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Legal Update
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The Impact of Tax Reform on Leveraged Lending Transactions

Introduction

On December 22, 2017, the US Internal Revenue Code ("IRC") underwent a major overhaul through the enactment of the bill informally known as the "Tax Cuts and Jobs Act" (the "Tax Act").[1]

Mayer Brown's Tax Transactions and Banking & Finance practices closely monitored the Tax Act throughout the legislative process and, in this Legal Update, provide a condensed overview of some of the provisions of the Tax Act applicable to leveraged lending transactions and their potential impacts on documentation and structuring.

This Legal Update will touch on the following broad topics:

- Section 956 Deemed Dividend Rules
- 30% Limitation on Interest Deductions
- Pass-Through Entities and Permitted Tax Distributions

For additional analysis of the Tax Act's main provisions, please see "The Good, the Bad and the Ugly – Fundamental Tax Reform Is Enacted Into Law," and for an overview of the Tax Act's impact on securitization, CLO and other structured finance transactions, please see "The Impact of Tax Reform on Securitization and Other Financing Transaction – What You Need to Know."

Section 956 Deemed Dividend Rules

Although many US-based companies derive a significant percentage of their earnings from foreign subsidiaries, US borrowers have rarely been able to use overseas assets or revenues as additional collateral or credit enhancement in finance transactions due to IRC Section 956. Very simply, Section 956, both prior to and under the new Tax Act, prevents US corporations from realizing benefits from overseas earnings "onshore" without first paying a tax on those earnings.

Prior to the implementation of the Tax Act, the revenues of a non-US subsidiary of a US parent entity (that were not subject to current taxation under applicable anti-deferral regimes, including the "subpart F regime") generally were not taxable unless and until the revenues were distributed to the US parent entity. Until recently, Section 956(d) and the regulations thereunder provided that any "US shareholder" owning at least 10% of the voting shares of an overseas subsidiary that constitutes a "CFC" (defined generally in IRC Section 957 as a foreign corporation majority-owned by US 10% shareholders), receives the functional equivalent of a dividend (a "deemed dividend") from its subsidiary when (a) that subsidiary provides a pledge of its assets or provides a guaranty or (b) two-thirds or more of the voting stock of such subsidiary is pledged, in either case, to secure the obligations of such subsidiary's US parent. In order to avoid the adverse tax impact of such a deemed dividend, credit facilities for US borrowers typically do not require guarantees from, or pledges of the assets or shares of, foreign subsidiaries of the borrower, other than a pledge of less than two-thirds of the voting

equity (and, often, all of the non-voting equity) of first-tier foreign subsidiaries of the US borrower.

The Tax Act effected multiple changes to the tax treatment of earnings and profits of foreign subsidiaries:

a) it mandated a one-time inclusion (as "subpart F income") of all of a CFC's undistributed earnings as of the higher of November 2 or December 31, 2017 – essentially a deemed repatriation of those monies into the United States; and

b) it created a 100% "participation" exemption or "dividends-received" deduction for dividends (to the extent based on foreign income) received by US corporate (and only corporate) shareholders from most foreign subsidiaries (excluding passive foreign investment companies).

Due to these changes, overseas revenue of the foreign subsidiary of a US parent will now either (a) not be subject to US income tax at all or (b) be taxed to the US shareholder when earned under either the subpart F rules or the new "GILTI" rules discussed below. In addition, 10% domestic corporate shareholders (who have owned their equity at least one year (which holding period can be satisfied post-distribution)) generally can receive actual distributions of accumulated and current earnings and profits from their non-US subsidiaries without being subject to US federal income tax.

Given that, after tax reform was adopted, an actual repatriation of foreign earnings can be achieved tax-free, it was widely expected that the Tax Act would repeal Section 956 (and, indeed, early drafts of the Tax Act would have repealed Section 956). However, despite the new tax-free repatriation regime described above, Section 956 has been retained and the potential for deemed dividend taxation persists for US borrowers.

Not only was Section 956 unexpectedly retained, but the Tax Act changes two relevant rules that (a) make application of Section 956 to borrowing arrangements more complicated than under prior law and (b) could render the standard Section 956 provisions in new and existing credit agreements inadequate to protect the borrowing group from a deemed dividend.

First, the Tax Act expands the definition of a "United States shareholder" for purposes of the CFC rules. Under prior law, a "United States shareholder" was a US person who owned (applying certain attribution rules) 10% or more of the combined voting power of all classes of voting stock of a foreign corporation. The Tax Act modifies this definition to also include US persons who own 10% or more of the total *value* of shares of all classes of stock of the foreign corporation (even if they do not own 10% of the voting power).

Second, the Tax Act adds "downward attribution" rules that can result in stock owned by a foreign person being attributed to a US person. For example, if a foreign company owns the majority of both a foreign and a US subsidiary, the parent's ownership of the foreign subsidiary could be attributed to its US subsidiary. This could result in the classification of the foreign subsidiary as a CFC even though it is not owned by a US 10% shareholder. Accordingly, a guaranty by the foreign subsidiary of debt of its sister US subsidiary could constitute a deemed dividend to a US shareholder (including a US person, which could be a partnership) that owns directly or indirectly 10% or more of the foreign parent, measured by voting power ***or*** value.

It should be noted that there is no "grandfathering" provision in the new tax statute, and, indeed, this change in the downward attribution rules is effective for the 2017 tax year. A transaction that would not have triggered a deemed dividend under prior law (such as the fact pattern described in the immediately preceding paragraph) may now be

subject to such adverse consequences unless the collateral package is modified to take into account the revisions contained in the Tax Act. Therefore, borrowers and lenders in new and existing credit facilities that may be affected by these changes should carefully review the provisions of their loan documentation that exclude or limit requirements relating to CFCs providing guarantees and collateral.

Notwithstanding the foregoing, there are some mitigants to the deemed dividend rules. Section 956 results in a deemed dividend only to the extent that the relevant CFC has previously untaxed earnings and profits. As discussed above, the Tax Act mandates a special one-time deemed repatriation of deferred earnings and profits for all CFCs. In addition, the Tax Act adds a new type of deemed income tax liability called "GILTI" (an acronym for "global intangible low-taxed income"). The GILTI tax regime requires a US shareholder of a CFC to include in income as a deemed dividend the "non-routine" income of a CFC (including income from the performance of services for, or sales of property to, non-US customers). The "non-routine" income of a CFC is generally the excess of the CFC's income over a 10% routine return calculated on the CFC's adjusted basis in tangible assets. This deemed dividend is effectively taxed at the lower rate of 10.5% for corporate US shareholders (increasing to 13.125% starting in 2026). Therefore, between Section 956 and GILTI (and the unchanged subpart F income rules), many CFCs are likely to have significant previously taxed earnings and profits, which when included pursuant to Section 956 as a deemed dividend, would not be subject to tax a second time. Finally, as noted above, there is now the ability to repatriate earnings without the imposition of US federal taxes to domestic corporate shareholders.

The curious result of these changes is that overseas earnings can now be transferred via dividend to a US parent tax free, but if the cash remains with the foreign subsidiary, and that foreign subsidiary provides a pledge or guaranty in support of its US parent's obligations, there may be a "deemed dividend" taxed at the regular corporate rate to the extent of the subsidiary's earnings that were not previously taxed.

TAKEAWAYS

Parties to credit facilities with multinational companies are well-advised on both the borrower and lender side to review the structure and modeling of their collateral packages in light of the provisions of the Tax Act (whether domestic parented or foreign parented). Both existing agreements and the boilerplate provisions in new agreements may need to be reviewed and possibly amended both to avoid adverse tax consequences as well as to take advantage of new features put in place by the Tax Act.

The availability of the participation exemption, when compared to the negative consequences of a pledge or guaranty from a foreign subsidiary, may encourage lenders to impose new requirements on borrowers, such as covenants requiring the repatriation of excess cash back to the United States from material foreign subsidiaries. Some commentators have questioned whether such a required repatriation to the United States could be construed as an indirect pledge of the CFC's assets (thereby triggering a deemed dividend). To mitigate the risk on this point, a potential mechanic could be to (a) permit the foreign subsidiary to make distributions to the US borrower and (b) require that the US borrower repay an amount equal to the excess cash earned at the CFC. While the implementation of such a requirement may initially be viewed by borrowers as restrictive, it may induce lenders to give more credit to a borrower's overseas operations in evaluating a credit and provide cheaper pricing in connection with a loan extended solely to a US parent that derives a significant portion of its EBITDA from overseas operations. Such a provision, of course, would need to be weighed against possible countervailing considerations such as withholding taxes or similar assessments

imposed by local jurisdictions on such distributions.

Likewise, many current credit agreements that contain excess cash flow or asset sale mandatory prepayments that apply to a borrower and its subsidiaries do not require the borrower to make such a payment if it would require repatriation of cash that would result in material adverse US tax consequences to the borrower. Given the reduced risk of adverse tax consequences from an actual repatriation following the implementation of the Tax Act, many borrowers that were previously able to avoid making such payments may no longer be able to do so. More immediately, many of these provisions require the making of such payments if such repatriation would no longer have adverse tax consequences. It is therefore likely that certain borrowers may be in payment default with respect to such mandatory prepayment provisions due to the failure to make such repatriating distributions upon implementation of the Tax Act.

30% Limitation on Interest Deductions

The Tax Act also introduced a new limitation on deductions for net "business interest"[2] expenses pursuant to Section 163(j) of the revised IRC for tax years beginning after December 31, 2017. Such limitation is generally applicable to borrowers such as partnerships and corporations but specifically excludes real estate mortgage investment conduits (REMICs),[3] businesses with gross receipts less than a $25 million threshold, businesses that operate in certain industries and floor plan financing interest.[4]

If applicable, Section 163(j) limits the amount of net interest expense a business may deduct to 30% of its adjusted taxable income ("ATI"). For purposes of this limitation, ATI is determined in a manner similar to EBITDA for tax years 2018 through 2021 and, starting in 2022, in a manner similar to EBIT. The amount of interest expense that is disallowed can be carried forward, treated as interest expense of the business in subsequent taxable years.

For purposes of determining the amount of ***net*** business interest expense under Section 163(j), a taxpayer's interest expense is netted against its interest income. Therefore, the effects of Section 163(j) will be mitigated (or entirely eliminated) for borrowers that generate significant business interest income.

TAKEAWAYS

Due to the limitation on the deductibility of business interest expense under Section 163(j), we expect that borrowers may reevaluate their capital and structures and debt/equity mix. It is likely that some borrowers will seek to reduce their overall interest expense by reducing unsecured, junior, mezzanine and/or other high-interest-rate debt and issuing additional secured debt or equity. Multinational borrowers also are more likely to incur a portion of debt through foreign affiliates (for US based multinationals, possibly with a US parent guarantee) that may be better positioned to take advantage of interest deductions under their local taxation regimes (and, as described above, such structures may be more likely due to the reduced risk of adverse US tax consequences from repatriation of cash to the United States).

Highly leveraged borrowers will feel the effects of the Section 163(j) limitation immediately, with those effects heightened beginning in the 2022 tax year since ATI will be computed based on EBIT (rather than EBITDA). Many practitioners believe that the effects of Section 163(j) on highly leveraged borrowers could adversely impact the capital markets and lending activity more generally and that, as a result, Congress will have no choice but to change the tax law to at least remove the scheduled 2022 change to the more stringent EBIT-based calculation. The market will watch this issue closely over the coming months and years to see whether Congress addresses the issue.

Pass-Through Entities and Permitted Tax Distributions

A major driver of the Tax Act was the reduction of the federal corporate income tax rate to 21%, which may lead some borrowers to reevaluate their "choice of entity" decisions. Currently, many US private company borrowers are set up as pass-through entities for tax purposes (S-corporations, limited liability companies, partnerships, etc.), but the reduction to the corporate income tax rate may make corporate tax treatment more desirable.[5]

Many existing credit agreements allow pass-through borrowers to make certain "permitted tax distributions." These provisions allow the owners of the borrower to receive dividends in an amount necessary for them to pay the owner's share of the taxes associated with the earnings from the borrower's business. Lenders generally permit these distributions because, in practice, they were similar in amount to what the borrower would be required to pay in income tax if it were taxed as a corporation. (Prior to the introduction of the Tax Act, the highest US corporate income tax rate was 35% and the highest US individual income tax rate was 39.6%.) However, tax distribution provisions are often drafted to permit a distribution based on an assumption that the owner is subject to the highest combined federal, state and local tax rate applicable to a corporation ***or*** an individual in the relevant jurisdiction. While in the past the difference between the top tax rate applicable to corporations versus the top marginal rate for individuals was not deemed significant (or at least not significant enough for lenders not to agree to such a formulation), under the new Tax Act the top corporate income tax rate is 21%, but the highest individual income tax rate was only reduced to 37%. So, depending on the tax status of the owner and absent revisions to reflect the changes in tax rates (and the potential application of other provisions, such as the "199A" "qualified business income" deduction and the limitation on deductibility of certain SALT taxes for individual owners), such a provision may allow the payment of dividends in an amount significantly higher than the actual tax liability they are intended to cover.

TAKEAWAYS

Depending on its particular situation, a borrower that elects to be taxed as a corporation could benefit from the Tax Act. Even in situations where a borrower does not elect to be treated as a corporation, lenders will need to carefully examine the provisions limiting the amount of such distributions and understand whether these provisions allow for distributions of greater amounts than they intend.

Conclusion

The impact of implementation of the Tax Act on leveraged financing transactions is not as great as it would have been if Section 956 had been repealed (as most practitioners anticipated). In addition, several aspects of the Tax Act have implications on the structuring of these transactions.

Ultimately, these changes may result in (a) an increased focus on the development of different borrower mechanics in credit agreements, including periodic mandatory repatriation of free cash flow back to the United States; (b) the parties balancing various considerations in determining which entity will be a borrower under a US credit facility, including whether to include a foreign subsidiary borrower and whether a parent entity should be a pass-through entity or a corporation; and (c) a review and potential modification of permitted tax distribution provisions.

Mayer Brown's team of experienced tax and lending lawyers is continuing to monitor ongoing developments with respect to the Tax Act and expects to provide additional updates as the legal landscape becomes clearer.

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Endnotes

[1] Pub. L. 115-97, 131 Stat. 2054 (2017).

[2] Business interest expense is interest paid or accrued on indebtedness properly allocable to a trade or business. IRC Section 163(i)(5)

[3] Section 163(j) only applies to interest expense and interest income allocable to a trade or business, and does not impact investment interest within the meaning of Section 163(d) of the IRC. Pursuant to 1.860C-2(b)(4), a REMIC is not treated as carrying on a trade or business for purposes of Section 162 of the IRC, and ordinary operating expenses are deductible under Section 212 of the IRC.

[4] Floor plan financing interest means interest paid or accrued on floor plan financing indebtedness. Floor plan financing indebtedness, in turn, means indebtedness (i) used to finance the acquisition of motor vehicles held for sale or lease and (ii) secured by the inventory so acquired. IRC Section 163(j)(9)

[5] We note, however, that if all of the shareholders/members of an existing pass-through entity borrower are taxed as corporations and the lowered corporate rate also applies to such shareholders/members, we would not expect a borrower to change its tax treatment.

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