Comparison of the House and Senate Tax Reform Proposals Impacting Private Equity

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Topics Covered

- The slides below summarize certain provisions of the Tax Cuts and Jobs Act that would affect private equity sponsors, investors or portfolio companies.
- The slides compare:
  - The legislative text of the Tax Cuts and Jobs Act approved by the Ways & Means Committee of the House of Representatives on November 9, 2017 (the "House Tax Bill") with
  - The Description of the Chairman's Mark of the Tax Cuts and Jobs Act Scheduled for Markup by the Senate Committee on Finance on November 13, 2017, Prepared by the Staff of the Joint Committee on Taxation, dated November 9, 2017 (the "Senate Tax Plan").
- The slides consider:
  - Carried Interest
  - Changes in Tax Rates
  - Taxation of Business Income of Partnerships
  - Deductibility of State and Local Taxes by Individuals
  - 30% Cap on Deduction for Business Interest
  - International Cap on Deduction for Interest by Domestic Corporations
  - Deferred Compensation
  - Stock Options and RSUs Issued by Certain Private Corporations
  - Sale of Operating Partnership Interest by Foreign Person
  - International Tax Changes, including:
    - Dividends-Received Deduction for Distributions from Foreign Subsidiaries
    - Deemed Repatriation
    - "Foreign High Return" Income/"Global Low-Taxed Intangible Income"
    - Anti-Base Erosion Measures
    - Limited Applicability of Section 956
  - State Pension Plans
  - UBTI Losses
  - Changes to Self Employment Taxes

Carried Interest

House Tax Bill

- Would generally limit the favorable taxation of carried interest on gains from sales of investments to investments that have a holding period of more than three years.
- Would treat carried interest attributable to gains on investments held for three years or less as short-term capital gain (taxed at the rates applicable to ordinary income).
- Qualified dividend income allocated in respect of carried interest would remain eligible for long-term capital gains rates without regard to the three-year holding period.

Senate Tax Plan

- No provision but there have been public statements by some Senators indicating that one may be added.

Changes in Tax Rates

House Tax Bill

- For corporations, would reduce the highest tax rate from 35% to 20% (effective 2018).
- For individuals:
  - would retain 39.6% as the highest individual income tax rate (excluding the Medicare tax and employment-related taxes) and
  - would retain the 20% maximum tax rate for long-term capital gain and qualified dividend income.

Senate Tax Plan

- Same as House Tax Bill except
  - Highest individual rate reduced from 39.6% to 38.5%
  - Corporate rate reductions delayed until 2019.

Taxation of Business Income of Partnerships

House Tax Bill

- Would tax certain "qualified business income" derived by individuals through sole proprietorships, partnerships and other pass-through arrangements at a special 25% maximum tax rate.
  - The special tax rate would generally not be available in the case of a "specified service trade or business" (including a financial services business).
- Individual investors (limited partners and, potentially, individual members of the sponsor general partner) in private equity funds that hold investments in portfolio companies that are organized as pass-through entities (so-called "operating partnerships") would generally be eligible for the 25% rate with respect to the business income derived from such investments (including the portion allocated as carried interest).
- Private equity firm owners who are (or have been) engaged in the business of the management company would generally not be eligible for the special 25% rate on income received from the management company.
  - It is not clear how the rules would apply in the case of management company income if the private equity firm sponsors funds that employ differing investment strategies and an individual does not do work for one or more of the strategies.
- You can read more about the special pass-through rate here.

Senate Tax Plan

- Would establish a deduction for individuals generally equal to 17.4% of "domestic qualified business income" received from a sole proprietorships, partnerships and other pass-through arrangements.
  - The deduction would generally not be available in the case of a "specified service trade or business" (including a financial services business).
- Although not clear, it appears that in the case of a partnership or S corporation, the deduction would be limited to 50% of W-2 wages paid by the entity.
- The application of the proposal to an operating partnership held by a private equity fund and to the owners of a management company would be similar to the application of the 25% tax rate that would apply under the House Tax Bill.

Deductibility of State and Local Income Taxes by Individuals

House Tax Bill

- Deduction for state and local income taxes would be repealed in the case of individual taxpayers.
- Chairman Brady recently clarified that the provision would also apply to deny deductions for state and local income taxes imposed on an individual's share of the income received from a partnership (including a portfolio company that is an operating partnership).

Senate Tax Plan

- Same as the House Tax Bill.

30% Cap on Deduction for Business Interest

House Tax Bill

- In General
  - Would generally limit the deduction for "business interest" to (i) business interest income plus (ii) 30% of the taxpayer's "adjusted taxable income" (ATI) for the taxable year.
  - ATI would be defined to mean taxable income but computed without regard to (i) any deduction for depreciation, amortization or depletion, (ii) any NOL, (iii) any non-business items, and (iv) any business interest income or business interest expense.
  - Any interest that is not deductible under the provision could be carried forward for five years. Following a change of control, unused interest expense carryforwards would be subject to limitation.
  - Under a specific exception, the 30% cap would not apply to business interest attributable to a real estate business.
  - There would be no grandfather for existing debt.
- Special Rules for Partnerships.
  - For business interest of a partnership, the 30% limitation would be determined at the partnership level based on the ATI of the partnership.
  - In applying the 30% limitation to business interest incurred at the partner level, the partner's ATI would generally be determined without regard to business-related items allocated to the partner by a partnership.
  - If business interest expense of a partnership is below the 30% cap, the cap on business interest deductible by the partners would be increased.

Senate Tax Plan

- Generally the same as the House Tax Bill except that
  - ATI would be determined:
    - by taking into account the deduction for depreciation, amortization or depletion and
    - without regard to the 17.4% deduction for "domestic qualified business income" derived from pass-through entities and arrangements.
  - Any interest that is not deductible under the provision could be carried forward indefinitely.
- The JCT estimates that the Senate proposal would raise revenue by approximately $308 billion over the next 10 years.
  - By contrast, the House Tax Bill version is estimated to raise revenue by $172 billion over the same period.

30% Cap on Deduction for Business Interest (continued)

House Tax Bill (continued)

- Application to Blocker Corporations
  - It is not entirely clear how the provision would apply to debt of a "blocker corporation" the sole asset of which is an interest in an operating partnership. Assuming that interest on blocker debt is treated as business interest under these rules (a point that is not clear) and that the business interest at the operating partnership level equals or exceeds the cap (as determined at the partnership level), a blocker may not receive a current tax benefit for any interest on any blocker-level debt.
  - Not clear whether carryforward of nondeductible interest could be deducted against gain from blocker's sale of operating partnership investment.
- Application to Fund Level Borrowing
  - Provision would generally not apply since the interest would generally be considered investment interest rather than business interest.
- You can read more about these proposals here and here.

International Cap on Deduction for Interest by Domestic Corporations

House Tax Bill

- An additional limitation on interest deductibility would apply to US corporations that are members of an "international financial reporting group," which would generally be defined as a group of entities that
  - includes one domestic corporation and one foreign corporation (or at least one foreign corporation engaged in a US trade or business or at least),
  - prepares consolidated financial statements and
  - reports average annual gross receipts in excess of $100 million over a 3-year period.
- The provision would limit a corporation's deduction for net interest expense to an amount equal to 110% of the same percentage of its net interest expense as its pro rata share (based on EBITDA) of the group's net interest expense (as measured for accounting purposes).
  - A corporation's limitation would be the lesser of the allowable interest deduction determined under this rule and under the 30% of ATI rule for business interest.
  - Any interest disallowed under the provision could be carried forward for five years.
  - Following change of control, unused interest expense would be subject to limitations.
- This limitation can be expected to alter the financing structure of some portfolio companies with international operations, particularly if the parent portfolio company is organized in the United States.

Senate Tax Plan

- Would similarly disallow interest expense of a US member of a worldwide group based on proportionality, but looks to group debt-to-equity ratios instead of EBITDA ratios:
  - Would apply to US corporations that are members of a "worldwide affiliated group" (generally defined as at least 50% ownership by vote and value), regardless of whether the members of the affiliated group prepare consolidated financial statements and with no apparent threshold amount of gross receipts.
  - Deductible interest of a US corporation reduced by the "debt-to-equity differential percentage" of net interest expense. This percentage is the ratio of (x) the amount by which the total US group indebtedness exceeds 110% of the debt the US group would have if the members of the worldwide group had proportionate debt-to-equity ratios (excluding intercompany debt) to (y) the total US group indebtedness.

Deferred Compensation

House Tax Bill

- Initial versions of the House bill would have largely ended the ability to structure compensation in a manner that allows an employee (or other service provider) to defer income beyond when the income vests. However, an amendment to the bill released on November 9th, 2017 eliminated these provisions.

Senate Tax Plan

- Like initial versions of the House Tax Bill, the Senate plan would largely eliminate the ability to structure compensation in a manner that allows an employee (or other service provider) to defer income beyond the time of vesting. These new rules would apply to stock options and SARs (and similar arrangements involving non-corporate entities), regardless of how the exercise price compares to the value of the related stock on the date of grant of the option or SAR.
- If enacted, these rules would require significant changes in the compensatory equity programs typically used by portfolio companies in the private equity context, both with respect to new grants of options and with respect to options (or other deferred compensation) that are "rolled over" in the context of an acquisition.
- You can read more about this proposal here.

Stock Options and RSUs Issued by Certain Private Corporations

House Tax Bill

- Would allow employees holding stock options or restricted stock units issued by certain private corporations to defer income resulting from the exercise of the options or settlement of the restricted stock units for 5 years after the date on which the options or restricted stock units vest or, if earlier, the date the stock becomes transferable or publicly traded or the date of certain other events.
- Not available to an employee who is or was at any time the company's CEO or CFO (or a related person) or was at any time during the previous 10 years a 1% or greater owner of the corporation or one of the four highest compensated officers of the corporation.
- Available only to corporations that, pursuant to a written plan, grant stock options or restricted stock units to at least 80% of their US employees in the calendar year in which the relevant options or restricted stock units were granted.

Senate Tax Plan

- No similar provision.

Sale of Operating Partnership Interest by Foreign Person

House Tax Bill

- No provision.

Senate Tax Plan

- Would effectively overturn a recent court case holding that a non-US person was not subject to US tax on gain from the disposition of an interest in an operating partnership that conducted business in the US (other than in respect of "FIRPTA" assets (*i.e.*, US real property assets) held by the partnership).
- Under the proposal, gain recognized by a non-US person on such a disposition would generally be subject to US income tax.
- In addition, under the proposal, a person who acquires any partnership interest from a non-US partner would be required to withhold 10% of the proceeds.

International Tax Changes

House Tax Bill, Senate Tax Plan

- Both the House bill and Senate plan include several changes in the international area that would have a significant impact on multinational portfolio companies that have a US parent or a US subsidiary.
- The changes include (among others):
  - a dividends received deduction ("DRD") for distributions from foreign subsidiaries to certain domestic corporate holders,
  - deemed repatriation provisions of untaxed foreign earnings on transition to the DRD regime,
  - intangible related provisions,
    - in the House Tax Bill, a requirement that a US shareholder include in income its share of a foreign subsidiary's "foreign high return income" or
    - in the Senate Tax Plan, a requirement that a US shareholder include in income its shares of a foreign subsidiary's "global intangible low-taxed income" (or GILTI) plus a 37.5% deduction of the amount of intangible income that together result in a 12.5% rate of tax on foreign-source income from intangibles (a "patent box"),
  - anti-base erosion measures, and
  - and the repeal of Section 956 for US corporations (all described below).

Dividends-Received Deduction for Distributions From Foreign Subsidiaries

House Tax Bill

- Would create a dividends received deduction for the foreign-source portion of any dividend received by a domestic corporation from a 10%-owned foreign corporation.
- However, provision must be considered in the context of the other international provisions of the House Tax Bill.

Senate Tax Plan

- Same as the House Tax Bill
- Provision must be considered in the context of the other international provisions of the Senate Tax Plan (which differ in many respect from the House Tax Bill).

Deemed Repatriation

House Tax Bill

- Would provide for a one-time transition tax that would require a US portfolio company with at least a 10% interest in a non-US company to include in income the non-US company's previously untaxed accumulated earnings and profits, or "E&P" (which is like retained earnings, but computed based on US federal income tax principles).
- In some cases, the amount of previously untaxed accumulated E&P could be significant.
- The bill (as amended) specifies a 14% tax rate on cash or cash equivalents and a 7% tax rate on non-cash amounts, and the tax can be paid in equal installments over 8 years.
- In addition to applying to a US portfolio company as described above, the transition tax would also apply to any 10% US shareholder of a non-US portfolio company that meets certain requirements.
- You can read more about this proposal here.

Senate Tax Plan

- Similar to House bill, except that tax rate on cash or cash equivalents would be 10% and the tax rate on non-cash amounts would be 5%.
- Special rules would apply to US corporations that "invert" within the next 10 years.

Tax on So-Called “Foreign High Return” Income/ “Global Intangible Low-taxed” Income (Patent Box)

House Tax Bill

- Would require a US portfolio company with an interest in one or more CFCs to include in income an amount equal generally equal to 50% of the excess (if any) of:
  - the CFCs’ aggregate net income (with certain exclusions) over
  - a determined return (7% plus the federal short-term rate) on the CFCs’ aggregate adjusted bases in depreciable property, adjusted downward for interest expense.
- Special foreign tax credit rules are provided.
- In some cases, the foreign high returns will represent substantially all of the non-US subsidiary’s income. The intent of the provision is to subject the foreign subsidiary’s foreign high returns to a minimum 10% tax in the United States.
- In addition to applying to a US portfolio company, the inclusion rate would also apply to a 10% US shareholder of a non-US portfolio company that is treated as a CFC for purposes of this provision.
- You can read more about this proposal **here**.

Senate Tax Plan

- Would require a US portfolio company with an interest in one or more CFCs to include in income an amount generally equal to the excess (if any) of:
  - the CFCs’ aggregate net income (with certain exclusions), over
  - 10% of the CFCs’ tax bases in depreciable property

  This inclusion is referred to as “global intangible low-taxed income” or “GILTI.”
- Would grant a US corporation a deduction generally equal to 37.5% of the sum of (i) the amount of GILTI included in income and (ii) the corporation’s “foreign derived intangible income” (or, if lesser, 37.5% of its taxable income, determined without regard to the GILTI inclusion).
- In addition to applying to a US portfolio company, the inclusion rule would also apply to a 10% US shareholder of a non-US portfolio company that is treated as a CFC for purposes of this provision.

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Anti-Base Erosion Measures

House Tax Bill

- Would impose a 20% excise tax on certain amounts (not including dividends or interest) paid by US corporations to non-US affiliates that are members of the same international financial reporting group unless the non-US affiliate elects to treat the payment as effectively connected income (which is subject to US federal income tax on a net basis at the rates applicable to US corporations).
- This excise tax, in particular, may affect planning by non-US parented multinational groups that have US subsidiaries.

Senate Tax Plan

- In the case of a US corporation with annual gross receipts of at least $500m, would impose a tax equal to the excess of (x) 10% of the corporation's taxable income (determined without regard to deductions attributable to certain payments to related foreign persons) over (y) the corporation's regular tax liability, reduced by certain credits.

Section 956 Limited to Non-Corporate Shareholders

House Tax Bill

- Would eliminate the application of Section 956 for US corporations.
- Section 956 is the provision that, in the context of a US borrower with a non-US subsidiary, effectively limits the ability of the non-US subsidiary to provide a guarantee of the US borrower's debt or to allow for a pledge of more than 65% of the voting stock of the non-US Subsidiary.
- This change may cause lenders to now seek changes in credit agreements going forward.

Senate Tax Plan

- Same as the House Tax Bill.

State Pension Plans

House Tax Bill

- Would subject ***all*** entities exempt from tax under Section 501(a) to the unrelated business income tax ("UBTI") rules, notwithstanding an entity's exemption under any other provision of the Code.
- The Ways and Means section-by-section summary indicates that this "clarification" is meant to bring state and local government-sponsored entities—such as public pension plans—that are exempt under Section 115(l) within the scope of the UBTI rules.
- This provision may cause some state pension plan investors to seek to restructure their interests in existing portfolio investments in operating partnerships or for which there is "acquisition indebtedness" (including fund-level leverage).
- It also may affect the willingness of state pension plan investors to invest in funds that may have significant fund-level leverage or significant investments in operating partnerships.
- Some state pension plans may challenge the constitutionally of any provision that purports to subject them to US tax.

Senate Tax Plan

- No similar provision.

UBTI Losses

House Tax Bill

- No provision

Senate Tax Plan

- Would require a US tax-exempt to compute its UBTI separately for each trade or business, such that losses from one business could not be used to offset income from another business.
- NOLs from a trade or business would be able to be carried forward to offset UBTI from the same trade or business in a subsequent year.
- Apparently, under the proposal, if a fund invested in two operating partnerships, an “unblocked” tax-exempt investor in the fund would not be able to offset its share of net loss from one investment against its share of the net income from the other investment.
- This proposal may affect the willingness of tax-exempt investors to invest in funds that may have significant investments in operating partnerships. It would also likely increase the situations in which tax-exempt investors elect to use corporate “blocker” structures.

Changes to Self-Employment Tax

House Tax Bill

- Initial versions of the House bill would have
  - repealed a current law exception from self-employment tax for an individual's share of income received as a limited partner in a partnership, and
  - provided that an individual would be subject to self-employment tax based on his or her "labor percentage" (generally, 70%) of trade or business income.
- However, an amendment to the bill released on November 9th, 2017 eliminated these provisions.

Senate Tax Plan

- No provision.