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U.S. Tax Reform - Provisions Impacting Private Equity

On December 15, 2017, a Conference Committee established by the House of Representatives and the Senate released a unified agreement on the "Tax Cuts and Jobs Act" (the "Conference Agreement") in the wake of the passages of the House version of the Tax Cuts and Jobs Act on November 16, 2017, and the Senate version on December 2, 2017. Below is a brief summary of certain provisions of the Conference Agreement that will likely have an impact on private equity and private equity funds.

Corporate Income Tax Rate Reduction and Repeal of Corporate Alternative Minimum Tax

The Conference Agreement reduces the corporate income tax rate to 21% and repeals the corporate alternative minimum tax. Additionally, the withholding provisions under the Foreign Investment in Real Property Tax Act of 1980, or FIRPTA, are modified to reflect the reduced 21% corporate income tax rate for (i) gains from the disposition of United States real property interests ("USRPIs") realized by U.S. partnerships, U.S. trusts or U.S. estates that are allocable to non-U.S. persons who are partners or beneficiaries of such U.S. partnerships, U.S. trusts or U.S. estates, or are allocable to a portion of a trust treated as owned by a non-U.S. person; (ii) distributions by non-U.S. corporations to non-U.S. persons of gain from the disposition of USRPIs; and (iii) distributions by regulated investment companies or real estate investment trusts to non-U.S. persons of gain from the disposition of USRPIs. If enacted, the foregoing is effective for taxable years beginning after December 31, 2017.

Potential private equity impact: Portfolio companies may have lower U.S. federal income tax liability, which in turn could decrease the value of their tax attributes and impact their cash flow projections. Such considerations should be factored into any acquisition planning at a portfolio company level. The use of "blocker corporations" in private equity structures may have less tax leakage as a result of the lower corporate income tax rate, which may in turn impact the assessment of the use of such blocker corporations.

Effectively Connected Income and Codification of Revenue Ruling 91-32

In Revenue Ruling 91-32, the Internal Revenue Service took the position that a non-U.S. partner's gain from the sale of a partnership interest would be treated as income effectively connected with a U.S. trade or business ("ECI") to the extent the seller would have had ECI if the partnership had disposed of its assets. In 2017, the United States Tax Court (in *Grecian Magnesite Mining, Industrial & Shipping Co., SA, v. Commissioner*, 149 T.C. No. 3) disagreed with the Internal Revenue Service and held that a non-U.S. partner's gain on the disposition of its

partnership interest (to the extent the gain is not attributable to USRPIs) is not ECI.

The Conference Agreement codifies Revenue Ruling 91-32. That is, gain or loss from the sale or exchange of a partnership interest by a non-U.S. person is effectively connected with a U.S. trade or business to the extent the transferor would have had effectively connected gain or loss if the partnership sold its assets at fair market value as of the date of the sale or exchange. Additionally, a new withholding rule is enacted that requires the transferee of the partnership interest to withhold ten percent of the amount realized on the sale or exchange of the partnership interest absent certification that the transferor is exempt from withholding. As a backup enforcement mechanism, a failure to withhold the ten percent by a transferee partner imposes an obligation on a partnership to deduct and withhold from distributions to such transferee partner those amounts that should have been withheld by the transferee partner.

If enacted, the codification of Revenue Ruling 91-32 applies to all partnership interests sold or exchanged on or after November 27, 2017, and the withholding provisions apply for taxable years beginning after December 31, 2017.

Potential private equity impact: Non-U.S. persons that invest in a private equity fund that is treated as a partnership for U.S. federal income tax purposes and which is directly engaged in a U.S. trade or business, will be impacted by this provision in that such non-U.S. persons should be subject to U.S. tax if they were to transfer their interest in the private equity fund. Furthermore, if a private equity fund treated as a partnership for U.S. federal income tax purposes disposes of an interest in an underlying portfolio company that is treated as a partnership for U.S. federal income tax purposes and is engaged in a U.S. trade or business, the private equity fund will generally be required to withhold U.S. federal income tax on any gain from such disposition that is attributable to a non-U.S. partner in the private equity fund. This provision will also potentially impose more administrative obligations on a private equity fund that is required to withhold ten percent from distributions to a transferee partner in the event such partner failed to withhold such amount when it acquired the interest in the private equity fund.

New 3-Year Holding Period for Carried Interest

After many prior attempts to tax service partner “carried interest” as compensation income, the Conference Agreement reached a compromise that retained the capital nature of the income but requires a 3-year holding period (versus a one-year holding period under current law) to obtain the benefits of long-term capital gain rates. Specifically, this provision applies to taxpayers receiving partnership interests in connection with the performance of substantial services in any applicable trade or business consisting of: (i) raising or returning capital; and either (ii) investing in (or disposing of) specified assets (or identifying specified assets for investing or disposition); or (iii) developing specified assets. “Specified assets” generally means securities, commodities, real estate held for rental or investment, cash or cash equivalents, options or derivative contracts with respect to such securities, commodities, real estate, cash or cash equivalents, as well as an interest in a partnership to the extent of the

partnership's proportionate interest in the foregoing. The fact that an individual may have included an amount in income upon acquisition of a partnership interest, or that an individual may have made a "Section 83(b) election" with respect to such partnership interest, does not change the 3-year holding period requirement for long-term capital gain treatment with respect to such partnership interest.

Holders of partnership interests that transfer their interests to related parties prior to three years in certain instances will trigger immediate gain taxed as short-term capital gain.

If enacted, this provision is effective for taxable years beginning after December 31, 2017.

Potential private equity impact: Private equity funds typically hold their investments for more than three years, and therefore the impact of this provision on private equity funds may not be significant. However, to the extent that a private equity fund holds any investments for fewer than three years, it will likely need to separately track the income from such investments as a result of, and in order to implement, this provision, and thus it will have an additional administrative obligation that is not currently required.

Business Deductions with Respect to Passthrough Entities

The Conference Agreement provides that a non-corporate taxpayer (partnerships, S corporations, trusts and estates, and sole proprietorships) is entitled to a potential deduction for "qualified business income," which effectively reduces the maximum marginal tax rate from 37% to 29.6%. Mechanically, a non-corporate taxpayer may generally deduct in any taxable the lesser of (i) 20% of the taxpayer's combined qualified business income; or (ii) the greater of (x) 50% of the W-2 wages paid with respect to a qualified trade or business, and (y) the sum of 25% of the W-2 wages with respect to the qualified trade or business plus 2.5% of the unadjusted basis, immediately after acquisition, of all qualified property (property currently being used and depreciated as part of a qualified business).

For this purpose, qualified business income includes income generated from a qualifying U.S. trade or business (but excludes items such as dividends, income equivalent to a dividend, or payments in lieu of dividends, as well as interest income (other than that which is properly allocable to a trade or business)). The W-2 wage base include all wages, including withholding amounts and amounts an employee elects to defer. A qualifying trade or business is any trade or business other than (1) a "specified service trade or business"; and (2) the trade or business of performing services as an employee. A specified trade or business is expressly defined to include: health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees. Additionally, a specified trade or business includes the performance of services that consist of investing and investment management, trading, or dealing in securities, partnership interests, or commodities. However, engineering and architectural

services are excepted from the list of specified services that are denied the deduction.

The provision also contains income thresholds, phase-in limitations, and rules intended to prevent guaranteed payments, reasonable compensation, and payments paid to partners in non-partner capacities from qualifying for the 20% deduction. A special rule also allows a deduction of 20% of qualified REIT income and publicly traded partnership income. Finally, for partnerships and S corporations, the deduction is applied at the partner or shareholder level.

If enacted, the foregoing is effective for taxable years beginning after December 31, 2017 and ending before January 1, 2026.

Potential private equity impact: Many private equity funds generate income (e.g., dividends) that will likely not be treated as qualifying business income for purposes of this provision, such that this provision may not have a significant impact in such instance. However, to the extent that a private equity fund (treated as a partnership for U.S. federal income tax purposes) holds partnership portfolio companies that are engaged in a U.S. trade or business and which generate qualifying business income at the portfolio company level, it is possible that individual limited partners of the private equity fund, or individual members of a general partner entity (treated as a flow-through for U.S. federal income tax purposes) could benefit from this provision.

Interest Expense Deduction

The Conference Agreement contains provisions that limit the deductibility of business interest. Specifically, the deduction for business interest is limited to the sum of (i) business interest income; (ii) 30% of the adjusted taxable income of the taxpayer for the taxable year (computed without regard to deductions allowable for depreciation, amortization, or depletion for taxable years beginning after December 31, 2017 and before January 1, 2022); and (iii) the floor plan financing interest (*i.e.,* interest incurred on indebtedness used to finance the acquisition of motor vehicles held for sale to retail customers and secured by the inventory so acquired) of the taxpayer for the taxable year. Disallowed interest may be carried forward indefinitely.

The Conference Agreement further provides that the business interest limitation is applied at the partnership level for purposes of determining each partner's distributive share of bottom line net income. It further provides a formula for allocating to each partner a share of the business interest subject to the limitation that the partner is eligible to carry forward.

If enacted, the foregoing is effective for taxable years beginning after December 31, 2017.

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Potential private equity impact: Private equity funds that use blocker corporations in their structure (for example to protect non-U.S. investors from direct U.S. income tax payment and filing obligations) often leverage up such blocker corporations in order to mitigate the U.S. tax leakage associated with blocker structures. This provision will limit the deductibility of interest not only at a blocker corporation level, but also at the level of any portfolio company that is leveraged with debt. However, the overall adverse impact of this provision may be mitigated by other provisions in the Conference Agreement that are beneficial to corporations, such as the reduced corporate income tax rate and 100% expensing (see below).

100% Expensing

The Conference Agreement allows for full expensing of qualified property (*e.g.,* tangible depreciable property with a depreciable life of 20 years or less) placed in service after September 27, 2017 and before January 1, 2023. Used property is also eligible for expensing.

Potential private equity impact: Full expensing should benefit portfolio companies that hold qualified property, and should also help to reduce the tax leakage at a portfolio company level. Full expensing may also help mitigate any adverse impact from limits on interest deductibility as described above.   Additionally, this provision may impact private equity M&A activity in that private equity purchasers may seek to structure transactions as asset acquisitions (or deemed asset acquisitions through a Section 338 election), in order to take the full expensing advantage.

Net Operating Losses

The Conference Agreement repeals most net operating loss carrybacks and limits the net operating loss deduction to 80% of taxable income (determined without regard to the deduction) for losses arising in taxable years beginning after December 31, 2017. Net operating losses may be carried forward indefinitely.

Potential private equity impact: Blocker corporations and underlying portfolio companies with net operating losses will no longer be able to carry back such losses, and any deduction for losses will be limited to 80% of taxable income. This in turn may impact the amount of overall tax drag associated with a blocker corporation or a portfolio company in a private equity fund structure, although such tax drag assessment would also need to take into consideration other provisions of the Conference Agreement that impact corporations (including those described herein). This provision may also have an impact on the treatment, assessment and valuation of tax attributes in private equity M&A transactions.

Revision to Rules to Determine Controlled Foreign Corporation Status

Under current law, a controlled foreign corporation is any foreign corporation if more than 50% of (i) the total combined voting power of all classes of stock of

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such corporation entitled to vote; or (ii) the total value of the stock of such corporation, is owned by United States shareholders on any day during the taxable year of such foreign corporation. A United States shareholder of a foreign corporation in turn means a U.S. person who owns 10% or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation.

The Conference Agreement expands the definition of "United States shareholder" to include any U.S. person who owns 10% or more of the total value of shares of all classes of stock of a foreign corporation. The foregoing is effective for taxable years of foreign corporations beginning after December 31, 2017, and for taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

The Conference Agreement also provides that certain stock of a foreign corporation owned by a foreign person is attributed to a related U.S. person for purposes of determining whether the related U.S. person is a U.S. shareholder of the foreign corporation and whether the foreign corporation is a controlled foreign corporation. This "downward attribution" provision is effective for the last taxable year of foreign corporations beginning before January 1, 2018 and each subsequent year of such foreign corporations and for the taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end.

Potential private equity impact: The foregoing provisions may significantly increase the number of non-U.S. portfolio companies in a private equity fund structure that are treated as controlled foreign corporations. This in turn will result in increased obligations to comply with the U.S. tax rules within the controlled foreign corporation regime.

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