excluded Assets" under an applicable credit agreement.

Section 956 and "deemed dividend" concerns remain relevant, although the economic stakes and calculus involved are now very different and it will take time for the market to settle on new standards. There may be differences between, on the one hand, corporate multinational groups headed by a U.S. parent, whose inclusions would be taxed at the 21% corporate rate and, on the other, CFCs owned by funds, whose deemed dividend income flows through to non-corporate shareholders taxed at much higher rates.

The now significant disparity between individual and corporate rates may have other effects on loan market practices. This will complicate negotiation of, for example, tax

distribution exceptions to restricted payments for LLC or partnership borrowers. Often, tax distributions are permitted to allow partners of the borrower to pay taxes on income that flows through to them but at an assumed rate equal to the highest rate applicable to individual taxpayers resident in a high tax state. The disallowance of state and local deductions may, depending on how the provisions were drafted in legacy documents, permit higher distributions than anticipated. Conversely, in other legacy documents where the distribution was capped at the tax a stand-alone corporation would have paid, distributions may be substantially lower than anticipated by the parties and may leave individual investors in a partnership borrower with considerable tax exposure. In new deals, we expect more intensive negotiation of these provisions until market practice adjusts.

TAX GROUP

Please feel free to discuss any aspects of this Client Alert with your regular Milbank contacts or any of the members of our Tax Group.

This Client Alert is a source of general information for clients and friends of Milbank, Tweed, Hadley & McCloy LLP. Its content should not be construed as legal advice, and readers should not act upon the information in this Client Alert without consulting counsel.

©2018 Milbank, Tweed, Hadley & McCloy LLP

All rights reserved.

NEW YORK
28 Liberty Street, New York, NY 10005

Name	Email	Phone
Drew Batkin	dbatkin@milbank.com	+1-212-530-5122
Max A. Goodman	mgoodma1@milbank.com	+1-212-530-5536
Russell J. Kestenbaum	rkestenbaum@milbank.com	+1-212-530-5790
Eschi Rahhimi-Laridjani	erahimi-laridjani@milbank.com	+1-212-530-5141
Mike Shah	mdshah@milbank.com	+1-212-530-5501
Andrew R. Walker	awalker@milbank.com	+1-212-530-5624
Kelly P. Bartley	kbartley@milbank.com	+1-212-530-5012
James M. Beebe	jbeebe@milbank.com	+1-212-530-5206
Nicholas D. DeLuca	ndeluca@milbank.com	+1-212-530-5391
Michael F. Goon	mgoon@milbank.com	+1-212-530-5063
David G. Hanno	dhanno@milbank.com	+1-212-530-5525
Archan J. Hazra	ahazra@milbank.com	+1-212-530-5531
Jules Mugema	jmugema@milbank.com	+1-212-530-5211
Christina M. Skaliks	cskaliks@milbank.com	+1-212-530-5282