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New Tax Law (H.R. 1): Key Highlights Related to Interest Bearing Debt

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On Friday December 22, 2017, the President signed into law H.R.1, commonly referred to as the Tax Cuts and Jobs Act (TCJA). This is the most sweeping change to the US federal income tax laws in over three decades, and it will affect every US taxpayer, including participants in the capital markets. The purpose of this blog post is to focus on some of the provisions of the TCJA that will impact interest bearing debt, including leveraged loans and high-yield bond offerings. For background and a more detailed discussion of the TCJA provisions generally, please see, House of Representatives and Senate Conferees Reach Agreement on the Tax Cuts and Jobs Act (H.R. 1).

Changes to Deductibility of Interest Expense

The most important change in the TCJA relating to interest is the reform of the so-called "earnings stripping" rules, limiting interest deductibility for US federal income tax purposes. The TCJA establishes a limit on the deductibility of "net business interest expense" equal to 30% of an amount that is similar to earnings before interest, taxes, depreciation, and amortization (EBITDA) for taxable years 2018 through 2021, and similar to earnings before interest and taxes ("EBIT") for taxable years 2022 and thereafter. In both cases, the TCJA permits the indefinite carryforward of any disallowed interest expense. The TCJA does not provide any grandfather provision for outstanding debt; the interest deduction limitation applies to all interest that is paid or accrued on and after January 1, 2018. US consolidated groups will apply the limitation on a group-wide basis, while partnerships are evaluated on a separate entity basis, with "excess" adjusted taxable income allowed to flow up to partners in certain circumstances.

This change, which is similar to "thin capitalization" rules adopted in other countries, effectively places a cap on the amount of debt in a capital structure of a US corporate group, or allocated to US members of a multinational group.

We would expect the interest expense limitation to increase the after-tax cost of debt financings at the margins, and to result in shifts to other forms of capital raising. In addition, there may be an increase in the use of equity co-invests in connection with the issuance of debt to enhance the debt's yield, particularly where returns on such equity could benefit from the reduced corporate tax rate with respect to any corporate debtor or the pass-through rate applicable to a flow-through issuer, described below. However, the attractiveness of debt for US taxpayers looking to raise money from non-US investors seems likely to persist, since the "portfolio interest" exception and generally lower treaty rates of withholding tax on interest remain in force. The change to an EBIT-based limitation in 2022 and thereafter likely will increase this pressure on the value of debt financing in a US corporate group. US issuers will need to carefully model their expected deductible expenses well into future years to determine the value of interest deductions for US tax purposes.

The effect of this change on debtors will be immediate and profound. As a practical matter, the expected "tax shield" resulting from borrowings in the US will be limited (although the reduction in the corporate tax rate from 35% to 21% and the benefit of immediate expensing of any qualified depreciable personal property may provide some cushion from any effective tax rate shock). Borrowers that are able to on-lend the proceeds of financings to non-US entities that are able to use the benefit of interest deductibility in their local jurisdiction may be inclined to do so. Because the limitation applies only to net interest expense, on-lending borrowed funds to affiliates generally should not cause an issue of nondeductibility with respect to interest on the intercompany loan. However, on-lending to foreign affiliates could implicate the base-erosion anti-abuse tax (BEAT), described below.

The reduced availability for interest deductions may result in a market shift towards increased use of preferred equity in partnership deals, particularly where the coupon accruing on the preferred equity represents a "guaranteed payment" and can create a synthetic deduction for the other equity owners. However, preferred equity tends to benefit US taxable investors, and would generally be less appealing to foreign holders who have sensitivities to US trade or business income and filing a US tax return.

Real estate trades or businesses are permitted to elect out of the interest-expense limitation under the TCJA, but if they do, they are denied immediate expensing. This trade-off may encourage some US groups that have both real estate and non-real estate businesses to restructure in a way to take advantage of both immediate expensing for the non-real estate businesses and unlimited real estate interest expense for the real estate businesses.

Reduction in Corporate and Pass-Through Business Tax Rates

The TCJA reduced the US corporate income tax rate to 21% from 35% for taxable years beginning on or after January 1, 2018. Additionally, most US owners of flow-through businesses (other than non-real estate "service businesses" such as consultancies, accounting firms and law firms) will receive a deduction under the TCJA that could effectively reduce the top marginal tax rate on income from such flow-through entities to 29.6% for taxable years beginning on or after January 1, 2018.[1] In addition, a high-income US owner of such a flow-through business that is not a "material participant" in the business may also be subject to a 3.8% surtax on amounts received since such amounts may be treated as net investment income.

Changes to Treatment of Offshore Earnings

Under the TCJA, pre-2018 earnings of foreign subsidiaries are subject to a one-time "deemed" repatriation tax on all of the pre-2018 earnings of foreign subsidiaries at 15.5% on cash and equivalents, and on 8% on all other assets.[2]

Thereafter, "passive" subpart F income of foreign subsidiaries will continue to be currently taxable, as was the case before TCJA. The "active income" of foreign subsidiaries will be subject to a 10.5% "global intangible low-taxed income," or GILTI, in excess of a deemed return of 10% on the foreign subsidiary's "qualified business asset investment." However, US corporations owning 10% or more of a non-US corporate subsidiary will be entitled to a 100% deduction of the dividends paid by those non-US subsidiaries in respect of earnings on and after January 1, 2018. This provision will allow the repatriation to US corporate shareholders of future offshore earnings without additional US corporate-level tax.

The section 956 rules that treat *loans* by foreign subsidiaries to US affiliates, and guarantees from, and pledges of stock in, foreign subsidiaries (along with restrictive covenants) as taxable repatriations are retained. However, the definition of which entities are "controlled foreign corporations" under section 956 has been expanded through the modification of certain attribution rules to allow downward attribution from foreign persons to US persons.

The availability of offshore cash to US corporate members of multinational groups may substantially change the liquidity profile of these groups, and may result in reassessments of both the overall capital structure (taking into account the changes in deductibility of interest expense) and also the situs of future capital raises.

Base erosion anti-abuse tax

The TCJA imposes a 10% "base erosion anti-abuse tax" (BEAT) on the difference between a US corporation's actual tax liability over the tax liability it would have had if payments to foreign affiliates were not deductible, property purchased from foreign affiliates was not depreciable, and payments to foreign parents of inverted companies were not deductible. This tax is 5% for tax years beginning after December 31, 2017 and before January 1, 2019. The minimum tax increases from 10% to 12.5% in tax years beginning after December 31, 2025.

Whereas the interest deduction limitation and the modified territoriality system of TCJA may have the effect of reducing third-party borrowings, the BEAT tax will tend to increase the third-party borrowings of US multinationals, as the attractiveness of intragroup borrowings is diminished.

[1] The top marginal tax rate on individuals was lowered by the TCJA to 37%.

[2] This transition tax is payable over an eight year period, intended to reduce the cash tax effect but also effectively reducing the present value of the transition tax.

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