KIRKLAND & ELLIS

KIRKLAND **ALERT**

November 8, 2017

New Tax Bill Could Dramatically Impact Private Equity Funds and Public Companies

House Republicans' tax bill could dramatically impact current market practices.

On November 2, 2017, House Republicans published their highly anticipated tax reform bill (as amended through November 6, the **"House Proposal"**). The House Proposal, if enacted, would represent the most significant revision of the Code[1] since the Tax Reform Act of 1986, and could dramatically impact current market practices for raising investment capital, organizing business operations, structuring and financing M&A transactions, and compensating service providers. The House Proposal can be expected to change significantly as the process moves forward.

In particular, the House Proposal in its current form would:

- Reduce the corporate income tax rate from 35% to 20%;
- Create a new 25% preferential tax rate for investors in certain flow-through businesses (mainly "passive" investors and investors in, and owners of, capital intensive businesses);[2]
- Impose a three-year holding period requirement in order for income with respect to carried interest to be eligible for long-term capital gains tax rates;
- Limit the amount of interest deductions available to a leveraged business to 30% of EBITDA (as specifically defined for tax purposes);
- Expand the tax base for Medicare and other self-employment taxes;
- Substantially change the taxation of incentive equity and deferred compensation issued to management individuals;
- Impose tax on the unrelated business taxable income of state and local public pension plans; and
- Fundamentally overhaul the taxation of cross-border investments.

This *Kirkland Alert* summarizes the key business provisions of the House Proposal as well as certain of the practical effects that it would have on transactional actions of publicly traded companies and private equity funds ("PE Funds") and their portfolio companies and the choice of entity through which to operate and acquire businesses.

The House Proposal is controversial, creating a number of winners and losers. As a result, the bill may change significantly as the path to tax reform unfolds.

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Procedurally, the House Ways and Means Committee is expected to consider and markup the House Proposal over the course of the next few days, and its Committee Chairman Kevin Brady (R-TX) has suggested that further amendments may be made to the bill. Separately, the Senate Committee on Finance is expected to release a competing tax reform bill sometime this week.

Updates to this *Kirkland Alert* will be provided as tax reform progresses through Congress.

I. Reduced 20% Corporate Tax Rate

Under current law, income of corporations is subject to tax at graduated rates of up to 35%. The House Proposal would reduce the corporate tax rate to 20%. This reduced rate would be effective beginning in 2018, without any phase-in.[3] As described in further detail below, this and other changes may significantly alter the decision-making process on choice of entity and structuring in M&A and private equity transactions.

II. 25% Rate on Flow-Through Business Income

One of the biggest changes to current law in the House Proposal is a preferential 25% tax rate for certain flow-through business income earned by non-corporate taxpayers. While the rules regarding the preferential 25% tax rate are complex and may evolve in future iterations of the House Proposal, the relevant considerations in the current version of the House Proposal are detailed below.

a. Passive Flow-Through Business Income

Under the House Proposal, all of a taxpayer's "passive" flow-through business income is taxable at a preferential 25% rate. Whether flow-through business income is "passive" with respect to a taxpayer turns on the application of a facts and circumstances test, the primary focus of which is the amount of time the taxpayer spends in connection with the activity that generated the income.[4]

b. Active Flow-Through Business Income

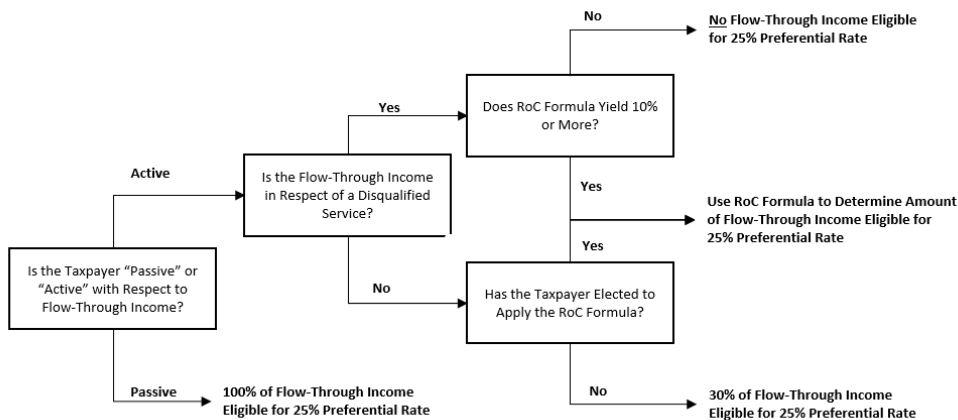
If a taxpayer's flow-through business income is treated as active, rather than passive, the general rule under the House Proposal is that 30% of the taxpayer's eligible flow-through business income is eligible for the 25% preferential rate (the **"30% Rule"**). The remaining 70% of the taxpayer's income from such business is subject to the ordinary income tax rates otherwise applicable to the taxpayer (leading to a blended rate of approximately 35%). Importantly, however, if the taxpayer is actively engaged in a capital intensive business, he or she may elect to use a formula designed to approximate the percentage of the taxpayer's income that represents a reasonable return on capital assets to determine the percentage of active income that is eligible for the 25% preferential rate (the **"RoC Formula"**).[5]

Notwithstanding this general rule, the 30% Rule does not apply with respect to activities involving the performance of personal services in specified fields. These specified fields include health, law, engineering, consulting, financial services, and investing, trading or dealing in securities (a **"Disqualified Service"**). Notably, the provision of investment management and advisory services by a management company of a PE Fund will likely constitute a Disqualified Service.

As a result, a taxpayer's active flow-through business income from a Disqualified Service business is generally never eligible for the 25% preferential rate. There is a narrow exception to this unfavorable rule. If a Disqualified Service business is sufficiently "capital intensive" that the RoC Formula yields 10% or more, the House Proposal permits taxpayers to elect to apply the RoC Formula to determine the percentage of income subject to the 25% preferential rate, notwithstanding that the activity generates income from Disqualified Services. Such an outcome is generally unlikely in the context of a Disqualified Service business, in which the provision of services is the predominant business activity.

These rules are illustrated and summarized in the flow-chart below:

25% Preferential Rate Eligibility Under the House Proposal



c. Implications for Investors and M&A

These rules would considerably alter how one might evaluate a flow-through investment. First, passive individual investors, active individual investors and corporate investors in any particular flow-through business would be subject to substantially different tax rates with respect to the operating income of the business. This has implications on how tax distributions from a pass-through entity are addressed,[6] and the benefit of granting partnership "profits interests" to managers.[7] Also, the benefit of maintaining a flow-through structure in a 20% corporate tax rate environment, especially where a substantial portion of the investment must be held through a corporation for other reasons (e.g., to accommodate significant non-U.S. or unrelated business taxable income-sensitive investors), would need to be carefully considered and modeled, particularly if the target's business consists primarily of Disqualified

Services in which only passive investors will generally be eligible for the favorable 25% tax rate. Finally, the reduced tax rate on flow-through and corporate income would significantly reduce the value of a stepped-up asset basis in many cases.

III. Holding Period for Long-Term Capital Gains Tax Rate on Carried Interest

Under current law, investment professionals who hold so-called "carried interest" in an investment partnership are entitled to flow-through capital gains treatment with respect to such partnership's investments. The taxation of carried interest has been a political flashpoint, and various proposals have been introduced over the years that would have changed the taxation of carried interest. Although the original House Proposal did not include any provisions regarding carried interest, an amendment to the House Proposal added by House Ways and Means Committee Chairman Brady on November 6 generally would require a three-year holding period in order to access the long-term capital gains rate with respect to (i) income allocated by an investment partnership (including partnerships that hold real estate investments) to carried interest holders and (ii) sales of partnership interests that represent carried interest, in each case for years beginning after December 31, 2017.

In particular, if a person is granted a partnership interest directly or indirectly in connection with the performance by the person of substantial services in any "applicable trade or business," such person's share of capital gains on partnership investments held not more than three years will be treated as short-term capital gains, taxed at ordinary income rates and generally subject to the 3.8% Medicare tax. Such person's share of capital gains on partnership investments held more than three years will be eligible for the long-term capital gains tax rate and generally subject to the 3.8% Medicare tax.

An "applicable trade or business" for these purposes is the business of raising or returning capital and investing or disposing of "specified assets" or developing "specified assets." "Specified assets" are securities, real estate held for rental or investment, cash/cash equivalents, and derivatives, and including through tiered partnerships. There are important exceptions for the investor's capital interest in the partnership, and for "profits interests" granted to service providers employed by a business that is not an applicable trade or business (i.e., an actual employee in the underlying operating business as opposed to an employee of the PE Fund).

IV. Taxation of Business Operations

The House Proposal contains a number of additional provisions intended to adjust the manner in which business operations are taxed in the United States.

a. Limited Interest Expense Deduction

Under current law, businesses are eligible for a deduction for all interest paid or accrued on a debt instrument except in certain limited circumstances (e.g., due to the application of certain related-party earnings-stripping rules).

The House Proposal modifies the deductibility of interest in two ways, without grandfathering for existing debt:

- **New 30% EBITDA Limit.** The House Proposal limits the deduction for net business interest expense to 30% of a taxpayer's "adjusted taxable income." For these purposes, "adjusted taxable income" is defined in a manner that roughly approximates EBITDA. Any interest that is disallowed as a deduction may be carried forward up to five years.[8]

- **New Worldwide Debt Limit.** The House Proposal curtails the deductibility of interest payments for U.S. corporations who are members of a multinational tax group.[9] Where these rules apply, the U.S. corporation's ability to deduct interest is tied to the U.S. corporation's share of the aggregate global earnings of the multinational group. Any disallowed interest expense would be carried forward for up to five tax years.

The impact of these interest deduction limitations on any particular investment should be carefully modeled in connection with the other changes discussed herein, including the significant reduction in the corporate tax rate, which may mitigate the effect of limitations on the deductibility of interest in whole or in part.[10]

b. 100% Expensing of Qualified Property

Under current law, the cost of capital investments in personal property made by taxpayers generally may be recovered through depreciation deductions over 3, 5 or 7 year periods. The House Proposal would allow taxpayers to immediately write-off 100% of the cost of "qualified property" acquired and put in service after September 27, 2017, and before January 1, 2023. "Qualified property" generally includes tangible personal property with a recovery period of 20 years or less under current law and certain computer software. Qualified property does not include property used by a regulated public utility company or property used in a real property trade or business (each such business is not subject to the 30% EBITDA limit on the deductibility of interest described above).

c. Net Operating Losses

Under current law, net operating losses **("NOLs")** generated by a corporate taxpayer may generally be carried back two taxable years and carried forward 20 taxable years. Under the House Proposal, NOLs arising for tax years beginning after December 31, 2017, may be carried forward indefinitely (and increased over time at a rate per annum of the AFR + 4%), but NOL carrybacks would generally be prohibited. In addition — drawing from the alternative minimum tax regime in effect under current law — the House Proposal would permit a corporation to use NOLs to offset only 90% of its income in a given taxable year.

While the carryforward features of the House Proposal are generally welcomed, the repeal of a corporation's carryback ability may prove costly to certain taxpayers. For example, an otherwise profitable corporation that generates losses during an industry downturn would not be able to look to refunds of taxes paid in profitable prior years to soften the blow of the downturn. In addition, PE Funds selling corporate portfolio investments would lose the ability to use transaction-related deductions

that create an NOL in the year of sale to obtain refunds of prior year taxes paid by the portfolio company.

d. Denial of Capital Gains Rate for Certain Self-Created Intangible Property

The House Proposal denies capital gains rates to inventors and other entrepreneurs who sell self-created patents or other similar intellectual property (whether or not patented). This could substantially change how such persons view the value of such assets (whether sold individually or in flow-through form) and puts pressure on the allocation of purchase price in transactions where a seller would prefer an allocation to goodwill to facilitate capital gains treatment and a buyer would prefer an allocation to intellectual property subject to this rule to facilitate future tax planning.

e. Taxation and Deductibility of Compensatory Amounts

The House Proposal substantially changes the taxation of compensatory amounts. Most notably, the House Proposal limits any deferral for non-qualified deferred compensation (including options) once the compensation is no longer subject to forfeiture (defined narrowly to include only service-related vesting requirements). In general, non-qualified deferred compensation would become taxable immediately following the expiration of a substantial risk of forfeiture, subject to a very limited exception aimed at start-up companies. In addition, public companies are denied a deduction for compensation paid to executives in excess of $1 million per year. Please see our *Alert* on executive compensation matters for more details.

For PE Funds, if the provisions regarding deferred compensation become law, it will likely be necessary to re-think the incentive package offered to portfolio company management, as traditional option and bonus plans may give rise to significantly negative tax results as compared to other alternatives. The proposals would similarly impact the compensatory arrangements traditionally utilized by public companies to incentivize employees.

V. Taxation of Service Providers and Expansion of Self-Employment Tax

The House Proposal would likely have the effect of meaningfully increasing the self-employment tax liability of investment fund professionals and owners of flow-through businesses.

Under current law, a limited partner is generally not subject to self-employment taxes with respect to its distributive share of partnership income.[11] Similarly, an owner of an S corporation is not subject to self-employment tax on its pro rata share of S corporation income.

The House Proposal would change current law by subjecting limited partners and S corporation shareholders to self-employment tax on the “labor percentage” of their allocable share of the income of a limited partnership or S corporation. The “labor percentage” is based on the portion of a taxpayer’s income that is not subject to the 25% preferential rate on flow-through income under the rules described in Section II. As a result, limited partners and owners of S corporations (particularly those per-

forming Disqualified Services) may be subject to substantial increases in the amount of their income that is subject to self-employment tax under the House Proposal.

VI. International Tax Reform

Under current law, a U.S. corporation is subject to tax on all of its worldwide income. In the case of foreign income earned by a U.S. corporation indirectly through a foreign corporate subsidiary, the U.S. corporation generally is not taxed on such income until the foreign subsidiary makes a distribution to the U.S. corporation (subject to the "controlled foreign corporation" and "passive foreign investment company" anti-deferral rules). To ameliorate double taxation of that income, the foreign tax credit system generally provides U.S. corporations with a credit for foreign taxes paid on the earnings of its foreign subsidiaries.

The House Proposal moves the U.S. international tax rules closer to a "territorial" regime in which foreign earnings are in many cases no longer subject to full U.S. tax, so that U.S. corporations are not dis-incentivized from repatriating those earnings to the United States.

a. 100% Participation Exemption for Foreign Dividends Received by U.S. Corporations

The House Proposal would, for the first time, enact a "participation exemption" system for U.S. corporations and their foreign subsidiaries. Under this system, no U.S. tax will be imposed on dividends received by a U.S. corporation from a foreign subsidiary if the U.S. corporation owns at least 10% of the voting stock of the foreign subsidiary and certain holding period requirements are met.[13] However, the participation exemption does not extend to (1) gain from the sale of foreign subsidiary stock (which remains subject to full U.S. tax) or (2) dividends received by U.S. non-corporate shareholders (such as individuals, partnerships, and LLCs).

b. Immediate U.S. Tax for 50% of Any "Foreign High Returns"

Despite the move towards a territorial system, the House Proposal also takes a step back towards a worldwide tax system by causing any 10% U.S. shareholder of a controlled foreign corporation to include in gross income on a current basis 50% of such U.S. shareholder's "foreign high returns" (whether or not such amounts are repatriated to the United States).

For this purpose, "foreign high returns" are generally the U.S. shareholder's pro rata share of the excess of (A) the aggregate net income of all controlled foreign corporations owned by such U.S. shareholder over (B) an amount intended to approximate a "routine return" on capital. The routine return is calculated as the product of (i) the aggregate amount of the U.S. tax basis in all depreciable tangible property held by such controlled foreign corporations multiplied by (ii) the AFR + 7%. No routine return is allowed for basis in intangible assets. However, a credit is available with respect to U.S. corporate shareholders for 80% of foreign income taxes actually paid with respect to the applicable foreign high return income.

c. One-Time Tax on Deferred Foreign Earnings

The benefits provided by the House Proposal's move toward a territorial regime come with a potentially significant transition cost in the form of a one-time tax on the deferred earnings of a foreign subsidiary. Specifically, any U.S. shareholder (whether corporate or non-corporate)[14] that owns 10% or more of the voting stock of a foreign corporation would be required to include in income its pro rata share of the foreign corporation's post-1986 accumulated earnings and profits ("E&P") to the extent those earnings were not previously subject to U.S. tax. E&P is measured on either November 2, 2017, or December 31, 2017, whichever produces a larger amount.[15] E&P retained in the form of cash and cash equivalents would be taxed at a 12% rate, and all other E&P (i.e., reinvested in illiquid assets) would be taxed at a 5% rate. U.S. shareholders may elect to pay the tax over a period of eight years, with no interest charge. Additionally, foreign tax credits would be partially available to offset the resulting tax liability.

For U.S. corporate portfolio companies of PE Funds, the one-time tax would generally be paid at the portfolio company level. However, for flow-through portfolio companies and non-U.S. portfolio companies, the one-time tax could be imposed at the PE Fund or investor level. The cost to U.S. multinational corporations holding large amounts of unrepatriated offshore cash will be significant, but the provision should have the desired effect of causing such companies to bring back such offshore cash for investment and for distribution to shareholders in the form of dividends and share buybacks. It should be noted that no attempt is made in the House Proposal to require U.S. corporations to use such cash in any manner (e.g., corporations are not required to use such cash, subject to tax at a 12% rate, for capital investment).

d. 20% Excise Tax on Payments to Related Foreign Corporations

The House Proposal would impose a new 20% excise tax on a wide range of "specified amounts" paid by a U.S. corporation to a related foreign corporation. A specified amount includes (1) any payment that produces a deduction for U.S. tax purposes (including a royalty payment or a service fee) and (2) any payment that is included in the cost of goods sold, inventory, or the basis of a depreciable asset (for example, the purchase of finished goods from a foreign affiliate). However, specified amounts do not include any interest payments or payments that are already subject to U.S. tax (including withholding tax). The excise tax does not apply to a financial reporting group that has annual global gross receipts of $100 million or less.

In lieu of paying the 20% excise tax, the foreign payee can elect to treat the payment as "effectively connected income" **("ECI")** and receive a deduction for the deemed expenses associated with such payment. The foreign payee's deemed expenses are calculated based on the ratio of net income of the foreign members of the group to the total revenue of such members with respect to the relevant product line, multiplied by 104% + the AFR. In calculating the amount of tax payable, the foreign payee is also entitled to a deemed foreign tax credit (calculated by reference to the group's overall foreign effective tax rate). As a result of the deemed expenses deduction, the ECI election will, in many cases, produce a smaller amount of overall tax, although the effect of branch profit taxes will need to be considered.

Like the anti-inversion rules and the more recent Code Section 385 debt/equity regulations, this 20% excise tax is aimed at preventing erosion of the U.S. tax base by eliminating U.S. tax benefits in the form of deductions or additional tax basis that result from payments made to foreign affiliates. Moreover, the 20% excise tax has elements of the previously-considered and dismissed border adjustment tax, although it would apply only to payments to related foreign affiliates (as opposed to any foreign party).

VII. Changes to Taxation of Certain Tax-Exempt Entities

Under current law, it is the long-standing practice of certain state and local public pension plans to take the position that they are not subject to tax on "unrelated business taxable income" **("UBTI")**, relying, in part, on Code Section 115 which excludes from gross income certain income accruing to State governments and their political subdivisions.

In a purported clarification of current law, the House Proposal provides that any organization exempt from federal income tax under Code Section 501(a), including state and local public pension plans, is subject to tax on UBTI even if the organization is also exempt under Code Section 115. If the House Proposal is enacted, public pension investors in PE Fund structures would generally be subject to federal UBTI tax on such investors' allocable share of (i) operating business income attributable to a portfolio company organized as a flow-through entity for U.S. tax purposes, such as a partnership or limited liability company, and (ii) income attributable to debt-financed portfolio acquisitions. However, it is unclear whether such UBTI would be taxed at the corporate rate (which would be reduced under the House Proposal to 20% as described above) or as flow-through business income subject to a preferential 25% rate under the Act. We would expect that where a public pension plan investor is organized as a trust and is a passive LP in the fund, that it would generally be taxed at the 25% rate.

If the House Proposal is enacted, public pension investors likely would vary in their sensitivity to UBTI generated by a PE Fund (similar to private pensions). However, private equity sponsors should expect that some public pension investors will become more sensitive to the structuring of flow-through investments and fund use of leverage to make debt-financed investments.

VIII. Real Estate Considerations

Notably, the House Proposal retains many of the long-standing tax preferences enjoyed by PE Funds investing in real estate. Real estate PE Funds and their investors can continue to effectuate like-kind exchanges of direct interests in real estate on a tax-free basis (notwithstanding the elimination of other assets from the benefits of tax-free like-kind exchanges). In addition, entities engaged in a real estate investment business generally are exempt from the new 30% interest expense limitation introduced by the House Proposal. And while real estate investments generally will not be entitled to the immediate 100% expensing of qualified property, the House Proposal has introduced a new 25% reduced tax rate (in lieu of the existing 39.6% maximum rate) applicable to ordinary REIT dividends.

IX. Conclusion

The House Proposal represents the first step in what is likely to be a long journey to tax reform. For reports on future tax reform developments and analysis regarding the application of proposed rules, please see our other *Kirkland Alerts*.

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1 References to the "Code" are to the Internal Revenue Code of 1986, as amended.

2 This *Kirkland Alert* generally refers to income attributable to sole proprietorships, S corporations and entities treated as partnerships for U.S. federal income tax purposes as "flow-through business income."

3 Certain personal services corporations would be subject to a 25% corporate rate.

4 It appears that the House Proposal intends the Treasury Department to adopt the current (temporary and complex) regulatory framework with respect to passive activity losses to determine whether the taxpayer's activities with respect to a category of flow-through income are "active" or "passive." Given the different purposes of the two provisions, it is unclear how these standards would be applied in practice if the House Proposal becomes law.

5 The RoC Formula is calculated as follows:

$$\frac{\textit{Tax Basis of Specified Capital Assets x (AFR + 7\%)}}{\textit{Net Business Income}}$$

Specified capital assets include amortizable intangible assets, the basis of which is reduced by regular depreciation and amortization. Thus, the percentage of income that is eligible for the 25% preferential rate using the RoC Formula may be different each year.

As an example, if a business (tested at the entity-level) has (i) $1,000 of tax basis in its capital assets and (ii) $200 of business income in a given taxable year, and if the short-term applicable federal interest rate at the close of the relevant tax year ("AFR") is 1%, then 40% of the taxpayer's income from the business would be entitled to the 25% preferential rate ($1,000 × (1% + 7%) = $80; $80 ÷ $200 = 40%).

The RoC Formula is further subject to a complex cap that may apply where a substantial portion of the taxpayer's income from an activity is attributable to wages, "guaranteed payments," or director's fees. This cap is designed to prevent the RoC Formula from recasting compensation for services as a return on capital assets.

6 For example, a manager rolling over in a flow-through deal would be subject to a top federal rate of 39.6% with respect to income allocated to such investor, except to the extent that the manager can access the 25% rate through the RoC Formula. If that manager is resident in a high-tax state, the manager could need a tax distribution well in excess of 50% of income allocated to her assuming that the provisions regarding the elimination of the state and local tax deduction in the House Proposal are applicable to such manager. In contrast, a blocker corporation would only need a tax distribution of 20% plus the applicable state rate, and a passive individual investor would only need a tax distribution of 28.8% (the 25% rate plus the 3.8% Medicare tax) plus the applicable state rate.

7 Although it does appear that the manager would still generally get the benefit of capital gains rates on the sale of her interest on an exit, subject to recapture rules and the like, as under current law.

8 The interest deduction limitation does not apply to (i) taxpayers engaged in a real property or public utility business, (ii) small businesses with average gross receipts of $25 million or less and (iii) investment interest.

9 A group for this purpose includes a plain vanilla U.S. parent corporation with foreign subsidiaries.

10 This limitation does not apply to a financial reporting group that has annual global gross receipts of $100 million or less. Where both of these two interest deductibility rules would otherwise apply to a taxpayer, the House Proposal applies only to the rule that would result in the disallowance of the greater amount of interest deductions.

11 Code Section 1402(a)(13).

12 For U.S. corporations, the House Proposal would also repeal the rules under Code Section 956 that can cause a deemed dividend if a controlled foreign corporation makes an investment in U.S. property. Notably, the new rules would likely change market practices with respect to financing transactions. Currently, as a result of Code Section 956, generally only 65% of a controlled foreign corporation's voting shares are pledged in support of a U.S. parent corporation's debt, and no guarantee from the controlled foreign corporation is provided. Under the House Proposal, 100% pledges of a controlled foreign corporation's shares and guarantees from a controlled foreign corporation may, in some cases, be possible without triggering material U.S. tax for U.S. corporations.

13 Note that the one-time tax appears to be imposed on non-corporate U.S. shareholders of controlled foreign corporations, even though such shareholders do not benefit from the 100% participation exemption for foreign dividends that is available to U.S. corporations.

14 This rule prevents a U.S. shareholder from attempting to manipulate its E&P in advance of the enactment date.

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