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Focus on Finance: Tax Reform and the Banking Industry Revisited

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The Tax Cuts and Jobs Act (TCJA) has far-reaching implications for the banking and finance industry. In our very first Bracewell Tax Report (click **here** for more), we noted certain issues that companies might consider when evaluating their financing options, namely whether to (i) exchange equity for outstanding debt or seek equity rather than debt financing or (ii) pursue financing in a foreign jurisdiction, in each case due to the new Interest Deduction Limitation (as detailed below). Now, more than eight months after passage of the TCJA, we may be seeing the manifestation of the concerns raised in that article, particularly insofar as it relates to debt versus equity considerations.

As we predicted, it appears that the TCJA's new limit on the deductibility of interest (the Interest Deduction Limitation) is indeed causing companies in need of financing to rethink using debt and instead consider turning to equity. Although the fact that borrowers may be considering preferred equity investment, both by private equity firms and otherwise, is not unexpected, it will be interesting to see if this trend will continue or if it is more reactionary to the change in law.

Of course, the Interest Deduction Limitation replaced the old "earnings stripping" rules, which limited the ability of U.S. corporations to borrow from foreign parents or affiliates. While the overall deduction is limited (i.e. the limit does not just apply to corporations with foreign related lenders), the limitation may not be as strong a barrier to a foreign shareholder loan as were the old rules (though we note that a U.S. corporation could avoid the old earnings stripping rules if it was able to manage its debt/equity ratio below 1.5:1). We might then expect to see an uptick in cross-border financing in situations where the borrower has strong business reasons for using debt to finance its operations namely in jurisdictions without similar deduction limitations. However, the TCJA certainly did not otherwise encourage foreign inbound lending. Consistent with its overall chill on inbound activity, the TCJA introduced hybrid rules that further limit the ability to create more sophisticated structures that rely on competing treatment of both payments (e.g., as interest in one jurisdiction but return of capital in the other) and entities (fiscally transparent in one jurisdiction but not the other). Still, it left open "plain vanilla" shareholder loans, provided of course the loan is respected as debt and the rate is consistent with third party terms. Market terms not only are required for debt treatment for tax purposes, but to protect against a transfer pricing challenge. While a full discussion of transfer pricing is outside the scope of this article, generally transfer pricing rules operate to ensure that related parties do not artificially inflate payments (or undercharge each other) in intercompany transactions to maximize a tax benefit or reduce taxable income. As a practical matter, transfer pricing rules generally require the parties to interact as unrelated third parties in order for the IRS to respect, for example, deductions made by a U.S. borrower to a related foreign lender. Thus, even if loans from foreign parents now are more accessible, the rest of the rules have not changed, and may limit, trends towards cross border lending transactions.

Moreover, certain constraints on foreign corporations still remain, thus mitigating their advantage over domestic lenders. For instance, a foreign lender that is lending through a so-called "blocker" corporation instead of a domestic branch or subsidiary must file U.C. Form 5472. This form is meant to disclose the amount of related party and reportable transactions a company entered into over the course of a taxable period in order to help the IRS ensure the legitimacy of pricing with respect to intercompany transfers. Thus, these payments still are subject to additional scrutiny, and not only with respect to the interest rate charged by the lending company and transfer pricing concerns.

And still, there are several reasons why the Interest Deduction Limitation will not act as a death blow to the banking industry or debt financing. Firstly, the new lower tax rates, may make the limited deductibility of interest an easier cost to bear as (i) companies may find themselves with more cash on hand and (ii) the lower corporate tax rate means the deduction itself is less valuable. Banks also offer a good source of cash to borrowers but without any desire to control the decisions of the company (as opposed to their equity investor counterparts). Further, although the TCJA does limit the borrower's ability to deduct interest on debt, there is no corresponding deduction when using equity financing at all; a partial benefit in many circumstances is better than no benefit at all. These factors may mean that, although certain businesses may indeed opt for equity financing in situations where they would have used debt financing before the passage of the TCJA, it certainly should not result in a complete move away from debt and towards equity investment.

Indeed, given how the Act disproportionately impacts foreign inbound investment, we may not be likely to see significant non-U.S. equity investment, especially in pass-through form. As we have previously discussed (click **here** for more), the TCJA codified Revenue Ruling 91-32 (the Ruling), which held that a foreign partner has "effectively connected income" (or ECI, which generally is taxable in the same manner as if the partner were a U.S. person) to the extent the gain is attributable to ECI-producing assets, defined as those assets belonging to a partnership that is carrying on a trade or business in the United States through a fixed place of business. This controversial ruling, which many challenged, now is codified in new Code Section 864(c), which states that ECI is to be treated in the same manner as if the partnership had sold the assets generating ECI and allocated the gain to the partner. Moreover, in calculating the taxable gain of a foreign partner of a partnership that is engaged in a U.S. trade or business, the new provision states that any gain on the disposition of a partnership interest will be presumed to be U.S. source ECI gain and any loss will be presumed to be foreign source non-ECI, unless the partner is able to produce evidence demonstrating otherwise.

While the impact of this holding certainly is more far-reaching than its impact on financing alternatives, the implications with respect to equity financing for passthrough entities – a particularly common structure in certain industries, such as energy – must be considered as companies consider alternate financing sources post tax reform. Thus, even if the equity markets rise on the new laws, new Code Section 864(c) may act to limit the uptick primarily on cross border equity financing options.