Tax Reform Proposals of Interest to Financial Institutions

On November 2, 2017, Representative Brady — Chairman of the House Ways and Means Committee — released the proposed text of the long-awaited federal income tax reform bill H.R. 1, entitled the "Tax Cuts and Jobs Act." On November 9, 2017, the Senate Finance Committee released a "Description of the Chairman's Mark of the 'Tax Cuts and Jobs Act.'" Both the House and the Senate versions of the bill are quite lengthy and detailed, also differing in numerous significant respects.

This short summary highlights four provisions in the proposed legislation that will be of particular interest to financial institutions: the imposition of a general limitation on the deductibility of business interest; the imposition of a special limitation on the deductibility of interest in multinational affiliated groups; the imposition of a minimum or excise tax with respect to certain payments from US corporations to related non-US corporations; and the denial of deductions for certain amounts paid in "hybrid" transactions.

If enacted, each of these provisions could have a potentially far-reaching impact on clients of financial institutions as well as financial institutions themselves. For example, most businesses generally will have their interest deduction limited to 30 percent of the income of the business. In addition, multinational groups may have additional deduction limitations or special taxes applied.

General Limitation on the Deductibility of Business Interest

Both the House and the Senate versions of the bill include a general limitation on the deductibility of interest.

The House bill, if enacted, would modify Internal Revenue Code ("Code") Section 163(j) as follows:

> (j) LIMITATION ON BUSINESS INTEREST.—
>
> (1) IN GENERAL.—In the case of any taxpayer for any taxable year, the amount allowed as a deduction under this chapter for business interest shall not exceed the sum of—
>
> (A) the business interest income of such taxpayer for such taxable year, plus
>
> (B) 30 percent of the adjusted taxable income of such taxpayer for such taxable year.
>
> (C) the floor plan financing interest of such taxpayer for such taxable year.

For these purposes, the term "business interest" means any interest paid or accrued on indebtedness properly allocable to a trade or business. The term does not include investment interest within the meaning of Code Section 163(d). In the case of a corporation, it may not be clear how one distinguishes between investment interest and business interest, particularly where the interest is incurred by a partnership in which the corporation is a partner.

Under the House bill, "adjusted taxable income" is taxable income without regard to depreciation, amortization, depletion, interest deductions, and net operating loss. The Senate bill does not disregard "depreciation, amortization and depletion" in the definition of "adjusted taxable income," making adjustable taxable income lower and, thus the limitation more restrictive, than the House bill.

The interest limitation does not apply to interest deductions for "floor plan financing interest," which would generally exclude car dealers (and certain other dealers) from the limitation.

Under both versions of the bill, certain businesses have been excluded. For example (A) a real property trade or business or (B) the trade or business of the furnishing or sale of
(i) electrical energy, water, or sewage disposal services,
(ii) gas or steam through a local distribution system, or

(iii) transportation of gas or steam by pipeline would not be subject to the proposed limitations (with the caveat that the rates charged by the business described in clause (B) must also have been established or approved by a governmental authority or regulatory commission).

The proposed provision applies to corporations and partnerships. For partnerships, the limitation is first applied at the partnership level in calculating the non-separately stated income of the partnership. Then the limitation applies again at the partner level with the partner permitted to include in the partner's calculations additional non-partnership interest expense in an amount equal to the difference in (x) the potential partnership level deductible interest expense that could have been allocated to the partner under the proposed provision and (y) the amount of interest expense actually allocated to the partner. Thus, the partner may be permitted to deduct additional separate, non-partnership interest expense against the partner's separate, non-partnership income to the extent the partnership had unused capacity to deduct additional business interest. On the other hand, there is no rule that permits a partner that has capacity to deduct interest at the partner level to deduct its share of the partnership's disallowed interest expense.

Under the House bill, the excess interest expense can be carried forward five years. Under the Senate bill, the excess interest expense can be carried forward indefinitely. In some circumstances, the limitation will only create a timing issue. In other transactions, the limitation could create a permanent difference.

Limitation on the Deductibility of Interest in International Affiliated Groups

In addition to the general limitation on the deductibility of interest, both the House and Senate bill include a limitation on the deductibility of interest paid or accrued by a US corporation that is a member of an "international affiliated group" (or in the parlance of the Senate bill, a "worldwide affiliated group"). These limitations are designed to prevent US corporations that are members of a multinational affiliated group from being entitled to interest deductions from excessive and disproportionate borrowing in the United States, evidently as part of the administration's recently announced legislative replacement of controversial 2016 debt equity regulations issued under Code Section 385. The two bills take slightly different approaches, however.

The House Bill

The House bill, if enacted, would add a new subsection to Code Section 163(n)(1) as follows:

> IN GENERAL.—In the case of any U.S. corporation which is a member of any international financial reporting group, the deduction under this chapter for interest paid or accrued during the taxable year shall not exceed the sum of—
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> (A) the allowable percentage of 110 percent of the excess (if any) of —
>
> > (i) the amount of such interest so paid or accrued, over
> >
> > (ii) the amount described in subparagraph (B), plus
>
> (B) the amount of interest includible in gross income of such corporation for such taxable year.

For these purposes, the term "international financial reporting group" means with respect to any reporting year, any group of entities which (i) includes at least one non-US corporation engaged in a trade or business within the United States, or at least one US corporation and one non-US corporation, (ii) prepares consolidated financial statements with respect to such year, and (iii) reports in such statements average annual gross receipts (determined in the aggregate with respect to all entities which are part of such group) for the 3-year reporting-year period ending with such reporting year in excess of $100,000,000.

The term "allowable percentage" means, with respect to any US corporation for any taxable year, the ratio (expressed as a percentage and not greater than 100 percent) of (i) such corporation's allocable share of the international financial reporting group's reported net interest expense for the reporting year of such group which ends in or with such taxable year of such corporation, over (ii) such corporation's reported net interest expense for such reporting year of such group. For these purposes, "reported net interest expense" is the net interest expense on the group's financial statements.

A US corporation's allocable share is based upon the EBITDA of the corporation as compared to the EBITDA of the group.

Members of consolidated groups are treated as a single corporation for the purposes of calculating the limitation.

The Senate Bill

The Senate bill reduces the deduction for interest of any US corporation that is a member of a worldwide affiliated group by the product of the net interest expense of the US corporation multiplied by the debt-to-equity differential percentage of the worldwide affiliated group.

The debt-to-equity differential percentage means, with respect to any worldwide affiliated group, the excess US indebtedness of the group divided by the total indebtedness of the US corporations that are members of the group. All US members of the worldwide affiliated group are treated as one member when determining whether the group has excess US indebtedness as a result of a debt-to-equity differential. Excess US indebtedness is the amount by which the total indebtedness of the US members exceeds 110 percent of the total indebtedness those members would hold if their total indebtedness to total equity ratio were proportionate to the ratio of total indebtedness to total equity in the worldwide group. Total equity means, with respect to one or more corporations, the excess (if any) of: (1) the money and all other assets of such corporations, over (2) the total indebtedness of such corporations. Intragroup debt and equity interests are disregarded for purposes of this computation.

A worldwide affiliated group is one or more chains of corporations, connected through stock ownership with a common parent that would qualify as an affiliated group under Code Section 1504, with two differences. First, the ownership threshold of Code Section 1504(a)(2) is applied using 50 percent rather than 80 percent. Second, the restriction on inclusion of a non-US corporation under Code Section 1504(b)(3) is disregarded for purposes of identifying the worldwide affiliated group.

Payments in Hybrid Transactions

The Senate bill, but not the House bill, includes a proposal to deny a deduction in certain hybrid transactions for interest or royalties. The proposal denies a deduction for any “disqualified related party amount” paid or accrued pursuant to a hybrid transaction or by, or to, a hybrid entity. A “disqualified related party amount” is any interest or royalty paid or accrued to a related party to the extent that: (1) there is no corresponding inclusion to the related party under the tax law of the country of which such related party is a resident for tax purposes, or (2) such related party is allowed a deduction with respect to such amount under the tax law of such country. A disqualified related party amount does not include any payment to the extent such payment is included in the gross income of a US shareholder under Code Section 951(a). A related party for these purposes is determined under the rules of Code Section 954(d)(3), except that such section applies with respect to the payor as opposed to the controlled foreign corporation otherwise referred to in such section.

A hybrid transaction is any transaction, series of transactions, agreement, or instrument one or more payments with respect to which are treated as interest or royalties for federal income tax purposes and that are not so treated for purposes of the tax law of the non-US country of which the recipient of such payment is resident for tax purposes or is subject to tax. A hybrid entity is any entity that is either: (1) treated as fiscally transparent for US income tax purposes but not so treated for purposes of the tax law of the non-US country of which the entity is resident for tax purposes or is subject to tax, or (2) treated as fiscally transparent for purposes of the tax law of the non-U.S. country of which the entity is resident for tax purposes or is subject to tax but not so treated for US income tax purposes.

For example, an instrument that is treated as debt for US tax purposes but treated as equity for non-US tax purposes (and, therefore, eligible for a participation exemption), would be a hybrid transaction.

Tax on Base Erosion Payments

Under the Senate proposal, an applicable taxpayer is required to pay a tax equal to the base erosion minimum tax amount for the taxable year. The base erosion minimum tax amount means, with respect to an applicable taxpayer for any taxable year, the excess of 12.5-percent of the modified taxable income of the taxpayer for the taxable year over an amount equal to the regular tax liability of the taxpayer for the taxable year. For years after December 31, 2025, the regular tax liability is reduced by available credits.

An applicable taxpayer is any US corporation (other than a regulated investment company, a real estate investment trust, or an S corporation), which has average gross receipts of $500 million for the preceding three years and which has a base erosion percentage of 4 percent or higher.

Modified taxable income means the taxable income of the taxpayer for the taxable year, determined without regard to either any base erosion tax benefit with respect to any base erosion payment or the base erosion percentage of any net operating loss deduction.

A base erosion payment generally means any amount paid or accrued by a taxpayer to a non-US person that is a related party of the taxpayer and with respect to which a deduction is allowable, including any amount paid or accrued by the taxpayer to the related party in connection with the acquisition by the taxpayer from the related party of property of a character subject to the allowance of depreciation (or amortization in lieu of depreciation). A base erosion payment also includes any amount that constitutes a reduction in gross receipts of the taxpayer that is paid to or accrued by the taxpayer with respect to: (1) a surrogate non-US corporation which is a related party of the taxpayer, and (2) a non-US person that is a member of the same expanded affiliated group as the surrogate non-US corporation.

A base erosion tax benefit generally means any deduction allowed with respect to a base erosion payment for the taxable year. However, a deduction in respect of a payment upon which a US withholding tax has been imposed is not taken into account in computing modified taxable income as defined above. If the general rate of tax required to be withheld is reduced, the above exclusion only applies in proportion to such reduction.

The base erosion percentage means for any taxable year, the percentage determined by dividing the aggregate amount of base erosion tax benefits of the taxpayer for the taxable year by the aggregate amount of the deductions allowable to the taxpayer for the taxable year (subject to certain adjustments).

Related party means: (i) any 25-percent owner of the taxpayer, (ii) any person who is related to the taxpayer or any 25-percent owner of the taxpayer, within the meaning of Code Sections 267(b) or 707(b)(1), and (iii) any other person related to the taxpayer within the meaning of Code Section 482. For these purposes, rules under Code Section 318 regarding constructive ownership of stock applies to these related party rules except that that "10 percent" is substituted for "50 percent" in Code Section 318(a)(2)(C), and for these purposes, Code Sections 318(a)(3)(A), (B) and (C) do not cause a US person to own stock owned by a person who is not a US person.

The House has a similar provision with a somewhat different calculation (albeit styled as an excise tax, and imposed at a 20 percent rate on specified base erosion amounts). Significantly, however, that provision excludes the payment of interest from its scope.

We will continue to monitor the legislation and consider what steps might be advisable to plan for this significant potential change. Although the outlook of the bill is highly uncertain at this point, it is common for provisions of bills that are introduced to reappear in later versions or later bills.

As currently drafted, the bill would generally apply for years beginning after 2017.

For More Information

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