ALERT MEMORANDUM

Tax Cuts & Jobs Act: Considerations for Funds

January 25, 2018

On December 22, 2017, the President signed into law the 2017 U.S. tax reform bill formerly known as the Tax Cuts & Jobs Act (the "TCJA"). This event marks the culmination of an extremely rapid legislative process, beginning with the bill's introduction in the U.S. House of Representatives on November 2, 2017. Most of the TCJA's provisions took effect January 1, 2018.

The TCJA introduces significant changes to the U.S. tax system that are likely to have a profound impact both on the economy as well as on private equity and other investment funds. This memorandum sets forth a few key observations.

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Executive Summary

We believe there are 12 main takeaways, each of which is discussed in greater detail in this memorandum.

1. Significant reduction in headline tax rates for corporations and for most business income earned by individuals through partnerships, as well as moderate reductions in individual rates, will affect investors in funds as well as structuring of funds, portfolio companies, and acquisitions.

Fund Issues.

2. The deemed repatriation of offshore earnings may generate significant phantom income in 2017 for U.S. taxable investors in U.S. funds and U.S. sponsors of non-U.S. funds.
3. A new withholding tax on dispositions of fund interests by non-U.S. partners will affect the structuring of fund investments as well as LP transfers, and may need to be taken into account in limited partnership agreements and PPM disclosures.

4. Limitations or disallowance of various deductions, including miscellaneous itemized deductions, deductions for state and local taxes and deductions for net active business losses, will impact fund economics for U.S. taxable investors.

Portfolio Company Issues.

5. Limitations on net interest expense deductions may affect effective tax rates and financing arrangements, in particular for LBOs, and may reduce the ability to make full use of interest deductions at the blocker level.
6. The value of NOLs may be significantly reduced as a result of new limitations on their use.
7. For the next 5-10 years, the accelerated expensing of asset purchases may encourage asset acquisitions for businesses with significant tangible assets.
8. The shift to a territorial tax system will free up offshore cash and may increase M&A activities. It may also impact the structure of U.S. groups.
9. Both the operational structure of multinational groups (including intercompany cash flows) and the use of shareholder debt to finance acquisitions of portfolio companies may be affected by new base erosion rules.
10. U.S. portfolio companies that derive high returns offshore, or that have operations that require few assets offshore (*e.g.*, services or sales businesses), may be subject to a higher effective tax rate.
11. The number of entities that are subject to the CFC rules has been significantly expanded.

Sponsor Issues.

12. Limitations on favorable tax treatment for carried interest may affect structuring and co-investment arrangements in certain cases.

1. **Significant Reduction in Headline Tax Rates**.

— For corporations:

- The U.S. corporate tax rate is lowered to 21%, effective starting in 2018.
- The corporate alternative minimum tax is repealed.
- The reduction in tax rates mechanically reduces the value of any tax assets owned by portfolio companies (*e.g.*, deferred tax assets on company balance sheets, and the value of transaction expenses taken into account in purchase agreements). Similarly, the value of tax receivables agreements is reduced, which may affect expected returns on exit and on the relative value of holding investments in pass-through form.

— The tax rates that apply to individuals are reduced somewhat (for a top rate of 37% against 39.6% today). This rate reduction expires after 2025.

— In addition, the tax rate on business income earned by individuals through flow-through entities (including through partnerships, S corporations and sole proprietorships) is lowered by a complicated mechanism that results in an effective top bracket rate of 29.6%. The rate reduction is accomplished by providing for a deduction equal to 20% of qualified business income that is earned by non-corporate taxpayers through a partnership, S corporation or sole proprietorship. The deduction expires after 2025.

- The deduction does not apply to investment income (capital gains, dividends and most interest income). It also does not apply to reasonable compensation income and guaranteed payments paid to the taxpayer from the business.
- The deduction also does not apply to income from services businesses, including investment management businesses and securities trading businesses, although there is an exception for some individual taxpayers whose income is below $157,500 ($315,000 for married couples filing jointly), subject to a phase-out.
- The deduction is capped at the greater of (a) 50% of the taxpayer's allocable share of the W-2 compensation paid by the flow-through entity or (b) the taxpayer's allocable share of 25% of such W-2 compensation plus 2.5% of the unadjusted acquisition cost of the flow-through entity's tangible assets. The cap does not apply to certain individuals whose income is below the thresholds specified above. This cap is applied on a trade or business by trade or business basis. The definition of what constitutes an individual trade or business is uncertain.
- As a result of these exclusions and limitations, the 20% deduction is unlikely to be useful with respect to most of the income typically realized by private investment funds.
- *Flow-Through Deals*. The deduction may, however, be available with respect to income earned from investments in flow-through entities engaged in active businesses with employees.
- *Hedge Funds*. Hedge funds that have made an election under section 475 are unlikely to benefit from the 20% deduction, because they are treated as engaged in services businesses and/or because they do not have employees or tangible assets.
- *REITs*. The TCJA also provides for a deduction equal to 20% of certain dividends from REITs and cooperatives. This deduction is not subject to the W-2 wage cap described above. The deduction for REIT dividends expires after 2025.
- *Publicly Traded Partnerships*. The TCJA also provides for a deduction equal to 20% of business income from a publicly traded partnership or ordinary gain on the sale of a publicly traded partnership interest (*e.g.* from recapture). This deduction is not subject to the W-2 wage cap described above. The deduction for publicly traded partnership income expires after 2025.

— *Partnership vs. Corporate Form After the TCJA*. The changes in tax rates may affect the use of corporations and partnerships. Business income earned by individuals in the top bracket through a partnership is still subject to a lower federal income tax rate (29.6%) than income earned through a corporation (36.8%) *but* (i) the effective tax rate for income earned through a corporation is significantly lower than under prior law (48%), (ii) the corporate tax form allows for deferral (*i.e.*, taxation of earnings at 21% until dividends are paid or anti-abuse rules apply), and (iii) corporations are able to obtain other tax preferences that individuals cannot (*e.g.*, a lower rate of tax on GILTI income, effective deemed paid foreign tax credits, dividends received deductions and participation exemption on certain foreign dividends, and deductions for state and local taxes).

2. **Fund Issues**.

— **Deemed Repatriation**. Under the TCJA, *any* 10% U.S. shareholder of a foreign corporation (determined on December 31, 2017) will be required to include in income, for the taxable year 2017, its proportionate share of the foreign corporation's undistributed earnings, if the foreign corporation is either a controlled foreign corporation (CFC) or has at least one 10% U.S. shareholder that is a corporation. The tax applies to the undistributed earnings generally as of the end of 2017. There are rules permitting earnings deficits to offset undistributed earnings amounts.

- This could generate significant phantom income in 2017 with respect to 10%-or-greater owned foreign portfolio companies for both (i) U.S. taxable investors (including the GP and its owners) in funds organized in the United States and/or (ii) U.S. sponsors of non-U.S. funds.
- *Tax Payable*.
  - The rule provides for rates of 8% and 15.5% for corporate investors (for earnings invested in tangible assets vs. cash), and 9.05% and 17.54% for investors taxed as individuals and subject to the highest marginal rate.
  - The tax can be paid over an 8-year period, although there are triggers to accelerate the payment (*e.g.*, sale of all or substantially all of the assets of a taxpayer, which could potentially include a relevant partnership).

— **ECI on Sale of Partnership Interest**. The TCJA provides that gains from a sale of a partnership interest by a non-U.S. partner are treated as subject to U.S. net income tax (*i.e.*, treated as effectively connected income (ECI)) to the extent that a partner would be allocated ECI from a sale of the partnership's assets.

- This effectively affirms Revenue Ruling 91-32 and is contrary to the recent Tax Court decision in *Grecian Magnesite*.
- *Withholding Tax*. To the extent a partnership has any ECI-generating assets (and perhaps even if it does not), a seller of a partnership interest is required to provide a certificate that it is not a foreign person, and in the absence of such a certificate a purchaser is required to withhold 10% of the gross purchase price, including assumption of debt. If the purchaser does not withhold, the partnership itself will need to withhold on distributions to the purchaser to cover the withholding. The foreign seller should be able to recover or credit any withheld taxes by filing the required U.S. tax return.
- This rule will be effective for partnership sales occurring on or after November 27, 2017; however, the 10% withholding tax will apply only to sales occurring after December 31, 2017.
- This could have a significant effect on the structuring of fund investments, the documentation of LP transfers and the drafting of fund LPAs and PPM disclosures.

— **Itemized Deductions**.

- The TCJA repeals the overall limitations on itemized deductions (the 3% phase out and 80% cap), effective for taxable years after December 31, 2017. This repeal expires after 2025.
- In addition, *the TCJA repeals all miscellaneous itemized deductions, such as, most importantly for funds, investment expenses* (*e.g.*, deductions for management fees or other partnership expenses), for taxable years through 2025.

— **State and Local Taxes**. The TCJA allows up to $10,000 in aggregate deductions for state and local non-business income, property or sales taxes. The TCJA also allows unlimited deductions for state and local property, sales, etc. taxes attributable to a trade or business (*e.g.*, a management company). State and local non-business taxes become fully deductible again after 2025. 2018 state and local taxes prepaid in 2017 are not intended to be deductible in 2017.

— **Limits on Active Business Losses**. The TCJA significantly limits the extent to which non-corporate taxpayers can use active business losses to offset other income, such as income from investments, compensation and other nonbusiness income.

- Under the new provision, "excess business losses" of a non-corporate taxpayer are not currently deductible. The bill defines an "excess business loss" as the excess of the deductions attributable to trades or businesses of the taxpayer over the gross income or gain of the taxpayer for those trades or businesses plus a threshold amount ($250,000, indexed to inflation). In the case of partnerships or S corporations, the limitation applies at the partner or shareholder level. The limitation expires after 2025.
- This limitation could impact investors in funds with investments in flow-through entities engaged in active businesses. Individual taxpayers can aggregate their net trade or business income and loss from multiple trades or businesses (*i.e.* from multiple flow-through investments), which should mitigate the impact of the rule for some fund investors.
- Excess business losses disallowed by this provision are treated as NOLs and carried forward (subject to the limitations discussed in "Limits on Deductibility of NOLs" below). Although the statute is unclear, we believe that deductions in a subsequent year for NOLs attributable to excess business losses are likely themselves to be treated as attributable to a trade or business of the taxpayer, which could lead to excess business losses subject to limitation in subsequent years as well.

3. **Portfolio Company Issues**.

— **Limitation on the Deductibility of Net Interest Expense**. The TCJA introduces a new significant limitation on deductions for *net* business interest expense: net business interest expense cannot offset more than 30% of "adjusted taxable income."[1]

- The rule applies to any interest paid on or after January 1, 2018. There is no grandfathering for pre-existing debt.
- This rule, combined with the lower corporate tax rate, will significantly affect both corporate groups that have utilized acquisition debt as well as the planning and structuring for future LBOs.
  - It will diminish the existing incentive to allocate the maximum amount of debt to the U.S. in a cross-border acquisition.
  - It may increase the after-tax cost of financings for LBOs, and may make preferred equity financings, leasing or other interest equivalents more attractive than debt financings in some cases.
  - The rule also applies to businesses conducted in flow-through form, which will also have an incentive to use alternative forms of financing.
- The House-Senate Conference Committee has clarified that interest paid on shareholder loans at a blocker level is "business interest" that is subject to the limitation. As a result, the rule may reduce the ability to make full use of interest deductions at the blocker level. (The shareholder debt would continue to be useful in mitigating the need to pay dividends from the blocker.) It appears that the limitation may not apply to a real estate business, even if owned by a corporation. In addition, blocker corporations used for a

1 The separate limitation on interest expense deductions based on a worldwide leverage test, which was included in prior versions of the TCJA, was not adopted.

credit business may have significant interest income, which will reduce or eliminate the effect of the limit on *net* interest expense.

- The rule limits the deduction for net business interest expense to 30% of adjusted taxable income. "Adjusted taxable income" is similar to EBITDA for taxable years 2018 through 2021, and EBIT for 2022 and later years. Disallowed interest expense can be carried forward indefinitely.
    - Particularly in 2022 and later years, the change from EBITDA to EBIT may mean that businesses with significant expenditures eligible for expensing will have little or no capacity for interest deductions. That change would apply to any debt instruments that exist at that time (there is no grandfathering), creating a cliff effect; therefore the switch to EBIT should be taken into account in structuring acquisition debt beginning immediately.
        - For example, for a company with 100 of adjusted taxable income equal to EBITDA, and 40 of depreciation, the limit on interest expense deductions would be 30 through 2021. Starting in 2022, it would be 18. Companies therefore may want to take advantage of the immediate expensing permitted under the TCJA for certain types of tangible assets (described in "Expensing of Certain Assets" below) to accelerate such investments to pre-2022 years when depreciation is not taken into account in measuring adjusted taxable income for purposes of this interest expense limitation.
- The rule is expected to apply on a U.S. consolidated group-wide basis for domestic corporations. Partnerships are evaluated on a separate entity basis, with rules to avoid double counting and to allow "excess" adjusted taxable income to tier up. The location of debt financing among partnerships or non-consolidated companies may affect deductibility.
- This rule is consistent with similar changes in law that have been enacted recently by some of our trading partners (*e.g.*, Germany, UK) as a result of the OECD Base Erosion and Profit Shifting (BEPS) project.

— **Limits on Deductibility of NOLs**.

- Carrybacks of NOLs are no longer allowed. Carryforwards of NOLs become indefinite. These new carryback and carryforward rules apply only to NOLs that arise in taxable years *ending after* December 31, 2017 – *i.e.*, they capture some 2017 NOLs for non-calendar year taxpayers.
- For taxable years beginning after December 31, 2017, a company may use NOLs to offset only up to 80% of its taxable income (with unused NOLs carried forward into future years). This 80% cap applies to NOLs that arise in taxable years beginning after December 31, 2017.
- These changes will be relevant in modelling returns, such as the benefit of expensing, and should be taken into account in considering the impact of "transaction tax benefits" (*e.g.*, bonuses and refinancing costs) which a buyer is often asked to pay over to seller.

— **Timing Issues**. The TCJA requires most accrual-method taxpayers to take items of income into account for tax purposes no later than the time these items are included on the taxpayer's audited financial statements or annual reports, subject to certain exceptions (including an exception for mortgage servicing contracts). This rule generally takes effect beginning in 2018, but is delayed until 2019 for debt instruments with original issue discount.

— **Expensing of Certain Assets**. The TCJA allows very beneficial expensing of the cost of certain "qualified property".

- Immediate expensing of the entire cost in the year of purchase is available for qualified property acquired after September 27, 2017 and placed in service before January 1, 2023.
  - "Qualified property" is, generally, depreciable tangible property (including used property), and does not include shares in corporations, real estate, or intangibles such as goodwill and intellectual property. It also does not apply to property that is leased rather than purchased.
  - Accelerated expensing is also allowed for property placed in service in 2023 and afterwards, with the percentage of cost that is immediately deductible stepping down annually until it reverts to the previously existing depreciation schedule for property placed in service after 2026 (or 2027, in the case of certain property with longer production periods).
- The short life of the rule will create an incentive to acquire assets eligible for immediate expensing within the next 5 years (or accelerated expensing in years 6 to 10). As noted, because qualified property does not include intangible property, the deduction is likely to be less valuable to the tech industry or other businesses without significant tangible assets. In addition, because the deduction does not apply to goodwill, this provision may result in an increased focus on the value of tangible business assets as part of the purchase price allocation process.
- *Structuring Acquisitions*: Immediate (and accelerated) expensing will apply to purchases of used as well as new items, and thus may create incentives to structure acquisitions as asset purchases or deemed asset purchases (such as stock purchases with a section 338 or 336 election, or conversion of a corporate target to an LLC prior to the purchase), during the 5 to 10 year period. However, in determining the benefit of selling assets vs. selling stock, the relative value of immediate (or accelerated) expensing for the purchaser will still need to be balanced against potential additional tax on sellers.
- *Issues for Rollovers*: If the purchaser is "related" to the seller, immediate or accelerated expensing is not permitted; as a result in some circumstances the application of attribution rules will take on increased significance. For instance, depending on the specific facts, transactions that involve a partial rollover of the existing shareholders may result in the purchaser being "related" to the seller and thus a denial of this benefit.

— **Shift to a Territorial System**. The TCJA adopts a territorial system of international taxation, effective January 1, 2018.

- A one-time transition tax will be imposed on the earnings of foreign subsidiaries at the rates described above under "Fund Issues—Deemed Repatriation", effectively "unlocking" the trapped cash held offshore by U.S. multinationals.
- Under the new system, going forward, dividends received by a portfolio company that is a U.S. corporation from its 10%-or-greater-owned foreign subsidiaries (by vote or value) are generally exempt from tax if attributable to non-U.S. earnings of the subsidiaries.
  - The exemption does not apply to so-called "hybrid dividends" (dividends that are deductible by the foreign subsidiary).
  - The exemption is not available if the foreign corporation is a passive foreign investment company (a "PFIC").

- The exemption is available only to U.S. corporate shareholders who have held the foreign subsidiary stock for at least 1 year (subject to potential tolling rules).
- Dividends exempted from tax reduce the U.S. corporation's basis in the foreign subsidiary, reducing the U.S. corporation's ability to claim losses on a future sale of the subsidiary.

• *This is Not a Full Participation Exemption*.

- Dividends received by non-corporate taxpayers as well as dividends from subsidiaries in which the U.S. taxpayer does not own 10% of the equity (by vote or by value) will be fully taxable (with potential for foreign tax credit relief).
- The exemption does not apply to gains from the sale of shares (although it does apply to any gains recharacterized as dividends under section 1248). There may be a significant benefit to selling foreign assets and deriving exempt dividends as compared to selling foreign shares.

• *Limitations on Credit Support from CFCs Remain in Place*. Despite the exemption for actual dividends from foreign subsidiaries, the TCJA retains the existing rule (section 956) that requires a U.S. shareholder of a CFC to currently include in income the earnings of the CFC reinvested in United States property. Loans from CFCs to U.S. corporate shareholders, pledges of CFC stock to support borrowings of U.S. corporate shareholders, and other investments by CFCs in U.S. property (including owning stock of U.S. affiliates and other U.S. tangible and intangible property) will continue to give rise to deemed dividend inclusions that are fully taxable, and therefore section 956 will continue to constrain the structuring of debt incurred by U.S. entities with significant foreign assets.

• Absent additional provisions, the new territorial tax system would create a strong incentive to move operations offshore. In order to mitigate this, the TCJA broadens the scope of the CFC rules and introduces a series of new taxes and rules that affect the deductibility of payments to foreign affiliates. We discuss these and their potential impact for funds in the following three sections.

— **Base Erosion – Outbound Payments**.

• The TCJA targets earnings stripping or base erosion by imposing a new minimum tax (called the "BEAT") on the taxable income of a corporate taxpayer, modified so as to deny deductions for "base erosion payments."

• "Base erosion payments" are deductible payments from domestic corporations and branches to foreign affiliates, excluding mainly (i) cost of goods sold (except for corporations that expatriate from the United States after November 9, 2017), (ii) certain payments for services representing cost reimbursement with no mark-up, (iii) certain payments pursuant to derivatives that are marked to market for tax purposes (generally by banks or swap dealers) and (iv) payments that are subject to U.S. withholding tax.

- There are no exclusions for interest (*e.g.*, interest on shareholder debt) or other payments in connection with financial transactions other than derivatives. Moreover, there is an unfavorable rule that treats any interest expense that is non-deductible under the limit described in "Limitation on the Deductibility of Net Interest Expense" above as paid to unrelated parties for purposes of the BEAT, which maximizes the deductible interest that is treated as paid to related parties and therefore subject to the BEAT.
- "Affiliate" is construed broadly for this purpose, and includes not only entities that are "controlled" by, or "control," the U.S. taxpayer but also entities that own as little as 25% of the taxpayer (by vote or value) or are controlled by, or control, such owners.

- The tax due equals the excess of (a) the minimum tax rate applied to the corporation's taxable income after adding back base erosion payments over (b) the corporation's tax liability at the regular corporate rate.
  - *Rates*:
    - The minimum tax rate is 5% in 2018, 10% in 2019 through 2025, and 12.5% in 2026 and later years.
    - Increased rates apply to U.S. affiliated groups that include a bank or registered securities dealer: 6% in 2018, 11% in 2019 through 2025 and 13.5% in 2026 and later years. However, as noted above, the base erosion tax does not apply to most payments in connection with derivatives which are marked to market.
  - *Tax Credits*: In calculating a corporation's tax liability at the regular corporate rate for purposes of the BEAT, tax credits are generally taken into account, thereby increasing the BEAT liability. However, in 2018 through 2025, research tax credits and 80% of low-income housing and energy credits are excluded from the calculation, with the effect that these credits can mitigate BEAT liability.
- The BEAT applies to corporations with at least $500 million in annual gross receipts and for which base erosion payments represent at least 3% of total deductions (2% for a U.S. affiliated group that includes a bank or securities dealer). Aggregation rules apply to test related entities on a group-wide basis. Foreign corporations are subject to the rule if their income that is effectively connected to a U.S. trade or business meets the gross receipts and 3% tests.
- There is significant uncertainty about how the BEAT will be applied in practice. Guidance from the Treasury Department and the Internal Revenue Service is needed to clarify many aspects of the BEAT.
- *"Hybrid" transactions and entities.* The TCJA also disallows deductions for interest and royalty payments to foreign affiliates where the foreign recipient is not subject to tax on the payments due to a different characterization of the payment or the recipient (as to its regarded or transparent tax status) by the foreign jurisdiction.
- These provisions could have effects on the taxation and structuring of multinational portfolio companies and their supply chains.

— **Base Erosion – Low-Taxed Intangibles Income**.

- The TCJA targets the incentive to move operations offshore by expanding U.S. taxpayers' taxable income to include a new category of income: the "global intangible low-taxed income" or "GILTI" derived by the CFCs of which such taxpayers are 10% shareholders.
  - GILTI is taxed to individual shareholders at 100% of the applicable rate; and taxed to corporate shareholders at 50% of the usual rate (*i.e.*, a 10.5% rate) through 2025, and at 62.5% of the usual rate (*i.e.*, a 13.125% rate) in 2026 and later years.
- *Not Just Intangibles*. Despite its name, GILTI does not focus on intangibles. It is computed as the excess of the CFC's net income for the year (with certain exceptions) over a benchmark rate of return that is keyed off the CFC's basis in its depreciable assets.
  - As a result, GILTI will potentially subject to current U.S. taxes a significant portion of the income of CFCs that (i) earn high returns on assets (*e.g.*, intangibles), (ii) have assets that are not depreciable or have already been significantly depreciated, or (iii) have a business (*e.g.* sales or services) that does not require tangible assets.

- *Not Necessarily Low Taxed*.
  - 80% of foreign taxes attributable to the GILTI are creditable by corporate shareholders (subject to some limitations, including most notably no carryforwards or carrybacks of excess credits). As a result, a CFC would need to pay tax at an effective rate of 13.125% (through 2025) or 16.41% (in 2026 and later years) in order to avoid triggering tax for its corporate U.S. shareholders under this rule.
  - Individuals do not however get the benefit of these credits. In other words, individual U.S. shareholders of a CFC may be subject to tax at 100% of the applicable rate (see above) on their share of a CFC's GILTI, no matter how much tax the CFC has paid on that income.
- *Incentives for U.S. Production*. The TCJA also includes a special 13.125% tax rate (increased to 16.41% in 2026 and later years) for a domestic corporation's "foreign-derived intangible income," which is income related to services provided and goods sold by the domestic corporation for a foreign use, and is calculated in a similar manner as GILTI. This rule may encourage bringing some offshore intangible assets back to the United States.
- The TCJA's reduced rates on GILTI and foreign-derived intangible income of U.S. corporate investors, combined with the fact that the dividend exemption described in "Shift to a Territorial System" above is only available to U.S. corporate shareholders, should be considered in determining whether to hold certain foreign portfolio companies through U.S. corporate blockers.

— **Changes to CFC Attribution Rules**.

- In general, a CFC is defined as a foreign corporation that is directly or indirectly controlled by 10% U.S. shareholders who collectively own more than 50% of the foreign corporation's equity. Attribution rules apply for this purpose. However, under prior law, "downwards attribution" from foreign persons to U.S. persons did not apply.
- The TCJA expands the attribution rules applicable for CFC purposes, allowing downwards attribution from foreign persons to U.S. persons. This could cause a foreign corporation to be treated as a CFC in a situation where significantly less than 50% of the foreign corporation's equity is directly or indirectly owned by U.S. shareholders, in particular where such foreign corporation is affiliated with (but not a subsidiary of) another U.S. corporation. As a result, U.S. shareholders that directly or indirectly own or invest in at least 10% of the equity of a foreign corporation that was not previously treated as a CFC could become liable for tax on subpart F income and subject to the GILTI rules described above.
  - This change is effective beginning with the last tax year of a CFC that begins *before* January 1, 2018 (in other words, it will apply to the 2017 tax year for a CFC that is on a non-calendar tax year).
  - An explanation by the House-Senate Conference Committee indicates that the new downward attribution rule was not intended to result in income allocations to 10% U.S. shareholders who are not otherwise related (at a 50% level) with U.S. entities that are attributed ownership of the foreign corporation. However, the text of the TCJA does not include language to reflect that intent.
- The TCJA also expands the definition of a 10% U.S. shareholder to any U.S. person that owns 10% by value (as well as the current rule which looks to 10% of voting power).

— **Specific Industry Issues**. The TCJA has a number of industry-specific provisions that may affect your existing portfolio companies and prospective investments. For example:

- The TCJA modifies how insurance companies calculate their taxable income (and makes offshore insurance companies more likely to be PFICs), in ways that may negatively affect the insurance industry and their investors.
- The rules for like-kind exchanges are narrowed so as to only apply to real property.
- The TCJA imposes new reporting rules relating to the acquisition of life settlement policies.
- The TCJA provides numerous additional rules reducing the excise tax imposed on certain alcoholic beverages.

4. **Sponsor Issues: Carried Interest**.

— The TCJA includes a provision dealing with the treatment of carried interest.

— The provision is considerably simpler than carried interest provisions that have previously been proposed. *It is not a broad attack on carried interest.* Rather, for certain partnership profits interests (of the sort that generally would be issued by an investment partnership), it applies a 3 year holding period requirement for *capital gains* derived by the partnership (or from the disposition of the profits interest) to qualify for the long-term capital gains rate. It does not apply however to recharacterize the taxation of carried interest with respect to qualified dividends (*e.g.*, from a leveraged recap).

— These rules are clearly intended to capture profits interests issued by private equity or other investment funds, and generally cover the usual sort of carried interest arrangement. Given the fact that private equity funds often hold investments for longer than 3 years before realizing capital gains, in many cases the effect is unlikely to be material. It could be, however, that in odd situations the rules (perhaps unintentionally) will cover other partnership profits interests, such as profits interests granted to management of portfolio companies.

— From a more technical perspective, under the new carried interest provision:

- Long-term capital gain recognized with respect to an “applicable partnership interest” is recharacterized as short-term capital gain if the holding period is less than 3 years. Short-term capital gains are taxed to individuals at ordinary income tax rates.
  - The provision does not disallow the offsets of short-term capital losses against the recharacterized short-term capital gains.
  - The provision does not change the normal rules for determining holding periods, including tacking holding periods upon a tax-free contribution to a partnership. As drafted the rules do not appear to affect the rules for recognizing gains (*e.g.*, gains on sale of partnership assets look to the partnership’s holding period for the property and not the partner’s holding period in the partnership interest), although it is not entirely clear and it is possible the IRS could take a broader position.
- An “applicable partnership interest” is one transferred or held in connection with the provision of services by a taxpayer (or related person) in the trade or business of raising or returning capital, and investing in, disposing, identifying or developing “specified assets”, which are generally investment assets (securities, partnership interests, debt instruments, derivatives, real estate, etc.).

- There are a number of exceptions: (i) regulations will provide an exception for income or gain attributable to any asset not held for portfolio investment by third parties (*i.e.*, this should not apply to non-investment partnerships, although it may cover certain partnerships with a passive capital-providing partner); (ii) the rule does not apply to a partnership interest held by a corporation (which pays tax on capital gains at the same rate as ordinary income); (iii) the rule does not apply to capital interests commensurate to contributed cash, or to the extent included as compensation for services under section 83 (note that this does not technically apply to interests acquired for cash in a secondary transaction, and it does not cover capital interests that reflect prior allocations of taxable income).
  - It will need to be clarified whether investments made on a fee-free or carry-free basis might not be treated as "commensurate" with the capital invested; if not then this rule may apply also to co-investments by investment professionals as well as the carried interest.
- Any gains from a transfer of an applicable partnership interest to a "related party" (defined as a family member or a person who performed services within the prior three years in the same applicable trade or business), that are attributable to an asset held by the partnership for not more than 3 years, will also be treated as short-term capital gains.
  - It is unclear what this provision is intended to cover that is not already covered by the general rule. One possibility is that it covers the transfer to a related party of a partnership interest with a long-term holding period in a partnership that has assets with a holding period of 3 years or less. A second possibility is that it is intended to cause recognition of otherwise non-taxable transfers to related persons.

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