CLEARY GOTTLIEB

ALERT MEMORANDUM

Tax Cuts & Jobs Act: Considerations for Funds

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On November 2, 2017, the much anticipated Tax Cuts & Jobs Act was introduced in the U.S. House of Representatives. The bill was amended several times before being approved by the House Ways & Means Committee on November 9.

On November 9, the Senate introduced its own version which, while having many similarities, is also significantly different (although the Senate's version is reflected only in a description, not legislative text).

This memorandum sets forth a few key observations about the proposed bills that may be relevant to private equity and other investment funds. It must be emphasized, however, that the House and Senate bills are likely to go through many additional changes before a single agreed-upon version becomes law, if ever.

1. **Fund Issues**.

— **Deemed Repatriation**. Under both the House and Senate bills, *any* 10% U.S. shareholder of a foreign corporation (determined on December 31, 2017) would be required to include its proportionate share of the foreign corporation's undistributed earnings, even if the foreign corporation is not otherwise a controlled foreign corporation (CFC).

- This could generate significant phantom income in 2017 with respect to 10%-or-greater owned foreign portfolio companies both (i) for U.S. taxable investors (including the GP and its owners) in funds organized in the United States and/or (ii) for U.S. sponsors of non-U.S. funds. *Sponsors may want to identify the investments that may be subject to this one-time inclusion to consider the magnitude of the potential tax payable as well as whether any steps can be taken to minimize the tax.*

- Tax Payable:
  - The Senate bill provides for rates of 5% and 10% (for earnings invested in tangible assets vs. cash), and the House bill provides for rates of 7% and 14%.
  - The tax can be paid over an 8-year period, although both bills provide for 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 Senate bill (but not the House bill) provides that gains from a sale of a partnership interest by a non-U.S. partner would be 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: A seller of a partnership interest would have to provide a certificate that it is not a non-resident individual or foreign corporation, and in the absence of such a certificate a purchaser would be required to withhold 10% of the gross purchase price (which the foreign seller should be able to recover by filing a U.S. tax return). If the purchaser does not withhold, the partnership itself would need to withhold on the purchaser's distributions to cover the withholding.
- This could have a significant effect on the structuring of fund investments as well as LP transfers.

— **State Pension Plans Subject To UBTI**. Under the House bill, the rules for unrelated business taxable income (UBTI) would be "clarified" to subject state pension plans, and certain other state and local governmental entities, to tax on UBTI. This proposal has appeared in multiple bills over the years (including in the Camp tax reform proposal of 2014).

- The Senate bill does not contain this proposal.
- If the proposal survives (and if it is determined that it is constitutional and enforceable), it would apply to taxable years beginning after December 31, 2017, with no grandfathering for preexisting investments. If enacted, this provision could have a significant impact on fund structuring.

— **Some Changes to the Tax Rate Applicable to Individual Investors' Income**.

- House's 25% Rate:
  - Under the House bill, there is a new 25% tax rate for individuals investing in partnerships. However, that rate does not apply to capital gains and qualified dividends (which will continue to benefit from the lower rates under current law), or to most interest income, and certain other categories of income. As a result it should not affect the large majority of income typically realized by private investment funds. This change may, however, be beneficial for hedge funds, private equity investments in flow-through entities (like LLCs) and certain other investments.
  - *Hedge Funds*. The bill does not appear to exclude "mark to market" gains from the provision. As a result, absent further changes in the bill, individuals investing in hedge funds that have made an election as a "trader" under section 475 may be able to obtain the 25% rate.

  - *Flow-through deals*. A portion of the income realized by individual limited partners, and potentially a portion of the carried interest, from investments in flow-through entities engaged in active business (including many MLPs) should qualify for the 25% rate.
  - *REITs*. Dividends from REITs would also be eligible for a 25% rate. This would enable real estate investing (including also real estate mortgages) to be done through REITs with a preferential tax rate.
- The Senate bill reduces somewhat the tax rates that apply to individuals (for a top rate of 38.5% against 39.6% today). In addition, it provides for a 17.4% deduction against business income that is received through a partnership (with a cap equal to 50% of the W-2 compensation treated as paid by the taxpayer).

— **Itemized Deductions**. Both the House and the Senate bills would repeal the overall limitations on itemized deductions (the 3% phase out and 80% cap), effective for taxable years after December 31, 2017.

- In addition, *the Senate bill would repeal most miscellaneous itemized deductions, such as, most importantly for funds, investment expenses* (*e.g.*, deductions for management fees or other partnership expenses). The House bill does not have a similar provision.

— **State and Local Taxes**: Generally, neither bill would allow individuals to claim deductions for state and local income taxes. However, both bills would allow deductions for state and local property, sales etc. taxes attributable to a trade or business (e.g., management company).

2. **Portfolio Company Issues**.

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

- For corporations, the bill would lower the U.S. corporate tax rate to 20% and the corporate alternative minimum tax would be eliminated. Under the House bill, the rate reduction would be effective starting in 2018. The Senate bill would delay this for one year and have the rate reduction effective starting in 2019.
- For pass-through entities in which a fund invests, the House bill would generally reduce the tax rate applicable to certain individual investors to 25%, and the Senate bill would provide for a 17.4% deduction against business income (capped at 50% of the W-2 wages paid).
- However:
  - There are significant limitations on interest deductions (see below).
  - Many other tax preferences would be eliminated (*e.g.*, section 199 domestic production deduction).
  - The deduction for dividends received from less-than-80% owned U.S. corporations would be reduced such that the effective tax rate for these dividends is the same as under current law (i.e. unaffected by the lower 20% corporate rate).
  - The reduction in tax rates will mechanically reduce the value of any tax assets owned by portfolio companies (*e.g.*, value of tax receivable agreements and deferred tax assets for transaction expenses or NOLs).

— **Limitations on the Deductibility of Net Interest Expense**. Both bills contain two separate limits on net interest expense deductions. In each bill, the "worst of" the two rules will apply. The proposals would apply to any debt outstanding on January 1, 2018; *there is no grandfathering*.

- *First Rule. 30% Earnings Limit.* In both bills, the first rule would limit the deduction for net business interest expense to 30% of adjusted taxable income (similar to EBITDA in the House bill and EBIT in the Senate bill).
  - This 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.
  - This rule may significantly increase the after-tax cost of financings for LBOs, and may make preferred equity financings more attractive than debt financings in some cases.
  - It is unclear whether interest paid on shareholder loans at a blocker level would be treated as "business interest" or, rather, as attributable to an investment in an underlying portfolio company. If the shareholder debt is treated as business interest then the bill 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.
  - 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 leverage in a tiered partnership scenario, and related allocations, may affect deductibility.
- *Second Rule. Limit based on Groupwide Leverage.* Both bills also include a rule intended to limit the net interest expense deductions of companies that are overleveraged in the United States compared to the company's global operations.
  - The net interest expense of U.S. borrowers would be capped at 110% of the U.S. share of the group's overall EBITDA (in the House bill) or the group's global leverage ratio (in the Senate bill).
  - This rule is a blunt instrument. It may deny interest expense deductions if U.S. operations have higher leverage as a result of different capital needs for different types of business inside and outside the United States. The rule could also affect groups with low overall leverage, if that leverage is unevenly distributed between the group's U.S. and global operations – there is no de minimis exception.
  - This rule could limit the ability to push debt into the U.S. entities within a multinational group, and could mean that acquiring or selling businesses outside the U.S. could have implications for U.S. interest deductions.

— **Limits on Deductibility of NOLs**. Both bills would place limits on the ability to deduct NOLs.

- Carrybacks of NOLs would no longer be allowed. However, carryforwards would become indefinite (with an inflation adjustment, in the House bill). The carryback and carryforward rules would apply only to NOLs that arise in taxable years beginning *after* December 31, 2017.
  - This may be relevant in modelling returns, and should be taken into account in considering the impact of "transaction tax benefits" (*e.g.*, bonuses and refinancing costs).
- A company would be able to deduct NOLs only to the extent of 90% of the company's taxable income under the proposal. Since this rule applied in the AMT context under current law this means that, in many cases, the effective tax rate for the use of NOL carryovers is not changing materially.

    - The 90% restriction would apply to taxable years beginning after December 31, 2017. Under the House bill (but not the Senate bill), the 90% restriction would *not grandfather preexisting NOLs*.
    - This proposal—together with the proposed 20% corporate rate—could significantly reduce the benefit of NOLs in existing portfolio companies.

— **Expensing of Certain Assets**. Both bills would allow a taxpayer to immediately expense the entirety of the cost of "qualified property" acquired and placed in service before January 1, 2023.

- The short life of the rule would create an incentive to acquire assets eligible for immediate expensing within the next 5 years (including stock purchases with a section 338 or 336 election), or to structure transactions as asset sales or deemed assets sale during that 5 year period.
- "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. In determining the benefit of selling assets vs. selling stock, the relative value of immediate expensing for the purchaser may need to be balanced against additional corporate-level gains attributable to intangibles or other non-qualified property.

— **Shift to a Territorial System**. Both bills would adopt a territorial system of international taxation, effective January 1, 2018.

- A one-time transition tax would be imposed on the earnings of foreign subsidiaries (in the House bill, at a rate of 14% on liquid assets, and 7% on illiquid assets; and in the Senate bill at rates of 10% and 5%), effectively "unlocking" the trapped cash held offshore by U.S. multinationals.
- Under the new system, dividends received by a portfolio company that is a U.S. corporation from its 10%-or-greater-owned foreign subsidiaries would generally be exempt from tax if attributable to foreign source income.
- The bill would repeal 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.
    - This would greatly simplify the acquisition of multinational groups and their financing. It is possible that even prior to the bill becoming law, credit agreement negotiations may start to take into account potential changes of law (*e.g.*, springing credit support).
- There are a few notes of caution however:
    - 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% will be fully taxable (with potential for foreign tax credit relief). In addition, gain from the sale of shares of foreign companies is generally not exempt from tax (though the Senate bill would provide a potential exemption for a portion of such gains from the sale of a CFC). There may be a significant benefit to selling foreign assets and deriving exempt dividends as compared to selling foreign shares.

— **Base Erosion – Low-taxed Intangibles Income**. Under the House bill, U.S. shareholders of CFCs would be subject to tax on a current basis on 50% of a CFC's returns in excess of a certain threshold which is keyed off the CFC's depreciable assets (resulting in a 10% rate). Under the Senate bill, subpart F income would include a new category of "global intangible low-taxed income" taxed at 62.5% of the usual rate (*i.e.*, a 12.5% rate). These rules most likely are intended to capture CFCs that earn high returns on assets consisting of intangibles or that have assets that are not depreciable or that have already been significantly depreciated.

— **Base Erosion – Outbound Payments**. Both the House and the Senate bills impose tax on outbound payments to foreign affiliates.

- The Senate bill provides for a minimum tax of 10% of taxable income for certain large U.S. corporations, as adjusted for base erosion payments to foreign affiliates. The Senate bill also disallows deductions for interest and royalty payments to foreign affiliates that are hybrid payments or made to hybrid entities.
- The House bill would impose a 20% excise tax on certain payments to foreign affiliates, with an option to elect to treat those payments (less deemed expenses) as ECI instead.
- Each provision could have effects on the taxation and structuring of multinational portfolio companies and their supply chains.

— **Changes to CFC Attribution Rules**.

- Under current law, a CFC is 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 in determining who is a 10% shareholder for purposes of determining whether a foreign corporation is a CFC. However, "downwards attribution" from foreign persons to U.S. persons does not apply.
- Both bills would expand the attribution rules applicable for CFC purposes, allowing downwards attribution from foreign persons to U.S. persons. This could cause foreign corporations to be treated as CFCs in situations where significantly less than 50% of the foreign corporation's equity is directly or indirectly owned by U.S. shareholders, particularly 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 is not treated as a CFC under current law could become liable for tax on subpart F income and subject to the rules for low-taxed foreign intangibles income described above.
- The Senate bill 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)

— **Deferred Compensation (Senate bill only)**. The Senate bill (but not the House bill) would significantly limit the flexibility of non-qualified deferred compensation (*e.g.*, such as equity options) as a tax-efficient form of compensation for portfolio company management. This may significantly impact the incentive structure for the management teams in your portfolio companies.

- Performance vesting does not allow for deferral. Non-qualified deferred compensation would be included in income immediately upon vesting, with only service-based conditions (which would not include a non-compete) respected as vesting conditions that prevent immediate income inclusion. Performance-based conditions (*e.g.*, return thresholds or the occurrence of an IPO or qualifying exit) would not be treated as vesting conditions for this purpose.
- The rule would not apply to compensation in the form of property that is subject to section 83 (*e.g.*, restricted stock), but would otherwise cover deferred equity compensation (*e.g.*, options, SARs, RSUs or other deferred payments). The rule would not change the treatment of the grant of profits interests.
- The proposal would require all preexisting deferred compensation to be included in income by 2026 or the year it vests, whichever is later.
- The bill would eliminate current law sections 409A and 457A, with related benefits of simplicity.

— **Specific Industry Issues**. Both bills have a number of industry-specific provisions that may affect your existing portfolio companies and prospective investments.

- For example, both bills would modify how insurance companies calculate their taxable income (and make offshore insurance companies more likely to be PFICs), in ways that may negatively affect the insurance industry and their investors.
- In addition, in the House proposal, the tax-exempt treatment of interest on private activity bonds would be repealed, the benefits of certain renewable energy tax credits would be narrowed, and research and experimentation expenses would be required to be amortized rather than immediately deducted. In both the House and the Senate bills, the rules for like-kind exchanges would be narrowed so as to only apply to real property. The Senate bill would impose new reporting rules relating to the acquisition of life settlement policies.

3. **Management Company and Individual Issues**.

— **Carried Interest**. The House bill proposes a carried interest provision. The Senate bill does not have a similar provision.

- The provision in the House bill 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 would cover the usual sort of carried interest arrangement. Given the fact that private equity funds often hold investments for longer than three 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 (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" if the holding period is less than 3 years is recharacterized as short-term capital gain. 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 would provide an exception for assets 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).
  - 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 income.
- 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, would 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.

— **Reduced Rate for Business Income from Pass-Through Entities**. As noted on page 3 above, the House bill provides that individual owners of pass-through entities would be subject to a 25% maximum rate on the entity's business income (the portion not treated as attributable to the performance of services or to interest or dividends). The Senate bill provides for a 17.4% deduction for business income received through pass-through entities, with a cap equal to 50% of W-2 wages. In either case, because of limitations applicable to specified services businesses, these reduced rates are unlikely to apply to the individual owners of fund management companies.

— **Deferred Compensation (Senate bill only)**. As noted on page 6 above, the Senate bill (but not the amended House bill) significantly limits the ability to use non-qualified deferred compensation arrangements. This would not apply to carried interest, but could apply to "phantom" carry plans utilized by fund sponsors.

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