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BLOG POST

Tax Reform: Impact on Funds

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The Tax Cuts and Jobs Act (TCJA) contains many provisions impacting private equity funds, which we explore below.

Lower Corporate Rate for Blocker Corporations

The most significant change in law brought by the TCJA is the reduction in the corporate tax rate to 21%. While most funds are organized as partnerships, funds with foreign investors often utilize blocker corporations to “block” the taint of income that is considered to be (a) effectively connected with the conduct of a U.S. trade or business (ECI) for foreign investors and (b) unrelated business taxable income (UBTI) for tax-exempt investors. Given this change, particularly where the investment strategy does not rely on dividend payments (also mitigating double taxation, which is consistent with most funds’ planning), blockers actually may be a sought after planning strategy for funds going forward.

Interest Deduction Limitation

The TCJA repealed the so- called earnings stripping rules that limited interest deductions for many blocker utilizing related party debt, replacing them with a new limitation that applies to all taxpayers. Under the new rules, interest deductions generally are limited to the sum of business interest income and 30% of taxable income. Disallowed interest expense is carried forward indefinitely, and complex rules apply to partnership interest deductions. While most funds do not borrow directly given prohibitions relating to incurring UBTI, when they do it often is at the blocker level to reduce entity level tax. Funds with leveraged blockers, particularly those that are leveraged at less than 1.5:1 debt to equity to avoid the old earnings stripping rules, should be re-evaluating their structures in light of this change, especially taking into consideration the new lower corporate tax rate (discussed above).

International Provisions

The TCJA introduced comprehensive international tax reform, largely focused on (a) creating a territorial tax system for U.S. corporations and (b) combatting perceived abuses where U.S. taxpayers hold valuable assets offshore or make deductible payments to foreign affiliates in low tax jurisdictions. While funds were not specifically targeted, funds with a substantial U.S. investor base and non-U.S. corporate investments will be impacted, as such provisions affect the classification of such corporations as “controlled foreign corporations” (CFCs). “United States shareholders” of CFCs are required to include their shares of certain types of the corporation’s income (subpart F income) if the corporation is a CFC. A CFC is a foreign corporation more than 50% of the voting power or value of which is owned by one or more said United States shareholders. A United States shareholder is a “United States person” (as defined for U.S. tax purposes) who directly, indirectly or constructively owns 10% or more of either the vote or value of the stock in a foreign corporation. This is a significant departure from prior law,

which only took into account voting power – under prior law, a United States person could own over 10% of the value of a corporation and not "count" as a United States shareholder. In addition, the TCJA allows for increased attribution of stock ownership from foreign persons to United States persons, by repealing the rule that "turned off" so-called downward attribution in certain circumstances where it would cause a United States person (including a corporation or partnership) to own stock held by a foreign person (including a shareholder or partner). When taken together, these changes could result in significant changes (and income recognition) for investors with respect to foreign portfolio companies held by funds, as many fund structures relied on the intricacies of the now-repealed or amended rules to avoid CFC status for portfolio company investments – and related income inclusions for sponsors as well as investors.

While these issues warrant more detailed discussion, it is important to note that funds with offshore investments may be disproportionately impacted by the complex new international provisions versus corporate shareholders, particularly if they are subject to the new Global Intangible Low-Taxed Income (or GILTI) rules (click ***here*** for more) and the new repatriation tax imposed on certain shareholders of certain foreign corporations. Moreover, funds will not benefit from the new dividends received deduction for actual distributions, which is an integral part of a territorial tax system for U.S. corporations. However, this may be mitigated in the private equity space where portfolio companies traditionally do not pay out dividends.

Inbound investments by non-U.S. partners into funds also is impacted by tax reform. The TCJA codifies an earlier revenue ruling concluding that foreign investors are subject to U.S. federal income tax on the sale of an interest in a partnership or LLC to the extent that a partner or member would be allocated ECI income as the result of such sale by the partnership or LLC of its assets. While this change eliminates the uncertainty swirling around the ruling, which commentators argued was outside Treasury's authority, it also introduces practical uncertainty in application. The new provision (Code Section 1446(f)(3)) requires that the transferee of such an interest withhold at a flat rate of 10% and allows the IRS, at the request of either the transferor or transferee, to reduce the amount of withholding if it will not jeopardize the collection of tax imposed. However, there is no specific guidance as to when and how the transferor and transferee may request or otherwise obtain such a reduction. Presumably, new Code Section 1446(f)(3) provides the IRS with the authority to promulgate guidance regarding such procedures, but, until this is addressed, foreign investors selling interests in a fund that has ECI may find themselves waiting to file a tax return to obtain a refund.

Holding Period for Carried Interest

Finally, the TCJA modifies the holding period necessary for gains attributable to carried interests to qualify as long-term capital gains, subject to federal income tax at a rate of 20%, from greater than one year to greater than three years. Otherwise, such would be subject to tax at federal ordinary income tax rates at a maximum rate of 37%. The three-year holding period applies to gains from the sale or redemption of an applicable partnership interest, as well as gains attributable to such partnership's direct or indirect sale of assets to the extent allocated to the owner of the applicable partnership interest. An applicable partnership interest is an interest in a partnership transferred to a taxpayer in exchange for services performed in connection with the raising or returning of capital, and either investing in (or disposing of) or developing, specified assets. Specified assets include securities, commodities, real estate assets, cash and derivatives. An applicable partnership interest does not include a partnership interest held by a corporation (but likely not an S corporation per Secretary Mnuchin's public

comments), nor does it include a partnership interest, commonly referred to as capital interest, that constitutes a right to share in capital based on the amount of the taxpayer's contributed capital or the value of the interest taxable to the taxpayer upon receipt or vesting.

The three-year holding period applies to capital gains the taxpayer recognizes on or after January 1, 2018, regardless of when the taxpayer acquired the applicable partnership interest; there is no grandfathering rule.