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Impact of Tax Reform on Commercial Loan Documents: Adjustments to Financial and Other Covenants

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Impact of Tax Reform on Commercial Finance Documents

July 18, 2019

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Agenda

- The Tax Cuts and Jobs Act (“TCJA”).
- TCJA tax rate changes – impact on “tax distributions” provisions.
- Pledges and guarantees by foreign subsidiaries.
  - The pre-TCJA taxation of offshore earnings and Sec. 956.
  - Taxation of offshore earnings under the TCJA.
  - The May 2019 Sec. 956 regulations.
- The new 30% of EBITDA/EBIT limitation on interest deductions.

The Tax Cuts and Jobs Act

The Tax Cuts and Jobs Act

- December 22, 2017: President Trump signed the Tax Cuts and Jobs Act ("TCJA") into law, the most significant Internal Revenue Code overhaul in more than 30 years.
- 2018-2019: Treasury and the IRS issued proposed regulations (and other guidance) on many of the new provisions.
  - Clarifying open questions, closing perceived loopholes, etc.
- Treasury and the IRS are currently reviewing comments received on the proposed regulations and releasing final regulations.
- Certain of the new provisions have already shown an impact on the loan market, ranging from changes to borrowers' preferred capital structures to modifications in the documentation of financing transactions.

Tax Rate Changes – “Tax Distribution” provisions

TCJA Tax Rate Changes

- Individual top rate reduced to 37% (from 39.6%) - expires after Dec. 31, 2025.
- Corporate tax rate reduced to a flat 21% rate (from max 35% rate).
  - Corporate Alternative Minimum Tax eliminated.
  - Reduction in tax rates automatically reduced the value of tax assets (e.g., NOLs) and the amount of deferred tax liabilities impacting financial statements.
  - Free cash flow likely improved as a result of lower rate.
- "Qualified business income" earned by individuals through pass-through entities may qualify for a 20% deduction, resulting in an effective federal tax rate of 29.6% for top bracket individual.
- However, no change in withholding tax rates for amounts paid to foreign persons (still 30% or lower treaty rate).

Impact on Permitted Tax Distributions

- Many existing loan agreements provide exceptions from restricted payment covenants to allow pass-through borrowers to make "permitted tax distributions" to cover the owners' taxes on their respective share of the borrower's income.
  - Pre-TCJA, lenders generally viewed these distributions as a proxy for taxes the borrower would pay if it were a corporation.
- Under the TCJA, however, there is a significant rate differential between the corporate rate (21%) and the highest individual rate (37%) – potential for excessive tax distributions if the borrower has corporate partners.
- In addition, the TCJA introduced other rules relevant to the distinction between corporate vs. pass-through borrower:
  - "Qualified business income" earned by individuals taxed at a 29.6%.
  - State taxes fully deductible by corporations, but not by individuals.

Impact on Permitted Tax Distributions

- Market practice is still in flux as to how these multiple factors should be addressed in "tax distributions" provisions.

- Balance accuracy (prevent material cash shortfalls or cash leakage) with administrability (analysis of investor-specific attributes?).

Pledges and Guarantees by Foreign Subsidiaries

Pre-TCJA taxation of offshore earnings and Sec. 956

- Pre-TCJA, the earnings of a "controlled foreign corporation" (a "CFC") were generally not taxable unless and until distributed to its US parent (other than "Subpart F" earnings, which were, and still are, taxed on a current basis).
- The Sec. 956 rules were originally intended to prevent taxpayers from realizing onshore the benefits of those offshore earnings, without first distributing the earnings into the US and paying the corresponding US tax. Thus, Sec. 956 would create a "deemed dividend" from a CFC when:
  - the CFC provides a pledge of its assets in support of an obligation of its US parent or US affiliate;
  - the CFC guarantees the debt of its US parent or US affiliate; or
  - 2/3 or more of the CFC's voting stock is pledged to secure the obligation of its US parent or US affiliate.

Pre-TCJA taxation of offshore earnings and Sec. 956

- Market practice:
  - To avoid these deemed dividends, credit facilities for US borrowers typically do not require guarantees from, or pledges of the assets or shares of, the foreign subsidiaries of the borrower, other than a pledge of 65% of the voting equity (and 100% of the non-voting equity) of <u>first-tier</u> foreign subsidiaries.
  - Other Sec. 956 considerations:
    - US Parent and CFC as joint and several co-borrowers
    - Pledge of intercompany notes
    - Pledge of stock of "CFC HoldCos"
    - Pledge of stock of disregarded entities
- The potential for multiple deemed dividend inclusions in excess of the guaranteed loan amount.

Post-TCJA taxation of offshore earnings

- The TCJA dramatically changed the US taxation of earnings of foreign subsidiaries:
  - One-time inclusion of all CFCs' undistributed earnings as of the higher of Nov. 2 or Dec. 31, 2017 (the "deemed repatriation" or "toll charge").
  - Non-Subpart F earnings now subject to US tax on a current basis under the new tax on "global-low taxed intangible income" ("GILTI").
  - Dividends received by US *corporate* shareholders from foreign subsidiaries are generally exempt from US tax (the "participation exemption").
- Because US corporate shareholders can now generally receive dividends from their foreign subsidiaries free from US tax, it was expected the TCJA would repeal Sec. 956 for US corporations. However, the final version of the TCJA did not repeal Sec. 956.
  - Asymmetry between "real" and "deemed" dividends.

Post-TCJA taxation of offshore earnings

- In practice, the TCJA rules mitigated the impact of Sec. 956 rules for various reasons including:
  - significant amounts of "previously taxed income" (by reason of the "toll charge" and GILTI),
  - US corporate shareholders allowed to receive distributions of otherwise "untaxed earnings" free from US tax, and
  - in case of a Sec. 956 "deemed dividend," foreign tax credits would now more often absorb any resulting US tax
- Post-TCJA market reaction:
  - Practice on credit support generally remained the same, with occasional discussions around:
    - Mandatory prepayment provisions
    - Covenants requiring repatriation of excess foreign cash

May 2019 Sec. 956 Final Regulations

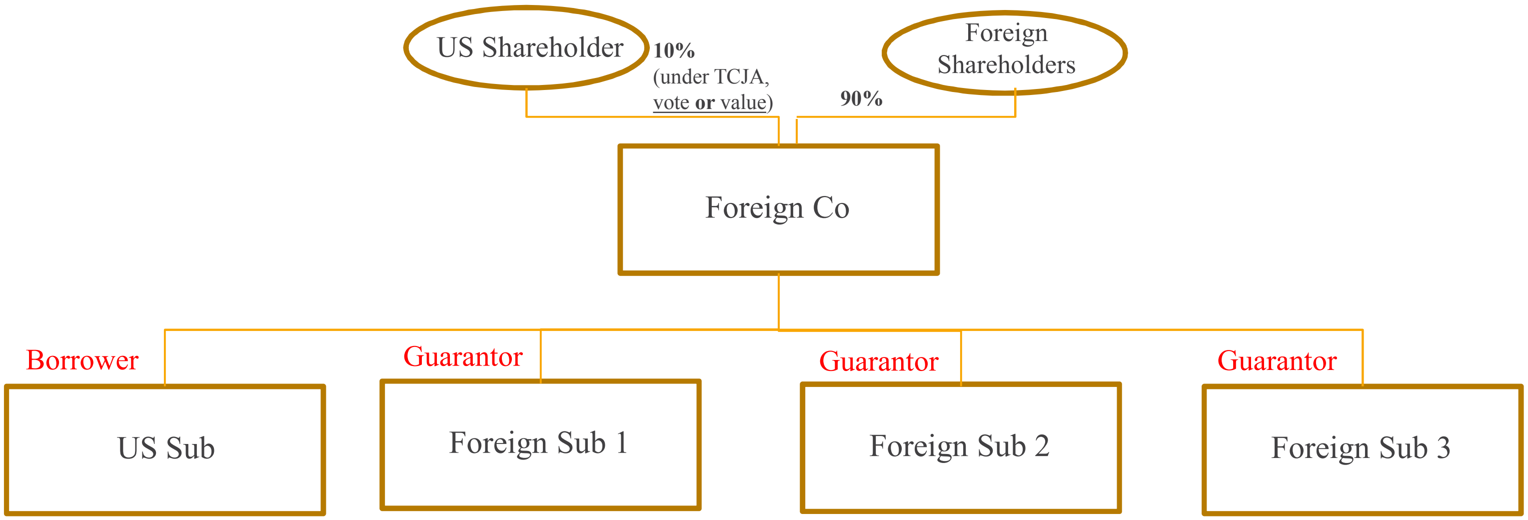
- October 2018: IRS issued proposed regulations providing that credit support from a CFC would generally not result in a deemed dividend if the US borrower would be allowed to obtain a tax-free dividend from the CFC under the "participation exemption" rules.
- May 2019: IRS finalized the proposed regulations, with certain technical modifications.
- The regulations are applicable to taxable years of CFCs beginning on or after July 22, 2019, but taxpayers may apply the final regulations to tax years beginning after December 31, 2017, if all US-related parties apply them consistently to all their CFCs.

May 2019 Sec. 956 Final Regulations

- Expected impact on market practice?
- Non-tax costs and difficulties in obtaining foreign subsidiary guarantees/pledges.
- Payment of guarantee fees to CFCs – tax considerations.

- Scenarios where Section 956 still has teeth:
  - Non-corporate US borrowers (but relief available to 10% US corporate partners).
  - CFC with certain US source earnings.
  - CFCs with hybrid instruments (e.g., Lux PECs).
  - CFC that does not satisfy the "holding period" requirement.

Sec. 956 and "downward attribution"



- Prior to the TCJA, Foreign Subs 1, 2 and 3 were not CFCs and, thus, could provide a guarantee/pledge to support an obligation of US Sub with no Section 956 implications at all.
- The TCJA added "downward attribution" rules so that Foreign Subs 1, 2 and 3 are considered CFCs. As a result, US Shareholder (an individual) could have deemed dividend income.
- This change is effective for the 2017 tax year.
- **Need to review existing loan documentation.**

30% EBITDA/EBIT Limitation on Interest Deductibility

30% EBITDA/EBIT Limitation on Interest Deductibility

- Prior to the TCJA, the limitation on interest expense deductibility mainly applied to interest with respect to (1) debt with related foreign lenders or (2) third-party debt guaranteed by foreign affiliates.
- The TCJA imposed a new limit on the deductibility of a company's "net interest expense" (from intercompany and third-party loans, cross-border and domestic).
- Disallowance of deduction for net interest expense in excess of 30% of "adjusted taxable income" ("ATI"):
  - ATI determined in a manner *similar* to EBITDA for 2018-2021, and
  - ATI determined in a manner *similar* to EBIT starting 2022.
    - No grandfathering.
- Disallowed interest deductions can be carried forward indefinitely.
- Exempt businesses (businesses with gross receipts of less than $25M; certain regulated public utilities; businesses providing for floor plan financing; certain real property businesses can elect out of the provision)

30% EBITDA/EBIT Limitation on Interest Deductibility

- What is "interest" for purposes of this rule?
  - ***General definition***: (i) Amount paid or accrued as compensation for the use or forbearance of money under an instrument characterized as debt for tax purposes, and (ii) amounts otherwise characterized as interest in the Internal Revenue Code. For example: OID, repurchase premium, payments under repos treated as debt for tax purposes, market discount, certain swaps with significant non-periodic payments
  - ***Other amounts treated as interest specifically for purposes of this rule***:
    - Commitment fees (to the extent of the drawn portion)
    - Substitute interest payments
    - Factoring income
  - ***Broad anti-avoidance rule***: Any deductible *expense* or *loss* incurred in a transaction or series of transactions in which the taxpayer secures the use of funds for a period of time if such expense or loss is predominantly incurred in consideration of the *time value of money*

30% EBITDA/EBIT Limitation on Interest Deductibility – Some Open Questions

- Is factoring expense considered "interest expense" for purposes of the limitation?
  - Factoring expense in *non-recourse* factoring is generally not treated as "interest" for other tax purposes.
    - However, *recourse* financing secured by trade receivables does result in interest expense for tax purposes.
  - The regulations explicitly treat factoring *income* as interest *income*, but are silent about the factoring expense – caught by the anti-avoidance rule?
  - If factoring expense is <u>not</u> interest expense, it will not be subject to the 30% limitation, but would reduce the ATI of the Seller of AR for purposes of the limitation on its other (unrelated) interest expense.
- Depreciation that is required to be capitalized to inventory is <u>not</u> added back to arrive to ATI, even when ATI approximates EBITDA (i.e., pre-2022).
  - This could create concern for many manufacturing companies.

30% EBITDA/EBIT Limitation on Interest Deductibility – Impact on borrower's decisions

- Borrowers may reevaluate their capital structure as a result of the new limitation:
  - Reduce overall interest expense by reducing unsecured, junior, mezzanine and/or other high-interest rate debt and issuing additional secured debt or equity.
  - Alternative financing arrangements may become more attractive (e.g., offshore financing, preferred equity, sale-leaseback).
- Particularly in 2022 and later years, there may be little capacity for interest deductions due to the change from EBITDA to EBIT. Important consideration when modeling borrower's cash flow.
- The limitation may raise the cost of financings for highly-leveraged companies, including capital intensive companies, recently acquired companies and companies in a growth mode funded by debt.
- Combined with the reduced US corporate tax rate of 21%, there may be less incentive to allocate significant debt to the US in a multinational structure – borrowing at foreign subsidiary with US parent guarantee.

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