Tax Reform Implications – A Practical Guide for General Partners

SBIC Fund Conference

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Topics Covered

- Tax Reform
  - Carried interest
  - Interest expense deduction limitations
  - Reduction of corporate rate
  - Pass-through deduction and exemptions
  - Other tax return provisions
- Qualified small business stock
- Portfolio company planning
- Fund and investor issues
- Newly updated partnership audit rules

Tax Reform

Tax Reform: Carried Interest – General Provision

- Requires a three year holding period to qualify for long term capital gains with respect to “applicable partnership interests”
- Portion of carried interest relating to gain on property less than three years now considered STCG
- All other income and expense components of carried interest remain the same e.g., QDI (or dividend recap), interest, expenses, ordinary income
- Effective date: Taxable years after Dec. 31, 2017

Tax Reform: Carried Interest – Definition

- Interest transferred to or held by the taxpayer in connection with substantial services performed by the taxpayer
- Applicable trade or business – an activity conducted on a regular, continuous, and substantial basis
  - Raising or returning capital
  - Investing, disposing, or developing "specified assets"
- Specified assets
  - Securities, commodities, options, derivatives, or an interest in a partnership to the extent of the partnership's investment in the foregoing assets
  - Real estate held for rental or investment

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Tax Reform: Carried Interest – Exclusions

- Partnership interest held by a corporation
- Capital interest with a right to share in partnership capital commensurate with
  - The amount of capital contributed
  - The value of the interest included in income upon receipt or vesting
- Income or gain attributable to any asset not held for portfolio investment on behalf of "third-party investors"…..

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Tax Reform: Carried Interest - Implications

- Implication of a new carried interest holding period
  - Applies at the partnership level
  - Requires separate tracking of holding for 1 year capital gains (for LPs) and 3 year capital gains for carried interest (for GP)
  - Recordkeeping
- State tax treatment of carry
  - States may seek to change tax treatment of carry at the state level (e.g., NY and Illinois proposals)

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Tax Reform: Interest Expense Deduction Limitation

Tax Reform: Interest Expense Deduction Limitation

- Interest deduction capped at the sum of business interest income plus 30% of the adjusted taxable income of the taxpayer for the taxable year.
  - Adjusted taxable income is defined similar to:
    - EBITDA for taxable years beginning after 12/31/17 & before 1/1/22,
    - EBIT for taxable years beginning after 12/31/21
  - Limitation applies to both related party and unrelated party debt. Disallowed interest is carried forward indefinitely
  - Effective date: Taxable years after 12/31/17

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Tax Reform: Interest Expense Deduction Limitation (cont.'d)

- Interest expense ceiling could be problematic to highly levered private equity-backed companies.
- Exceptions:
  - Small Businesses - no cap on business interest deductions for small businesses (less than $25 million in average annual gross receipts)
- Implications for SBIC Funds:
  - Interest on SBA Debentures should be treated as investment interest expense (deductible to the extent of investment interest income)
  - However, if a fund that it is "engaged in lending business", interest on SBA Debentures should be treated as business interest expense subject to the limitation. In practice, business interest income should always exceed business interest expense

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Tax Reform: Reduction in Corporate Rate

Tax Reform: Reduction in Corporate Rate

- Max. marginal corporate tax reduced from 35% to 21%
  - **Effective date**: Taxable years after Dec. 31, 2017
- Implications:
  - Choice of entity
  - Increased use of blockers (also consider new UBTI rules)
  - May alleviate some of the added burden from the limitation of interest rate deductibility
  - Can spur portfolio companies to have more capital to enhance or expand operations
  - Elevates strategic acquirers' bargaining power in competitive auctions, potentially making them an even fiercer competitor for deals vs. private equity firms

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Tax Reform: Reduction in Corporate Rate (cont'd)

- LLCs and partnerships
  - Flow-through income was more tax-efficient in many circumstances
  - Step-up in basis to the buyer on acquisition
- Corporations
  - Double level of tax (at 35% rate plus dividend rate of up to 23.8%) was less efficient
  - Generally no step-up in basis on stock acquisitions
- Going Forward?
  - Evaluate the type of entity depending on business type and expected income

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Tax Reform: Reduction in Corporate Rate (cont'd)

- On the mergers and acquisition (M&A) side, the decrease in corporate rates will have a direct impact on future deal modeling.
- The decrease in rates lowers the value of tax attributes created or acquired in a deal, but will have a corresponding increase to cash flow due to the lower tax rate.
- One potential downside could be as more businesses operate in corporate form, the ability to achieve a step-up in basis on an acquisition could become more difficult, as there is still the issue of double taxation in corporations when distributions are paid out of earnings or upon liquidation of the portfolio.
- That combined rate is now lower, but for investors in high tax states the combined rate of this double taxation could still reach nearly 50 percent.

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Tax Reform: Corporate Rate (Choice of Entity – Example)

- Do you think with a reduction in corporate rate, more portfolio companies would be organized as corporations?
  - Let's go through an example to illustrate

Tax Reform: Pass-Through Deduction

Tax Reform: Pass-Through Deduction

- New deduction for non-corporate taxpayers of 20% of such taxpayer's share of domestic "Qualified business income" (QBI) from pass-through entities (e.g., partnerships, S corporations sole proprietorships, etc.) (which has the net effect of a 29.5 percent rate when combined with a top ordinary income tax rate of 37 percent assuming no other limitations). The deduction is limited to the greater of :
  - 50% of the W-2 wages of the business or
  - 25% of the W-2 wages of the business plus 2.5% of the initial depreciable asset basis of the tangible assets of the business
- QBI is generally effectively connected income with respect to a U.S. (or Puerto Rico) trade or business
  - Excludes passive investment income such as capital gains, dividends and interest income (unless the interest is received in connection with a lending business)
  - Excludes reasonable compensation paid
  - Excludes guaranteed payments for services
- Effective date: Taxable years after Dec. 31, 2017

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Tax Reform: Pass-Through Deduction : QBI – Phase outs

- Income threshold: $157,500 for individuals and $315,000 for joint filers
- If threshold exception met – results:
  - Not subject to W-2 or asset limitations
  - No specified trade or business carve-out
- Specified trade or business
  - Service businesses in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, or brokerage services
  - Services consisting of investing and investment management
  - Catch all: The principal asset is the reputation or skill of one or more employees or owners

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Tax Reform: Pass-Through Deduction - Considerations

- Consideration for Funds:
  - Pass-through deduction would not available with respect to management company income.
  - Available with respect to the income earned by non-corporate taxpayers through a fund’s portfolio companies that are owned in pass-through form.
  - Deduction is capped at 20% of the excess of the taxpayer’s taxable income for the year over the taxpayer’s net capital gain for the year.
- Key Takeaways:
  - Deduction will lower the effective tax rate for individuals on income earned through most portfolio companies.
  - Structure compensation arrangements in a manner that qualifies as W-2 wages, rather than as independent contractor or guaranteed payment.
  - Choice of entity: is pass-through still better vs. corporation?

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Tax Reform:
Other Provisions

Tax Reform: Other Provisions

- Foreign provisions
  - Repatriation – tax on deferred income of a foreign corporation.
  - GILTI – tax on US shareholders of a controlled foreign corporation share of "global intangible low-tax income" or GILTI.
  - BEAT – additional tax on all corporate taxpayers with more than $500 million of average gross receipts and deductible payments to foreign related parties. Tax is in addition to a corporation's regular income tax liability.
- Excess business loss limitation – new loss limitation limiting net business losses to $250,000 ($500,000 jointly). Excess loss amounts are carried forward as part of NOL carryforward
- Tax-exempt investors – subject to excess business loss limitation
- Elimination of §212 deduction
- NOL limitation revised to 80% for NOLs arising in years beginning after December 31, 2017.
- Accounting method conformity
- Fixed asset expensing
  - 100% bonus depreciation through 2022, then begins to phase out through 2026
  - Applies to new and used property
  - May create a whipsaw as many states are expected to decouple from bonus depreciation provisions
  - Section 179 – expanded to $1,000,000 limitation with increased phase-out of $2,500,000

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Qualified Small Business Stock

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§1202 – QSBS Gain Exclusion

- §1202 allows non-corporate taxpayers to exclude from gross income a percentage of gain from the sale or exchange of "**qualified small business stock**" (QSBS) held for more than 5 years
  - Minimal tax benefit prior to 9/27/10
  - Jobs Act of 2010 changed §1202 dramatically for QSBS acquired after 9/27/10:
    - Increased gain exclusion to 100%
      - previously 50% or 75%, depending on year of purchase
    - Eliminated AMT preference item for excluded gain
  - Excluded gain on any QSBS is limited to greater of:
    - $10 million, or
    - 10x the adjusted tax basis in QSBS

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What is QSBS?

- **C-Corporation** - must be stock in domestic C-corp (investments in LLCs do NOT qualify)
- **Original Issuance** – stock must be acquired at original issuance from the Qualifying Small Business (“QSB”) for money, property or services
- **Redemptions of Stock**
  - No redemptions of stock by QSB from the taxpayer at any time during the 4 year period beginning 2 years prior to issuance of the QSBS
  - No significant redemptions (>5% of value) by QSB of its stock from any shareholder during the 2 year period beginning 1 year prior to issuance of the QSBS
- **Gross Asset Test** - aggregate gross assets of the QSB must not have exceeded $50 million at any time prior to, or immediately after issuance of the QSBS
- **Active Business** - the QSB must satisfy the active business requirement (>80% of gross assets) during substantially all of the taxpayer’s holding period for the QSBS

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Representations by QSB

- National Venture Capital Association (NVCA) has boilerplate representation which can be included in Stock Purchase Agreement (http://nvca.org/?ddownload=389):

  2.25 Qualified Small Business Stock. As of and immediately following the Closing: (i) the Company will be an eligible corporation as defined in Section 1202(e)(4) of the Code, (ii) the Company will not have made purchases of its own stock described in Code Section 1202(c)(3)(B) during the one (1) year period preceding the Initial Closing, except for purchases that are disregarded for such purposes under Treasury Regulation Section 1.1202-2, and (iii) the Company's aggregate gross assets, as defined by Code Section 1202(d)(2), at no time between its incorporation and through the Initial Closing have exceeded $50 million, taking into account the assets of any corporations required to be aggregated with the Company in accordance with Code Section 1202(d)(3); provided, however, that in no event shall the Company be liable to the Purchasers or any other party for any damages arising from any subsequently proven or identified error in the Company's determination with respect to the applicability or interpretation of Code Section 1202, unless such determination shall have been given by the Company in a manner either grossly negligent or fraudulent.

- Representations are not onerous and should meet with little resistance
- Representations do not cover potential redemptions in next 12-24 months
  - Monitor capitalization to ensure that stock continues to be QSBS

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Other Notes on §1202

- §1202 treatment is passed through to Partners, LLC members or S-Corp S/H
  - Partner/Member/Shareholder must hold interest in the pass-through entity from the acquisition date of the QSBS through date of sale
  - Partner/Member/Shareholder exclusion is available only to the extent that such taxpayer's ownership interest is not greater than when the entity acquired the QSBS
- §1202 exclusion is an Partner/Member/Shareholder level determination
  - Gain on QSBS is reported on line 11 of Schedule K-1 – not on line 7 (LTCG)
  - Pass-through entity should provide sufficient information to its Partner/Member/Shareholder for calculation of their exclusion

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Tax Reform: Portfolio Companies

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Tax Reform: Portfolio Companies - Topics

- Choice of entity
- Temporary expensing provisions
  - 100% bonus depreciation through 2022, then phase out through 2026, now applies to both new and used assets.
  - Expanded Sec. 179 deduction to $1,000,000 with increased phase out of $2,500,000
- Valuations and deferred taxes
  - Companies will need to revalue deferred tax assets and liabilities at enacted rate
  - New NOL limitations and repeal of AMT may require adjustment to valuation allowance.
- BDC proposed legislations regarding pass-through deduction

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Fund and Fund Investors

Fund and Fund Investors - Tax Reform: ECI

- **Sale of partnership interests and ECI**: The TCJA effectively re-establishes by statute a provision (similar to Rev. Rul. 91-32) that can categorize the gain/loss on sale of a partnership interest as ECI for sales or exchanges of partnership interests on or after Nov. 27, 2017.
- More specifically, gain or loss realized on the sale or exchange by a foreign person of a partnership interest that is engaged in a U.S. trade or business would be treated as effectively connected income and subject to U.S. tax to the extent allocable to assets of the partnership that produce effectively connected income. **Withholding would be required at a rate of 10 percent on the realized gain attributable to the foreign partner.**
- *This provision overrides the recent court decision in Grecian Magnesite Mining Company vs. Commissioner. Fund managers of private equity fund structures that include investments engaged in a trade or business may want to consider reevaluating fund structures to protect ECI sensitive investors (e.g., increased use of blockers).*

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Funds and Fund Investors: Questions

- **Unrelated business taxable income (UBTI):** The TCJA prohibits the netting of separate trade or business activities when computing UBTI effective for years beginning after Dec. 31, 2017.
- *Private equity funds that have tax exempt investors (e.g., pensions, charitable organizations) with more than one unrelated trade or business must compute unrelated business taxable income separately with respect to each trade or business. As a result, a deduction from one trade or business for a tax year may not offset income from a different unrelated trade or business for the same tax year.*
- **Nonresident alien (chapter 3) and Foreign Account Tax Compliance Act (FATCA) (chapter 4) withholding:** Effective Jan. 1, 2018, W-8 forms provided to U.S. funds must include the investor's foreign tax identifying number (FTIN) or a reasonable explanation of why an FTIN was not provided; otherwise, the investor will be subject to 30 percent withholding.
- *Although not directly related to the provisions under the TJCA, this withholding and reporting regime change is still an area that should be taken under consideration. Funds should modify systems and be prepared to withhold if required and have systems and processes for identifying section 871(m) dividend equivalent payments and for reporting and withholding on such amounts.*

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Partnership Audit Provisions

New Requirements and Rules

- Effective 1/1/18, new rules apply to all entities treated as partnerships, unless the entity qualifies to elect out
- Only "small" entities, with less than 100 direct or indirect partners qualify to make this election
- In addition, qualifying entities can only be comprised of members who are:
  - Individuals
  - Estates of deceased partners
  - C Corporations
  - S Corporations
- Must make this election annually on the tax return

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Partnership Audits and Adjustments
New Requirements and Rules

- Audit adjustments will now be determined solely at the partnership level
- Partnerships must designate an authorized representative to have sole authority to act on behalf of the partnership in the audit. (does not have to be a partner)
- Barring an election to the contrary – the partnership will be liable for any tax resulting from the audit, with the assumption that all partners are taxable at top rate (39.6%[1])
- Provision to reduce the tax by showing documentations that partners have reduced tax rates (i.e. tax exempts, qualified dividends, long term capital gains) (270 days)

[1] denotes max top rate as the adjustment could be applicable to periods prior to TCJA

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Partnership Audits and Adjustments Election out of payment of taxes by Partnership

- Partnerships can elect out of entity level taxation by issuing "adjusted" K-1 statements to each partner
- The partners will pay the tax in the year they receive the adjusted K-1. No prior year amendment will be required
- Although paid in the current year, each partner will need to calculate the increase (or decrease) to tax as if the adjusted item were included in the adjusted year
- Have 45 days from FPA (final partnership adj) to make this election to "push out"

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Partnership Agreement Considerations

- Who should be the partnership representative?
- Should the partnership limit the authority of the partnership representative?
- Liability of partnership representative
- Succession plan for the partnership representative
- Elections that can or cannot be made
- To push out or pay?
- How to deal with partner withdrawals?
- Documentation gathering for reduced liabilities
- New partners vs old partners
- Conflict of interests
- Capital accounting for partnership payment

Considerations for Existing and New Partnerships

- Amend your operating agreements
- Watch for IRS announcements and regulations
- Consider opt out if available
- Expect many states to enact conforming rules
- Expect increased audit activity by the IRS and states
- Don’t forget about portfolio company LLC agreements

Other SBIC Fund Tax Benefits

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§582(c)

- §582(c) provides that sale/exchange of debentures & notes by "financial institutions" shall **<u>NOT</u>** be considered a sale or exchange of a capital asset
- "Financial institutions" are defined to include SBICs (§582(c)(2)(iii))
- Allows SBICs to recognize ordinary loss, instead of capital loss, on recognized losses on debt issued by portfolio companies
- Avoids capital loss deductibility limitations and offsets higher taxed ordinary income

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§1243

- Essentially an extension of §582(c)
- Allows SBICs ordinary loss, instead of capital loss, on recognized losses on stock received by SBIC “pursuant to conversion privilege of convertible debentures”
- Avoids capital loss deductibility limitations and offsets higher taxed ordinary income
- Requires tax return disclosure, including:
  - Statement affirming SBIC status
  - Name and address of small business concern (portfolio company)
  - Number of shares or face value of securities on which loss was sustained
  - Sale price and tax basis
  - Date of purchase and sale (or write-off)
  - If written off, reason for worthlessness

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