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Expert Q&A on Tax Reform Updates and the Leveraged Loan Market

Since the enactment of the Tax Cuts and Jobs Act (Act) at the end of 2017, the US Treasury has provided additional guidance in the form of both proposed and finalized regulations. Practical Law asked *Jiyeon Lee-Lim* and *Elena Romanova* of *Latham & Watkins LLP* to weigh in on recent developments relevant to the leveraged loan market, how the loan market has reacted to these changes so far, and expectations for the future.

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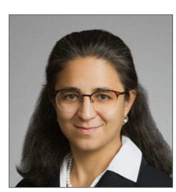

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The Act made several significant changes to the taxation of US businesses. What are the key changes that impact the leveraged loan market?

The main changes that impact the leveraged loan market include:

- Reduced US federal income tax rates for corporations and certain pass-through entities.
- Limits on the deductibility of interest expense.
- Changes in the net operating loss (NOL) rules and the enactment of the immediate expensing of investment in certain property used in US businesses (including previously used property).
- Significant international tax reform implementing a partial territorial regime, coupled with several new anti-base erosion provisions.
- Retention of the so-called deemed dividend rule of Internal Revenue Code (Code) Section 956, although with significantly limited impact due to the recently finalized US Treasury Regulations (Section 956 Regulations).

The federal corporate income tax rate has been permanently reduced to 21% from 35%. Subject to certain limitations, the federal top effective income tax rate for "qualified business income" of certain businesses conducted in a pass-through form (including sole proprietorships, partnerships, limited liability companies (LLCs) treated as partnerships for US tax purposes, and S-corporations) has been temporarily reduced to 29.6% from 39.6% (by deduction of up to 20% of such income through 2025).

However, a borrower's ability to deduct net business interest expense (any excess of business interest expense over business interest income) is now limited to 30% of its adjusted taxable income (ATI). ATI generally is calculated as business taxable income (without business interest income or business interest expense, NOLs, or qualified business income deductions), plus depreciation and amortization (until 2022).

The US Treasury has already proposed regulations that would provide significant guidance on how to compute business interest expense limitations (Proposed Section 163(j) Regulations). Under the Proposed Section 163(j) Regulations, ATI of a US corporation would include foreign income earned through foreign branches or foreign disregarded entities, but would not include any Subpart F income or global intangible low-taxed income (GILTI) of foreign subsidiaries, even though it is taxed currently in the US, unless certain elections are made. ATI also does not include foreign dividends exempt from tax under the new dividends received deduction (DRD). Further, foreign subsidiaries would be required to limit the deductibility of net business interest expense allocable to Subpart F income and GILTI in generally the same way as if they were US corporations, which would ultimately increase the amount of current taxable income for US parent companies.

The interest expense limitation applies to any expense that is treated as a business interest expense for US tax purposes (for example, original issue discount (OID), fees that are treated as OID, and OID on integrated debt). Under the Proposed Section 163(j) Regulations, however, the term "interest" would be further expanded to include certain items that previously were not viewed as interest, such as debt issuance costs, commitment fees, guaranteed payments and substitute interest payments, as well as payments on interest rate or foreign currency swaps hedging debt that adjust the cost of borrowing.

Any interest expense directly incurred (and any interest income directly earned) by a C-corporation is treated as business interest. Under the Proposed Section 163(j) Regulations, interest expense or income of a partnership allocated to a C-corporation partner is also generally treated as business interest. Any excess interest expense is carried over indefinitely and can be transferred in an acquisition, subject to limitations similar to those applicable to NOLs.

For a corporate borrower, the interest expense limitation applies at the consolidated group level. For a partnership borrower, the interest expense limitation for the year when business interest expense is incurred applies at the partnership level and is subject to complicated carryover rules at each partner level.

The availability of immediate expensing (including of used property acquired by the taxpayer) until 2023 may enable a borrower that makes significant investments to decrease its federal tax liability. NOLs that are generated after 2017 can be carried forward indefinitely, but can offset no more than 80% of the taxpayer's taxable income (pre-2018 NOLs are subject to the rules that were in effect prior to the Act). Due to the interest expense limitation and new NOL carryover rules, a corporation may potentially remain a cash taxpayer, even if it has large excess interest expense and NOL carryovers. These changes are likely to impact a borrower's after-tax cash flows and therefore its valuation and creditworthiness.

Projecting a borrower's cash flows now requires a significantly more sophisticated analysis. Understanding the borrower's group structure has become very important for this process. A corporate borrower now likely needs far less cash to cover its tax liabilities compared to an amount that a partnership borrower (or an LLC treated as a partnership or other pass-through entity) would need to distribute to its owners to cover their own tax liabilities. This is due to a much larger differential between the federal corporate income tax rate of 21% and the federal top individual income tax rate of 37% (or the pass-through rate of 29.6%, if that may be attained by the owners) and more favorable treatment of corporate shareholders under the new international rules, combined with the fact that individual taxpayers can no longer deduct state and local taxes above $10,000.

The tax impact of international operations has increased in complexity. There are now different types of income of foreign subsidiaries that may be subject to federal income tax at the US shareholder level without receipt of cash, while the receipt of foreign cash dividends by US corporations from certain foreign subsidiaries may be tax free (as a result of DRD permitted for such dividends). US non-corporate shareholders of foreign corporations are subject to more detrimental US tax rules with respect to the earnings of foreign corporations than US corporate shareholders, including by not being allowed a foreign DRD, despite the percentage of ownership.

The Section 956 Regulations facilitate foreign guarantee and collateral support by providing that a US corporate shareholder's Section 956 deemed dividend generally is treated as if it were an actual distribution from the foreign subsidiary providing the credit support.

The retention of Section 956 in the Code means that, as a general rule, a US borrower's ability to obtain credit support from a foreign affiliate may continue to be limited in some ways. It may now be more manageable, however, for US borrowers to obtain credit support from foreign subsidiaries despite Section 956. The Section 956 Regulations facilitate foreign guarantee and collateral support by providing that a US corporate shareholder's Section 956 deemed dividend generally is treated as if it were an actual distribution from the foreign subsidiary providing the credit support. Therefore, credit support generally will not give rise to US tax on the US corporate shareholder to the extent a cash distribution in the same amount would have been US tax free.

A US corporate partner in a US partnership (or an LLC treated as a partnership) will also generally qualify for this relief if it is a US corporate shareholder (owning at least 10% of the foreign subsidiary providing credit support directly, indirectly, or by attribution) with respect to the foreign subsidiary providing credit support. US non-corporate shareholders, however, continue to be subject to Section 956 deemed dividend rules, because they are not entitled to a foreign DRD. The Section 956 Regulations are effective for the tax years of foreign corporations beginning on or after July 22, 2019, but taxpayers are permitted to apply the Section 956 Regulations retrospectively, beginning January 1, 2018.

Additionally, a foreign subsidiary may provide credit support to its US affiliate to the extent of previously taxed income (PTI). As of the end of 2017, all previously unremitted earnings and profits of US-owned foreign subsidiaries were subjected to US tax pursuant to a one-time transition tax on accumulated foreign earnings (Transition Tax), potentially creating large pools of PTI. Future inclusions of GILTI may increase available PTI. Therefore, US-parented groups now have potentially more flexibility in providing foreign credit support for US borrowing.

Cash in foreign subsidiaries now may be more accessible. The Transition Tax has removed any lock-out effect with respect to the offshore earnings and profits of foreign corporations owned by US corporations, because repatriation no longer would be subject to incremental US tax. However, bringing cash into the US may still be impeded by local law, foreign currency restrictions, and foreign withholding taxes.

The Proposed Section 163(j) Regulations are expected to be finalized before the end of 2019. The US Treasury, however, may still make significant changes to the Proposed Section 163(j) Regulations based on taxpayers' comments.

How does the Act influence financing structures?

Although taxpayers are still waiting for the US Treasury to finalize guidance on certain aspects of the Act, with many key parts of regulatory guidance having been finalized, it is expected that financing structures will now be evolving.

Generally, multinationals may be expected to have more unrelated financing directly at the subsidiary level (both for US- and foreign-parented groups) and less parent-level borrowing followed by intercompany on-lending. Foreign credit support for US borrowing by US-parented groups has become more accessible due to the Section 956 Regulations, while credit support for US borrowing from foreign sister subsidiaries of foreign-parented groups may become more constrained if the foreign parent has significant US shareholders.

Multinational groups may become incentivized to borrow directly at the foreign subsidiary level or to push the existing debt down, even though the net interest expense deductibility may also be limited at the foreign subsidiary level for US federal income tax purposes. Borrowing directly at the foreign subsidiary level may be helpful in several ways. Direct borrowing by a foreign subsidiary can mitigate the potential for the greater interest expense limitation that may be triggered by placing all debt in the US, while certain types of foreign earned income would not be included in ATI.

If there is a desire to distribute cash from a foreign subsidiary with respect to which the US shareholder was taxed on pre-2018 earnings, but these earnings are invested in operating assets, borrowing by the foreign subsidiary can provide the necessary cash. Additionally, if US borrowing could benefit significantly from foreign credit support, but Section 956 would cause a deemed dividend inclusion for the US shareholder (for example, because the actual distribution from the foreign subsidiary would not qualify for the foreign DRD due to certain limitations), it may be more beneficial to borrow directly at the foreign subsidiary level, because foreign borrowing generally does not implicate Section 956.

There may be increased incentives to maximize the value of the potential interest expense deduction by locating leverage at foreign subsidiaries in countries with higher income tax rates than the US. Because the federal corporate income tax rate was reduced to 21%, more countries meet this criterion. Subject to any local thin cap rules, the interest expense incurred at the foreign subsidiary level may decrease the amount of foreign income tax incurred by the foreign subsidiary.

Managing foreign income taxes has also become more important. The Act created categories of foreign subsidiary earnings that would not be subject to federal corporate income tax or subject to a lower tax rate. Additionally, the new international tax rules limit the ability of a US shareholder to claim US foreign tax credits (FTCs) for foreign taxes on some categories of taxable foreign income.

As a result, foreign taxes paid by foreign subsidiaries on these categories of income would be of limited value for purposes of offsetting a US shareholder's US income tax liability. More generally, because of the lower federal corporate income tax rate, many more US-parented groups are expected to be in an excess FTC position and must focus more closely on their foreign taxes paid. Accordingly, direct borrowing by foreign subsidiaries, potentially with US parent guaranties, may become more common.

Because of the overall changes to the US international tax rules and the Section 956 Regulations, which align the treatment of foreign credit support and actual dividends, there are now more ways to structure credit support for US borrowing from foreign subsidiaries without significant tax issues. Additionally, cash sweeps and US borrowers' covenants to distribute foreign cash to repay a portion of the debt may become more common.

For foreign-parented groups, a US subsidiary borrowing intercompany from a foreign affiliate may present issues under the base erosion and anti-abuse tax (BEAT), which may apply if related party payments exceed certain thresholds. Therefore, intercompany borrowing is becoming less common where a US subsidiary can directly obtain unrelated credit. Some foreign-parented groups have started modifying their financing structures to create a direct borrowing at their US subsidiary, instead of a foreign parent or affiliate borrowing followed by an on-lending to a US subsidiary.

US subsidiary borrowers of a foreign-parented group and their lenders may also need to revisit financing structures with respect to foreign guaranties and the collateral package provided in their financings. Historically, foreign-parented groups with no significant US equity holders often had foreign sister subsidiaries provide collateral support for the debt of a US subsidiary, because these guaranties generally raised no deemed dividend issues under Section 956.

However, foreign subsidiaries that have US sister subsidiaries are now generally treated as controlled foreign corporations (CFCs) because, as part of other CFC-related changes, the Act changed the stock attribution rules to attribute the ownership of any foreign subsidiary stock "downward" from its foreign parent to the US subsidiary. However, a technical correction bill introduced in late 2018 includes a provision which, if enacted, would block downward attribution for this purpose. The Act also expanded the definition of a US shareholder subject to the CFC rules to include a US person owning (directly or indirectly) at least 10% of the CFC stock by vote or value (which previously was limited to vote only).

For a foreign-parented group, foreign sister subsidiary credit support of a US subsidiary's debt can still avoid deemed dividend issues, as long as there is no 10% US shareholder (by vote or value) or cross ownership by a US affiliate in another foreign affiliate. Foreign-parented groups that seek to borrow directly at a US subsidiary level with foreign sister subsidiary credit support should analyze whether this support would create any tax issues.

These factors incentivize multinationals to borrow directly from third-party lenders, both in the US and offshore, while maintaining uniformity in credit support and subordination among different tranches. Therefore, it is expected that financing structures that achieve pro rata loss sharing among various tranches, such as Debt Allocation Mechanisms (also known as Collateral Allocation Mechanisms), may become more popular.

How does the Act affect credit support from outside the US?

In the past, foreign subsidiaries were not typically expected to provide credit support to a US lender for a related US entity's borrowings in the form of guaranties, security over their assets, or a pledge of more than 65% of their equity. The impact of the Act on foreign credit support for US financings requires a nuanced analysis.

The Act introduces a partial territorial regime, under which certain income earned by foreign subsidiaries of US-parented multinational groups is generally exempt from federal income tax, including on distribution. The Act achieves this by way of a 100% DRD for the foreign-source portion of dividends received from a foreign corporation by a US corporate shareholder that owns 10% or more of that foreign corporation, subject to a one-year minimum holding period and certain other limitations. The Transition Tax is imposed on earnings as of November 2, 2017 or December 31, 2017, whichever is higher, at a rate of 15.5% (to the extent of foreign cash and other liquid assets) and 8% (on all residual earnings and profits). The Transition Tax also applies to non-corporate US shareholders, which are subject to higher effective rates.

The Act permits a US shareholder to elect to pay its Transition Tax liability over a period of up to eight years. Starting with 2018, earnings from a foreign subsidiary of a US corporation are now either fully exempt from US tax or currently taxed in the US under either the Subpart F rules or the GILTI rules introduced by the Act.

With this change, the notion of deferred offshore earnings no longer exists. Because 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 these earnings were not already subject to the Transition Tax and are not otherwise taxed currently as Subpart F income or GILTI).

The Section 956 Regulations provide that a US corporate shareholder's Section 956 deemed dividend amount is reduced by the amount of the dividend received deduction that the US corporate shareholder would have been allowed had it received from the CFC an actual distribution of any Section 956 deemed dividend amount.

The Act retains Section 956, the deemed dividend rule. 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), in the form of deemed dividends, an amount of earnings of a CFC when a CFC provides credit support to the debt of a related US borrower (or makes an investment in the US).

Foreign subsidiaries of a US entity generally are CFCs. US financings have traditionally included provisions precluding CFCs from providing guaranties or pledging assets in favor of US lenders and limiting the pledge of first-tier foreign subsidiary stock to 65% to avoid deemed dividends under Section 956. Without more guidance, the retention of Section 956 under the new partial territorial regime would have meant that, going forward, deemed dividends would be subject to regular tax at the level of US shareholders, while actual dividends would be exempt if paid to 10% US corporate shareholders.

To remedy this inconsistency, the US Treasury issued Section 956 Regulations that harmonize the taxation of actual dividends and the taxation of Section 956 deemed dividends for US corporate shareholders. The Section 956 Regulations generally treat "deemed dividends" under Section 956 as if they were actual dividends. Specifically, the Section 956 Regulations provide that a US corporate shareholder's Section 956 deemed dividend amount is reduced by the amount of the dividend received deduction that the US corporate shareholder would have been allowed had it received from the CFC an actual distribution of any Section 956 deemed dividend amount.

A US corporate partner in a US partnership (or an LLC treated as a partnership) also generally qualifies for this relief if it is a US corporate shareholder with respect to the foreign subsidiary providing credit support. Additionally, the combination of the Transition Tax and the partial territorial regime may substantially reduce the potential practical burden of Section 956 inclusion for some borrowers, even if they cannot benefit from the Section 956 Regulations.

As a result, borrowers may be receptive to providing foreign guaranties and foreign credit support for US borrowing, particularly when foreign subsidiaries have substantial PTI as a result of the Transition Tax, foreign subsidiaries plan to distribute all their future earnings annually, or, in some cases, when their earnings would be subject to US tax under the Subpart F or GILTI rules.

Search Guaranties: Tax Issues for more on the US tax issues counsel should consider when drafting guaranties.

Search Security: Tax Issues for more on the US tax issues that arise when a corporate borrower grants security to a lender in a secured financing transaction.

However, the complexity of the analysis that a borrower must undertake to evaluate the potential impact under the new rules may slow down changes in market practice.

Search Expert Q&A on Tax Reform Updates and the Leveraged Loan Market for the complete online version of this resource, which includes information on the impact of the Act on credit agreement restricted payment baskets dealing with projected expenses for pass-through borrowers.