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ALERT MEMORANDUM

Tax Cuts & Jobs Act: Considerations for Funds

January 2, 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"). Most of the TCJA's provisions take effect January 1, 2018.

The TCJA introduces significant changes to the U.S. tax system. This memorandum sets forth a few key observations about the TCJA that may be relevant to private equity and other investment funds.

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1. **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. 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 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 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, a seller of a partnership interest will have to provide a certificate that it is not a foreign person, and in the absence of such a certificate a purchaser will be required to withhold 10% of the gross purchase price, including assumption of debt (which the foreign seller should be able to recover or credit by filing the required U.S. tax return). If the purchaser does not withhold, the partnership itself will need to withhold on distributions to the purchaser to cover the withholding.
- 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 as well as LP transfers.

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

- The TCJA reduces somewhat the tax rates that apply to individuals (for a top rate of 37% against 39.6% today). This rate reduction expires after 2025.
- In addition, it provides for a deduction for purposes of income tax equal to 20% of qualified business income that is earned by non-corporate taxpayers through a partnership, S corporation or sole proprietorship, resulting in a federal tax rate of 29.6% for a top bracket individual. 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 (although there is an exception for some individual taxpayers whose income is below $207,500 ($365,000 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 partnership, S corporation or sole proprietorship or (b) the taxpayer's allocable share of 25% of such W-2 compensation plus 2.5% of the unadjusted acquisition cost of the pass-through entity's tangible assets. The cap does not apply to certain individuals whose income is below the specified thresholds.
  - 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 treated as engaged in services businesses and therefore ineligible for the 20% deduction.
- *REITs*. The TCJA also provides for a deduction equal to 20% of certain dividends from REITs and cooperatives. The 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). The 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**. 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 difference between the two rates is significantly smaller than under current law (39.6% for flow-through income vs. 52% for income earned through a corporation), and (ii) the corporate tax form allows for deferral (*i.e*., taxation of earnings at 21% until dividends are paid or anti-abuse rules apply).

— **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., 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.

2. **Portfolio Company Issues**.

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

- For corporations, the TCJA lowers the U.S. corporate tax rate to 21%, effective starting in 2018.
- Additionally, the corporate alternative minimum tax is eliminated.
- For pass-through entities in which a fund invests, the TCJA provides for a 20% deduction for individuals, trusts and estates against business income (capped at the greater of 50% of the W-2 wages paid or 25% of the W-2 wages plus 2.5% of tangible assets, and expiring after 2025).
- However:
  - There are significant limitations on interest deductions (see below).
  - Many other tax preferences are eliminated (*e.g.*, section 199 domestic production deduction).

    - The deduction for dividends received from less-than-80% owned U.S. corporations is reduced such that the effective tax rate for these dividends is similar to current law (although, it should be noted that the relative benefit of the dividends received deduction has been reduced).
    - 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).

— **Limitation on the Deductibility of Net Interest Expense**. The TCJA 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.

- 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, leasing, or other interest equivalents more attractive than debt financings in some cases.
- Particularly in 2022 and later years, for companies with significant expenditures eligible for expensing, there may be little or no capacity for interest deductions, due to the change from EBITDA to EBIT. That change would apply to any debt instruments that exist at that time (there is no grandfathering), creating a cliff effect, and therefore U.S. borrowers should take into account the switch to EBIT in considering their current debt profile.
    - Additionally, this change may encourage acquisitions of tangible assets eligible for 100% expensing (described in "Expensing of Certain Assets" below) in taxable years before 2022, to accelerate depreciation deductions into earlier years and increase capacity for interest expense deductions in 2022 and later years.
- 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 for a credit business may have interest income, which will reduce the effect of the limit on *net* interest expense.
- 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.

— **Limits on Deductibility of NOLs**.

- Under the TCJA, carrybacks of NOLs are no longer allowed. However, carryforwards become indefinite. The 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.
    - This will 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 may use NOLs to offset a maximum of 80% of the company's taxable income, for taxable years beginning after December 31, 2017 (with unused NOLs carried forward into future years).

  - The 21% corporate rate could significantly reduce the benefit of NOLs in existing portfolio companies, and therefore reduce the value of the companies' deferred tax assets.

— **Timing Issues**. The TCJA requires most accrual-method taxpayers to take items of income into account for tax purposes no later than the time it is 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 a taxpayer to immediately expense the entirety of the cost of "qualified property" acquired and placed in service before January 1, 2023. Immediate 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 is phased out completely 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 9-10 years.
  - Immediate expensing applies to purchases of used as well as new items, and thus may create incentives to structure stock purchases with a section 338 or 336 election, or to structure transactions as asset sales or deemed assets sale, during the 9 year period to which the rule applies. However, in determining the benefit of selling assets vs. selling stock, the relative value of immediate expensing for the purchaser will still need to be balanced against additional corporate-level gains for sellers.
  - "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.

— **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", 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 also does not apply to foreign corporations that are passive foreign investment companies.
    - The exemption is available only to U.S. corporate shareholders who have held foreign subsidiary stock for at least 1 year.
    - 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 gains recharacterized as dividends under section 1248 are exempt). There may be a significant benefit to selling foreign assets and deriving exempt dividends as compared to selling foreign shares.

- A domestic S corporation which owns 10% or more of the stock of the foreign corporation appears to be eligible for the participation exemption, in which case large individual shareholders (or groups of individual shareholders) may benefit from transferring the stock in a foreign corporation they own into an S corporation. There are additional consequences to owning an interest in an S corporation that individual shareholders should consider before undertaking such a transfer.
- 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. shareholders, pledges of CFC stock to support borrowings of U.S. 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 to place significant limitations on the structuring of debt incurred by U.S. entities with significant foreign assets.

— **Base Erosion – Low-Taxed Intangibles Income**. Under the TCJA, a U.S. shareholder's income includes a new category of "global intangible low-taxed income" taxed 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 for corporate investors, and at 100% of the usual rate (*i.e.*, a maximum rate of 37%) for individual investors. This rule most likely will capture CFCs that (i) earn high returns on assets consisting of 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.

  - On the other hand, 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 "global intangible low-taxed income." This rule may encourage bringing some offshore intangible assets back to the United States.
  - The TCJA's reduced rates on intangible income of U.S. corporate investors, combined with the fact that the dividend exemption described 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.

— **Base Erosion – Outbound Payments**.

- The TCJA imposes a minimum tax (called the "BEAT") on corporations' taxable income after adding back outbound payments to foreign affiliates.
  - The tax due equals the excess of (a) the minimum tax rate applied to the corporation's taxable income after adding back the outbound payments over (b) the corporation's tax liability at the regular corporate rate.
    - The minimum tax rate is 5% in 2018, 10% in 2019 through 2025, and 12.5% in 2026 and later years.
    - In calculating tax liability at the regular corporate rate, certain credits are not taken into account, with the effect that the credits can mitigate the amount of minimum tax paid.

    - The minimum tax only applies to certain large U.S. corporations with outbound payments exceeding a specified threshold.

- The TCJA also disallows deductions for interest and royalty payments to foreign affiliates that are hybrid payments or made to hybrid entities.
- These provisions 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.
- The TCJA expands 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.
    - An explanation by the House-Senate Conference Committee indicates that the new downward attribution rule was not intended to result in new 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).

— **Deferred Compensation**. The TCJA generally leaves intact the current regime for deferred compensation (though previous drafts of the TCJA included very significant changes). However:

- The TCJA includes a new deferral provision for certain types of broad-based employee equity, which may apply to certain private companies.
- The TCJA expands the group of covered employees that are subject to the $1 million cap on deductible compensation to include the CFO as well as the CEO, and repeal the exception from this rule for performance-based compensation. The TCJA grandfathers compensation vested prior to 2017 under existing contracts.

— **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.

- In addition, 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.

3. **Management Company and Individual 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 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 will 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, 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.

— **Reduced Rate for Business Income from Pass-Through Entities**. As noted above, the TCJA provides for a 20% deduction for business income received through pass-through entities, with a cap equal to the greater of 50% of W-2 wages or 25% of W-2 wages plus 2.5% of tangible assets, expiring after 2025. Because of limitations applicable to specified services businesses, the reduced rate is unlikely to apply to the individual owners of fund management companies (although individuals earning amounts below a $207,500 threshold may be able to avail themselves of lower rates).

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