KIRKLAND & ELLIS

KIRKLANDPEN
Private Equity Newsletter

November 8, 2017

New Tax Bill Would Impact PE Funds and Their Portfolio Companies

PENpoints

House Republicans' tax bill could dramatically impact PE 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 Internal Revenue Code since the Tax Reform Act of 1986, and could dramatically impact current private equity market practices for raising capital, structuring and financing portfolio company investments, and compensating service providers. And, as part of a recent amendment, the House Proposal would impose a three-year holding period requirement for PE fund principals to benefit from long-term capital gains rates with respect to carried interest.

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.

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.

Below is a brief summary of certain key aspects of the **House Proposal impacting PE funds and transactions.**

Three-Year Holding Period for Carried Interest

The House Proposal would impose a three-year investment holding period requirement in order for PE principals to benefit from long-term capital gain rates with respect to carried interest, effective for sales of portfolio company investments on or after January 1, 2018.

Limitation on Portfolio Company Interest Deductions

The House Proposal would limit the amount of interest deductions available to a portfolio company to 30% of EBITDA (as specifically defined for tax purposes), with unused deductions available to be carried forward only five years and no grandfathering for existing debt, effective January 1, 2018.

Reduction in Corporate Tax Rate to 20%

The House Proposal would reduce the corporate income tax rate from 35% to 20%, beginning in 2018 and without any phase-in.

New 25% Rate for Passive and Certain Other Investors in Flow-Through Businesses

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 through partnerships, LLCs and S corporations. For individual investors, access to this preferential rate would reflect a substantial reduction in the existing (and, under the House Proposal, retained) top 39.6% marginal income tax rate that would otherwise be applicable. However, access to the preferential rate generally is limited to "passive" investors and to active investors in capital intensive businesses.[1] Notably, the

INSIDE KIRKLANDPEN

1 The rules regarding the proposed 25% tax rate are highly complex. In general, all of a taxpayer's "passive" flow-through business income would be taxable at a 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. By contrast, only a formula-driven portion of a taxpayer's "active" flow-through business income is eligible for the preferential 25% rate. However, flow-through business income with respect to activities involving the performances of personal services in specified fields generally is not entitled to the 25% preferential rate.

25% rate generally would not be applicable to active investors in businesses involving the performance of personal services in specified fields, including management and advisory services by a management company of a PE fund.

Other Significant Changes

As described in the longer version of this article, available by clicking here, the House Proposal in its current form would:

- expand the tax base for Medicare and other self-employment taxes, including with respect to an investment professional's share of income earned by management companies structured as limited partnerships;
- eliminate carryback of corporate net operating losses and limit the deduction of corporate net operating loss carryforwards to 90% of the corporation's taxable income;
- permit immediate 100% expensing for certain tangible capital assets acquired and put in service before January 1, 2023;
- substantially change the taxation of incentive equity and deferred compensation issued to portfolio company management, potentially with the effect of dramatically reducing the use of stock options;[2]
- impose tax on the "unrelated business taxable income" of state and local public pension plans; and
- fundamentally overhaul the taxation of non-U.S. portfolio companies and portfolio companies with non-U.S. operations.

Currently, the House Proposal retains many of the long-standing tax preferences enjoyed by funds investing in real estate.[3]

Uncertain Road Ahead

These proposed changes, together with the other changes in the House Proposal, are significant and complex, so the path and timing of any finalized bill is uncertain.

2 Please see the following *KirklandPEN* article and our *Alert* on executive compensation matters for more details.

3 For example, real estate funds and their investors may continue to effectuate like-kind exchanges of direct interests in real estate on a tax-free basis (notwithstanding the elimination of like-kind exchange benefits for other asset classes). In addition, entities engaged in a real estate investment business generally will be exempt from the new 30% interest expense limitation, but generally will not be entitled to the immediate 100% expensing of certain capital investments afforded to non-real estate businesses by the House Proposal.

If you have any questions about the matters addressed in this *KirklandPEN,* please contact the following Kirkland authors or your regular Kirkland contact.

Dean S. Shulman, P.C.
http://www.kirkland.com/dshulman
+1 212-446-4740

Mike Carew
http://www.kirkland.com/mcarew
+1 312-862-3035

Sara B. Zablotney
http://www.kirkland.com/szablotney
+1 212-446-4772

William R. Welke, P.C.
http://www.kirkland.com/wwelke
+1 312-862-2143

Vincent Thorn
http://www.kirkland.com/vthorn
+1 212-446-6431

Adam Kool
http://www.kirkland.com/akool
+1 212-446-4788

Stephen Butler
http://www.kirkland.com/sbutler
+1 713-836-3732

Margaret R.T. Dewar
http://www.kirkland.com/mdewar
+1 212-446-5934

Proposed Tax Plan Would Affect Executive Compensation and Equity-Based Incentive Programs

PENpoints

House Republicans' tax bill could significantly affect management equity incentive plans and compensation arrangements.

The House Proposal, if enacted as currently proposed, will significantly affect the design of management equity incentive programs and other compensation arrangements commonly adopted by private equity-owned portfolio companies. Below are some of the potential impacts:

Earlier Taxation of Equity Awards. Stock options, stock appreciation rights, and restricted stock units will be taxable when "time vested," even if subject to additional performance conditions or not exercised or settled until a later taxable year. A private equity sponsor will face difficult choices in structuring stock option-based equity compensation plans, in an effort to balance the retentive effect of time-vesting or service-vesting equity awards with the potential tax liability to employees as those awards become vested. Profits interests, which are eligible for capital gains treatment and are not affected by the House Proposal in its current form, may become an increasingly more practical alternative.[1]

Changes to Deferred Compensation Rules. Nonqualified deferred compensation attributable to services performed after December 31, 2017, will be taxable when "time" vested — i.e., a subsequent "performance" vesting condition or continued compliance with restrictive covenants will not defer taxation. This requirement will all but eliminate deferral of vested compensation into retirement plans other than qualified 401(k) and pension arrangements, and will add considerable complexity to structuring severance pay and other separation payments, likely resulting in a shift to payment of severance in lump sums.

New Limits on Deductibility of Executive Compensation. Currently, a company whose shares are publicly traded may not deduct compensation to certain senior executives exceeding $1 million per year, with significant exceptions for stock options and performance-based compensation. The House Proposal extends this deduction limitation to privately owned companies with publicly traded debt — including companies owned by a single controlling shareholder — and eliminates the exceptions for stock options and performance-based compensation.

If enacted, these rules will apply to tax years beginning after December 31, 2017, and could affect existing equity awards and compensation plans. For more detail on these changes, see our related *Alert*.

1 The House Proposal includes a limited exception for employees of private companies that have never been public and that grant equity awards to at least 80% of their employees each year. This exception is targeted for start-up companies and is unlikely to provide relief to portfolio companies, which rarely grant equity to 80% of employees, and do not grant awards annually.

If you have any questions about the matters addressed in this *KirklandPEN,* please contact the following Kirkland authors or your regular Kirkland contact.

Scott D. Price
www.kirkland.com/sprice
+1 212-446-4851

Michael Krasnovsky
www.kirkland.com/mkrasnovsky
+1 212-446-5922

Jennifer Pepin
www.kirkland.com/jpepin
+1 212-446-4817

Tiffany B. Wong
www.kirkland.com/twong
+1 212-390-4565

Private Equity and Iran

On October 13, 2017, President Trump declined to recertify Iran's compliance with the nuclear deal formally known as the Joint Comprehensive Plan of Action (JCPOA). Although the President's decision did not trigger the immediate re-imposition of U.S. sanctions, it signaled a shift in U.S. policy toward Iran and created additional uncertainty for U.S. and non-U.S. businesses that do business in or with Iran. In light of this, and given the policy and attitudinal divergence with the European Union with respect to Iran business generally, Kirkland's Washington, D.C.-based International Trade & National Security practice recommends that our private equity clients look closely at their portfolios to assess their direct and indirect (e.g., a European reseller of a U.S. portfolio company's products) Iran exposure. Even absent a re-imposition of U.S. sanctions, the underlying policy shift on Iran itself may have near-term legal and commercial implications, including with respect to pending OFAC licenses, the interpretation of existing general or specific licenses, and OFAC's enforcement agenda.

If you have any questions about the matters addressed in this *KirklandPEN,* please contact the following Kirkland authors or your regular Kirkland contact.

Mario Mancuso, P.C.
http://www.kirkland.com/mmancuso
+1 202-879-5070

Jennifer Fernandez
http://www.kirkland.com/jfernandez
+1 202-879-5969

PENbriefs

U.S. State Department Issues Sanctions Guidance on Russia's Defense and Intelligence Sectors

On October 27, 2017, the U.S. State Department released a list of 39 Russian entities identified as being involved in the defense and intelligence sectors, and as a result, U.S. and non-U.S. companies may face sanctions for doing business with these listed entities. While this list puts companies on notice as to certain Russian counterparties with whom there is a heightened risk of conducting business, it is not exhaustive and does not affect existing export control restrictions or list-based sanctions. Companies will want to check carefully whether they may be doing business with Russian counterparties that have been or could be identified under the articulated criteria. To learn more, see our recent *Alert.*

Understanding the Rising Corruption, Sanctions and Money Laundering Risks of Doing Business with Venezuela

Recent actions by the U.S. and other governments targeting the government of Venezuela significantly raise the legal and reputational risks of doing business, directly or indirectly, with Venezuelan counterparties, and warrant close attention by financial institutions, companies and investors, especially those operating in or with the energy industry. With careful planning, however, this complex set of Venezuela-related international risks can be effectively identified, assessed and managed. To learn more, see our recent *Alert.*

PENnotes

PLI Tax Strategies for Corporate Acquisitions, Dispositions, Spin Offs, Joint Ventures, Financings, Reorganizations & Restructurings 2017
Chicago, IL, November 15-17, 2017
Los Angeles, CA, December 6-8, 2017

This three-day program will focus on tax issues presented by the entire spectrum of modern major corporate transactions. Evolving techniques for structuring, financing, and refinancing corporate turnovers and other activities will be emphasized. Kirkland partners Jack Levin, Todd Maynes, Dean Shulman and Donald Rocap will be panelists at the event. For more information or to register, click here.

PLI Drafting and Negotiating Corporate Agreements 2018
New York, NY, January 18, 2018
Chicago, IL, January 31, 2018

This PLI seminar will teach the basics of drafting and negotiating corporate agreements — from how the provisions of an agreement fit together, to the fundamental drafting and negotiating principles common to all corporate agreements. Kirkland partners Jonathan Davis and Keith Crow will be panelists at the New York and Chicago events, respectively. Click here for more information or to register.

45th Annual Securities Regulation Institute
Coronado, California, January 22-24, 2018

Hosted by Northwestern Law, the 43rd Annual Securities Regulation Institute will take place in Coronado, California. One of the most visible and highly regarded securities and corporate law conferences in the country, the Securities Regulation Institute reaches prominent attorneys from both firm and in-house practices. Kirkland partner Scott Falk is on the planning committee and will be a panel member for the Mergers & Acquisitions session. Click here for more information or to register.

17th Annual Beecken Petty O'Keefe & Company Private Equity Conference
Chicago, IL, February 23, 2018

Kirkland is a sponsor of this annual event, which brings together financiers, students and entrepreneurs to network and share insights into the dynamics of investing in a constantly changing economy. This year's conference is themed "Remaining Nimble and Achieving Returns While Facing Uncertainty and Volatility." Click here for more information.

Private Equity Practice at Kirkland & Ellis

Beijing
Boston
Chicago
Hong Kong
Houston
London
Los Angeles
Munich
New York
Palo Alto
San Francisco
Shanghai
Washington, D.C.

Kirkland & Ellis' nearly 400 private equity attorneys have handled leveraged buyouts, growth equity transactions, recapitalizations, going-private transactions and the formation of private equity, venture capital and hedge funds on behalf of more than 400 private equity firms around the world.

Kirkland has been widely recognized for its preeminent private equity practice. The Firm was named "Private Equity Group of the Year" in each of the last six years by *Law360* and was commended as being the most active private equity law firm of the last decade in *The PitchBook Decade Report*. Kirkland has been ranked as a Tier 1 law firm for Leveraged Buyouts and Private Equity for the past seven years in U.S. News and World Report, Best Lawyers' "Best Law Firms" rankings. In 2008-2017, Chambers and Partners named Kirkland the Leading Global-wide Private Equity Firm. The Firm was ranked as the #1 law firm for both Global and U.S. Buyouts by deal volume in Mergermarket's *League Tables of Legal Advisors to Global M&A for Full Year 2011-2016*, and has consistently received top rankings among law firms in Private Equity by The Legal 500, the Practical Law Company and IFLR, among others.

The Lawyer magazine has recognized Kirkland as one of its "Transatlantic Elite," having noted that the Firm is "leading the transatlantic market for the provision of top-end transactional services … on the basis of a stellar client base, regular roles on top deals, market-leading finances and the cream of the legal market talent."

KIRKLANDPEN

KIRKLAND & ELLIS

EDITORS
Jack S. Levin, P.C.
Margaret A. Gibson, P.C.
Norbert B. Knapke II

SUBSCRIPTIONS
To subscribe to *KirklandPEN*, please email
kirklandpen@kirkland.com
+1 (312) 862-3356

www.kirkland.com