Tax Reform for Private Equity
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Weil

December 21, 2017

Musings on the Intersection Between Tax Reform and Leveraged Finance Terms

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An interesting consequence of the recently passed (but as yet unsigned) tax reform bill, is its impact on the available cash flow of borrowers—in particular the differing effects it will have on the relative after-tax cash flow of domestic corporate borrowers relative to domestic pass-through borrowers. Historically, the restricted payment covenants of leveraged loan credit agreements have generally permitted borrowers to distribute enough cash to the borrower's consolidated parent (for a corporate borrower that is a member of a combined, consolidated or unitary tax group) and beneficial owners (for a pass-through borrower) to provide liquidity to those owners to pay their income tax liabilities attributable to the income of the borrower. Obviously, where the corporate borrower is itself a taxpayer, such tax payments are permitted.

When dealing with pass-through borrowers, simplifying conventions have typically been used for tax distributions, including the utilization of assumed tax rates (often the higher of the highest marginal combined income tax rate imposed on an individual or corporation in a relevant jurisdiction). Under current (pre-tax reform) law, the amounts permitted to be distributed to the owners of a pass-through borrower generally do not differ materially from the amount permitted to be distributed to the consolidated parent of a corporate borrower or the tax liability of a non-consolidated corporate borrower, as the highest marginal federal corporate income tax rate is 35%, compared to 39.6% for individuals (plus the 3.8% net investment income tax), and state and local taxes are generally deductible by both corporations and individuals. However, the gap between corporate and individual income tax rates is poised to significantly widen under the new law.

Under the new law, corporate borrowers will generally be subject to a highest marginal federal income tax rate of 21% and will generally be permitted to deduct their state and local income tax. The beneficial owners of pass-through borrowers, on the other hand, will be subject to a more complex set of highest marginal federal income tax rates, ranging from 0% to 37% (with stops at 21% and 29.6%, plus the 3.8% net investment income tax), depending on the nature of the beneficial owner and whether and to what extent the income produced by the pass-through borrower is eligible for all or any portion of the 20% deduction for pass-through qualified business income. In addition, beneficial owners that are individuals will no longer be permitted to deduct state and local income taxes in excess of $10,000.

As an illustration, consider a borrower producing $100 of pre-tax cash and income subject to state and local income taxes at a 13% rate and the highest

marginal federal income tax rate. The net after-tax cash available to support its debt will vary markedly depending on the nature of the borrower, and in the case of a pass-through borrower, the characteristics of its income and beneficial owners.

As can be seen below, the difference in net cash between a corporate borrower and a pass-through borrower will grow from $7.31 under current law to as much as $22.53, or more, under the new law.

Current Law	Pre-Tax Cash	S&L Tax	Fed Tax	Net Cash
Corporate Borrower	**$100**	**$13**	**$30.45**	**$56.55**
Pass-Through Borrower	**$100**	**$13**	**$37.76**	**$49.24**

New Law	Pre-Tax Cash	S&L Tax	Fed Tax	Net Cash
Corporate Borrower	**$100**	**$13**	**$18.27**	**$68.73**
Pass-Through Borrower (100% Qualified Business Income)	**$100**	**$13**	**$29.6**	**$57.40**
Pass-Through Borrower (No Qualified Business Income and Subject to Net Investment Income Tax)	**$100**	**$13**	**$40.8**	**$46.20**

Will lenders demand tighter control over the tax distributions of pass-through borrowers? Will pricing vary between pass-through and corporate borrowers to account for these disparate after-tax cash flows? It remains to be seen how the leveraged loan market will adjust to this new reality.

If you have questions concerning the contents of this issue, or would like more information, please speak to your regular contact at Weil, or to:

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