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US Tax Reform: Opportunities and Challenges for Leveraged Finance

The new tax rules are expected to have an immediate impact on leveraged companies and leveraged finance transactions.

On December 22, 2017, President Trump signed into law the "Tax Cuts and Jobs Act" (the Act).[1] This *Client Alert* summarizes the following key changes that may affect leveraged companies as well as the structuring of leveraged finance transactions:

- Reduced tax rates for corporations and certain businesses in pass-through entities
- Limits on the deductibility of interest expense
- Substantial revisions to the US tax regime applicable to multinational groups, including a partial territorial system, coupled with a minimum tax on foreign earnings, a transition tax on accumulated foreign earnings, and expanded application of the "controlled foreign corporation" (CFC) rules
- Unexpected last-minute retention of the "deemed dividend" rules governing credit support from CFCs

Latham & Watkins has published numerous additional materials analyzing provisions of the Act more broadly, and will continue to provide resources and insights through the Latham & Watkins US Tax Reform Resource Center.

I. Reduction in Tax Rates and Limitations on Interest Deduction

The Act reduces tax rates across the board on many types of income earned by various businesses. Before the Act, the top US corporate income tax rate was 35%, which was among the highest in the world, and the top US individual income tax rate was 39.6%. Business income earned through partnerships and S corporations (pass-through entities) was taxable at the rate applicable to their owners. The Act reduces the top corporate income tax rate permanently from 35% to 21%, putting it below the OECD average. The Act also temporarily reduces the top individual tax rate on ordinary income from 39.6% to 37% and the effective tax rate on pass-through "qualified business income" (by providing a deduction for up to 20% of such income), both effective only for 2018 through 2025.

The Act caps the deduction of net business interest expense at 30% of adjusted taxable income (ATI) (the 30% Cap). The ATI is calculated on a consolidated group basis or partnership basis and approximates EBITDA (for years before 2022) and EBIT (for years after 2022). The disallowed net business interest expense can be carried forward indefinitely. For a partnership issuer/borrower (including a limited liability company treated as a partnership for tax purposes), after applying the 30% Cap at the entity level, any business interest expense in excess of the cap is allocated to partners, and partners can carry over such excess business interest expense as if it was paid or accrued by the partner and use it in succeeding years, subject to special limitations. There is no grandfathering provided for existing debt of

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any taxpayer, nor is there any transition period. The 30% Cap replaces the prior law's "earnings stripping" rule that deferred interest deductibility on certain related-party debt.

Observations:

- Because each of the decreased tax rates and the 30% Cap become effective in 2018, with no transition periods or grandfathering for existing debt, issuers/borrowers may want to reevaluate their existing capital structure immediately.

- Leveraged companies that were not previously paying significant US income tax may face a substantial increase in their taxable income due to the 30% Cap. Due to the reduction in US tax rates, the impact of such increase on the overall US tax burden of those companies would depend on their specific situation.

- Decreased US tax rates, combined with the new limitations on business interest expense deductibility, may incentivize multinational groups with significant leverage to move debt to their foreign affiliates, particularly if such affiliates are subject to foreign tax rates higher than the new US tax rates.

- At the same time, the partial territorial regime and the one-time transition tax on accumulated earnings (both of which are described below) will allow US-parented groups to bring more cash back to the US without adverse US tax consequences. The cash can then be used to service or repay debt of the US parent. In particular, US-parented groups may seek to add leverage to their foreign subsidiaries that have substantial earnings invested in non-liquid assets, and repatriate all or a portion of the net proceeds from such debt.

- Decreased US tax rates and the 30% Cap will provide an additional incentive for certain US issuers/borrowers to favor debt paying lower rates of interest, even if that results in additional secured debt, floating rate debt, or debt with shorter maturities. Similarly, issuances of convertible debt with lower interest rates or preferred stock may become more desirable.

- US issuers/borrowers that could be impacted by the 30% Cap may also choose alternative financing structures that generate deductible expenses and are not treated as debt for US federal income tax purposes (*e.g.*, a sale-leaseback).

II. Foreign Subsidiary Credit Support for US Parent Debt (Section 956)

The Act introduces a partial "territorial" regime — subject to a one-time transition tax on accumulated foreign earnings — under which, subject to limited exceptions, income earned by foreign subsidiaries of US-parented multinational groups is generally exempt from the US federal income tax, including upon distribution. Prior to the Act, US parent companies of foreign subsidiaries were subject to US tax on such foreign subsidiaries' earnings on a worldwide basis, but the payment of such tax was deferred (subject to so-called Subpart F rules and other significant exceptions) until such earnings were distributed to the US parent. Upon distribution, dividends paid by a foreign subsidiary to a US corporate shareholder were taxed at 35% tax rate less any allowable foreign tax credits. These rules created a "lock-out effect," which resulted in US-parented multinationals keeping an estimated US$2-3 trillion of earnings of their foreign subsidiaries offshore in order to manage US taxes.

The Act provides a 100% dividends received deduction (DRD) for the foreign-source portion of dividends received from a foreign corporation to a US corporate shareholder that owns 10% or more of that corporation, subject to a one-year minimum holding period. With this change, the notion of deferred

offshore earnings, a fundamental part of the US international tax system for decades, is substantially altered. Earnings from such a foreign corporation will now be either fully exempt from US tax or taxed in the US when earned, under either the Subpart F rules or the new “global intangible low-taxed income” (GILTI) rules introduced by the Act. Notably, since the DRD for foreign dividends is only available for corporate shareholders, pass-through entities may continue to have incentives not to repatriate their foreign earnings (to the extent such earnings were not already subject to the transition tax, discussed below).

As part of the transition to a territorial tax regime, the Act imposes a one-time mandatory transition tax (the Transition Tax) on a US shareholder’s pro rata share of its foreign subsidiaries’ undistributed earnings and profits. The Act measures the earnings as of November 2, 2017, or December 31, 2017, whichever is higher. The Transition Tax is imposed at an effective rate of 15.5% to the extent of foreign cash and other liquid assets, and 8% on all residual earnings and profits. Even though the DRD is only available for corporate shareholders that own 10% or more of the foreign subsidiary, the Transition Tax generally applies to both corporate and non-corporate shareholders that own 10% or more of the foreign subsidiary (including those that own their interest through a partnership where the partnership has an ownership interest of 10% or more). Foreign tax credits will be partially available.

Now the good news: The Act permits a US shareholder to elect to pay the Transition Tax liability over a period of up to eight years. Additionally, the “lock-out effect” is no more: earnings subject to the Transition Tax can generally be repatriated without additional US tax, as such distributions would be treated as previously taxed income.

One surprise in the Act, however, is that unlike the initial House and Senate proposals, the Act does not repeal or amend Section 956.[2] Section 956 generally requires that a US shareholder include in income (after the Act, at a maximum 21% rate for a corporation and 37% for an individual) a “deemed dividend” from a CFC that provides collateral support to debt of a related US issuer/borrower (or makes certain investment in the United States). A CFC generally includes foreign subsidiaries of a US entity (and, as discussed below, its definition has been further expanded under the Act to include certain foreign sister corporations of a US entity). In the past, US financings have traditionally included provisions precluding CFCs from providing guarantees or pledging assets in favor of US borrowings and limiting the pledge of first-tier foreign subsidiary stock to less than 66 2/3% of the total combined voting power of all classes of voting stock in order to avoid such “deemed dividends” under Section 956. The retention of Section 956 under the new partial “territorial” regime means that going forward, “deemed dividends” are subject to the regular tax at the level of US shareholders while “actual dividends” are exempt if paid to 10% US corporate shareholders. The reasoning behind such rules is puzzling, and the exact interaction between the residual Section 956 and the DRD, GILTI, and the Transition Tax is unclear at this time.

Observations:

- Many existing leveraged loan agreements obligate borrowers to apply certain excess cash flow to prepay loans, but exclude cash from foreign subsidiaries to the extent repatriation would result in adverse tax consequences or violate local laws. Similarly, many high-yield bond indentures and leveraged loan agreements provide an “adverse tax consequences” exception to provisions that would otherwise require excess asset sale proceeds from foreign subsidiaries be repatriated to repay or repurchase debt. The DRD is largely expected to eliminate the US tax cost of repatriations. As a result, in the absence of withholding taxes or other restrictions imposed by the local jurisdictions, leveraged companies may now be obligated to repatriate amounts in order to make such payments.

- The enactment of DRD and the retention of Section 956 will result in disparate treatment between actual cash dividends and Section 956 deemed dividends resulting from credit support. In order to prevent Section 956 "deemed dividends," issuers/borrowers will likely continue to request customary foreign guarantee and collateral limitations. On the other hand, the combination of the decrease in US tax rates, the pool of "previously taxed income" created by the Transition Tax, the DRD, and the GILTI, may substantially reduce the overall burden of Section 956 inclusion for some leveraged companies. As a result, leveraged companies may be receptive to arrangements where they agree to repatriate cash periodically from their foreign subsidiaries, especially if, in the face of the 30% Cap, they want to enhance the credit support available to their debt and reduce their interest expense.

III. Impact on Tax Distribution Provisions

Prior to the Act, restricted payment covenants under high-yield bond indentures and leveraged loan agreements commonly allowed partnerships and other pass-through issuers/borrowers to make distributions to their equityholders so that such equityholders did not have to come out of pocket to cover their pass-through income tax liability. Permitted tax distributions were in substance viewed as equivalent to entity-level taxes that the issuer/borrower would have paid if the issuer/borrower were taxable as a corporation. While these provisions vary from deal to deal, they often permit the distribution of an amount determined based on the application of a fixed rate, or the highest combined federal, state, and local tax rate in effect applicable to an individual or a corporation (or, in certain cases, the higher of the two rates), to the taxable income of the issuer/borrower. The various changes under the Act discussed above, however, could cause debtholders to prefer a lower-tax corporate structure, add layers of complexity to calculating permitted tax distributions, and/or permit some distributions under existing agreements well in excess of actual tax payment obligations.

As discussed above, prior to the Act, the highest US corporate income tax rate was 35% and the highest US individual income tax rate was 39.6%; as a result, the difference between the corporate rate and the individual rate was not material, and lenders and bondholders were largely agnostic as to whether the issuer/borrower was treated as a corporation paying taxes at the entity level or as a pass-through entity making tax distributions. However, under the Act, the difference between the two rates has increased significantly — now the highest US corporate income tax rate is 21% whereas the highest US individual income tax rate is 37%. Furthermore, the Act also greatly limits the deductibility of state and local income taxes by individuals, whereas state and local income taxes remain fully deductible for corporations. As a result, the use of the highest combined maximum federal, state, and local individual tax rate, rather than the corporate tax rate, in determining the amount of permitted tax distributions could almost double the amount of cash permitted for distribution. One potential mitigant to that difference is that to the extent the pass-through issuer/borrower generates "qualified business income," its owners may be entitled to a deduction of up to 20% of such income.

In addition to the foregoing, issuers/borrowers may now be required to account for a significant amount of Transition Tax (discussed above). The tax distribution provisions under existing indentures and leveraged loan agreements do not address the Transition Tax specifically, and may be interpreted to allow tax distributions for the Transition Tax as a lump sum amount calculated with no offsets, even though the Transition Tax can be paid over eight years at the US shareholder's election, at an effectively reduced rate, and may also benefit from foreign tax credits. This Transition Tax issue would also be relevant for a corporate subsidiary issuer/borrower that is a member of a consolidated return group allowed to make permitted tax distributions to a non-guarantor corporate parent. As a result, there may be a significant disconnect between the amount and timing of the tax liability and the permitted tax distribution.

Observations:

- Tax distribution provisions under existing bond indentures and leveraged loan agreements of pass-through entities, depending on the tax status of their equityholders and the availability of the 20% pass-through deduction, could permit cash distributions that would substantially exceed the actual amount of taxes that will be owed under the Act. As a result, lenders and bond purchasers may want to reevaluate such tax distribution provisions.

- If pass-through entities require tax distributions in an amount to be calculated at a tax rate significantly higher than the tax rate applicable to corporations, lenders and bondholders may offer better financing terms to companies taxed as a corporation.

- The Transition Tax imposed on accumulated foreign earnings may permit a pass-through entity (and a corporate subsidiary issuer/borrower that is a member of a consolidated return group with a non-guarantor corporate parent) to make an immediate significant one-time cash distribution computed under the rates applicable to ordinary income, even though the net Transition Tax amount may be much lower and the actual tax payments might be spread out over eight years.

- In preparing cash-flow projections and drafting tax distribution provisions, issuers/borrowers and lenders should account for the potential leakage resulting from the interplay between the Transition Tax and other changes in the international tax rules, and the provisions of existing indentures and loan agreements.

IV. Foreign-Parented Groups

The Act changes the CFC rules that may impact the credit support provided for US subsidiary borrowings in foreign-parented groups.[3] Specifically, the Act broadens the stock attribution rules for determining CFC status and expands certain related definitions. As a result, in addition to the Transition Tax discussed above, US subsidiary issuers/borrowers with foreign parents and sister foreign companies and their US shareholders may suffer an immediate adverse US tax impact under existing financing structures, and may be more restricted in structuring future financings.

As discussed above, the Act retained Section 956, which requires a 10% US shareholder to include in its income a CFC's earnings when the CFC provides credit support for the obligations of a US entity. Under the revised attribution rules (effective retroactively, beginning with the 2017 tax year), the ownership by a foreign parent of a foreign subsidiary's stock can now be attributed "downward" to a US entity that is also owned by such foreign parent. As a result, for a foreign-parented group, in addition to any foreign subsidiaries of a US subsidiary, the foreign sister companies of a US subsidiary will now all be treated as CFCs.[4] In addition, the definition of a 10% US shareholder is broadened under the Act (but effective only prospectively, beginning 2018) to include a US person who owns (directly, indirectly, or by attribution) at least 10% of the vote or value of the CFC (as compared to the current definition, which only looks to ownership of voting power). If sister subsidiary CFCs provide credit support for obligations of a US subsidiary of the same parent, any 10% US shareholder (by vote or value) of the foreign-parented group as well as the US affiliate in the event such affiliate has any cross-ownership in such CFCs, may be required to include into income such CFCs' earnings as "deemed dividends" under Section 956 (and any such deemed dividends would not be eligible for the new DRD). Moreover, as discussed above, the interplay between the Transition Tax and such deemed dividends is not entirely clear. Consequently, a foreign-parented group with a 10% US shareholder (or cross-ownership by a US affiliate in a foreign

affiliate) may need to consider Section 956 implications in structuring a multi-borrower credit facility that includes a US borrower.

Observations:

- US subsidiary issuers/borrowers in foreign-parented groups, and their lenders, may need to immediately revisit the guarantee and collateral package provided in their financings, depending on whether the foreign-parented group has 10% US shareholders.
- Going forward, a foreign-parented group that desires to borrow directly or issue notes at a US subsidiary level with foreign parent and sister guarantees or collateral should analyze whether the foreign-parented group has 10% US shareholders (by vote or value). If there is a 10% US shareholder, the group may be unable to include a US subsidiary in a multi-borrower facility.
- On the other hand, for a foreign-parented group owned by the public or foreign private equity funds, debt of a US subsidiary issuer/borrower with foreign parent and sister guarantees or collateral can still avoid "deemed dividend" issues (even if foreign affiliates are considered CFCs), so long as there is no 10% US shareholder (by vote or value) of the foreign-parented group or cross ownership by a US affiliate in the group in another foreign affiliate.

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Endnotes

[1] Shortly before final Congressional approval of the Act, the Senate parliamentarian ruled that the previously attached short title, the "Tax Cuts and Jobs Act," violated procedural rules governing the Senate's consideration of the legislation. Accordingly, the Act no longer bears a short title, although commentators likely will continue to refer to it as the Tax Cuts and Jobs Act.

[2] Section references are to the Internal Revenue Code of 1986, as amended.

[3] The Act also imposes a new base erosion minimum tax on US corporations with more than US$500 million in annual gross receipts on a group basis if deductible expenses paid or accrued to their foreign affiliates make up at least 3% of such corporation's total tax deductions for the year. For the purposes of this tax, deductible expenses include payments of interest to foreign affiliates. In certain cases, this new tax may incentivize multinational groups with highly leveraged US affiliates to capitalize those affiliates more frequently with direct borrowings as opposed to intercompany debt.

[4] The foreign parent itself will not be treated as a CFC (even though foreign sister companies would be treated as CFCs), solely as a result of having a US subsidiary in the group.