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Potential tax reform

Implications for Venture Capital Funds and Portfolio Companies

Agenda

Overview

Trump Campaign and House Republican tax reform proposals

Trump Campaign and House Republican tax reform proposals

Before the election, the 2016 Trump Campaign released a proposal for tax reform

— Very brief and provides little detail

In June 2016, House Republicans released their "Blueprint" for tax reform

— The 2016 House Republican Blueprint (Blueprint) was developed by Ways and Means Chairman Kevin Brady, with broader input from the House Republican Caucus

— The Blueprint lays out broad parameters for tax reform, with many of the details unspecified

The two proposals share many similarities

Although the prospects for tax reform have increased significantly, it is not a "sure thing" and timing remains highly uncertain

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Comparison of tax reform proposals

Individual tax proposals

Blueprint	2016 Trump Campaign
— 33% maximum rate — 50% deduction for capital gains, interest, and dividends (resulting in a 16.5% rate for those items) — Maximum 25% rate on active business income from a sole proprietorship or pass-through entity, except that the amount representing reasonable compensation to owner-operators is taxable as ordinary income — Repeal net investment income tax — Repeal AMT	— 33% maximum rate — Retain 20% maximum rate for capital gains and dividends — Repeal net investment income tax — Repeal AMT

General business tax proposals

Blueprint	2016 Trump Campaign
— 20% corporate rate — Full expensing of the cost of investment in tangible property (other than land) and intangible assets — Interest expense deductible only to the extent of interest income, with any net interest expense that is not deductible being carried forward indefinitely (special rules to be provided for banks, insurance companies, etc.) — NOLs carried forward indefinitely and indexed for inflation, but no carryback; carryforwards limited to 90% of the net taxable amount for the year of the carryforward — Eliminate various “special interest deductions and credits” designed to encourage particular business activities, but retain the R&D credit — Retain the last-in-first-out (LIFO) method — Repeal corporate AMT	— 15% business rate for “all businesses, both small and large, that retain the profits within the business” — Firms engaged in U.S. manufacturing may elect to expense capital investment and lose the deductibility of business interest expense — “Leverage public-private partnerships, and private investments through tax incentives, to spur $1 trillion in infrastructure investment over 10 years on a revenue neutral basis” — Eliminate most “corporate tax expenditures” but not the R&D credit — Repeal corporate AMT

International business tax proposals

Blueprint	2016 Trump Campaign
— Destination-based tax system under which the taxation of business income would be based on the location of consumption rather than the location of production — Core features: (i) Adopt territorial tax system; (ii) Border adjustments exempting exports and taxing imports (amounts paid for imported items/services not treated as COGS or deductible) — 100% exemption for dividends from foreign subsidiaries — Foreign earnings accumulated under the current worldwide system subject to 8.75% tax to the extent held in cash or cash equivalents or 3.5% tax otherwise (tax payable in installments over 8 years)	— Deemed repatriation at one-time 10% rate

Who may be impacted?

Factors suggesting lower tax burden	Factors suggesting higher tax burden
— High ratio of domestic suppliers/service providers	— Highly leveraged companies
— High ratio of foreign customers	— High ratio of foreign suppliers/service providers
— Asset intensive business	— High ratio of domestic customers
— Infrastructure-related business	— Non-asset intensive business
— Domestically domiciled IP	— Management of ETR via offshore IP model for U.S. sales
— Minimal use of special deductions, credits, or preference items	— Heavy use of special deductions, credits, or preference items

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Implications for venture capital funds & portfolio companies

Management fees

Blueprint	2016 Trump campaign
— Management fee income qualifies as active business income eligible for maximum 25% pass-through rate? — If so, how to determine what portion constitutes reasonable compensation to owner-operators? — Management fees from a foreign fund or from foreign LPs exempt from U.S. tax?	— Management fee income (net of expenses) qualifies for 15% business tax rate? — What does it mean to “retain the profits within the business” to qualify for the 15% rate? What if some or all of any net amount remaining after expenses is distributed?

Aligning shareholder and founder interests

In light of potential tax rate and other changes consider compensation and equity arrangements

— Incentivizing the founders, employees, and investors

— Convertible preferred stock vs. common stock

— Use of options: non-qualified vs. ISOs vs. equity compensation

Pricing implications

Pricing models should take into account the potential effects of tax reform

Proposal	Pricing impact
Tax rates	Increase in value due to increase in cash flow from reduced tax rates
Interest deductibility	Decrease in value for highly leveraged companies due to decrease in cash flow from reduced interest deductions
CapEx deductions	Increase in value for asset intensive businesses due to increase in cash flow from immediate tax deductions
Repatriation	Increase in value for companies with large amounts of low taxed foreign earnings and cash available to be repatriated
Base adjusted tax	Decrease in value for companies with significant imports Increase in value for companies with significant exports
NOLs, credits, and incentives	Value of company's tax attributes or other preference items may be reduced

Limitation on interest deductibility

- Impacts tax-efficiency of business models involving significant leverage and pricing
  - Extent to which lower rates and full expensing compensate for this change is unclear and may depend on the particular portfolio company business
  - Affects portfolio company cash flows/modeling and capital structure decisions
- Impacts use of leverage to minimize tax on blockers
- Affects determination of optimal jurisdiction for borrowing for portfolio companies operating in multiple jurisdictions
- Possible impact on available amount of debt financing
- Changes to interest deductibility may impact financing of GP capital

Repatriation

- Some form of repatriation relief appears likely even if broader tax reform is not enacted
- Expected to result in offshore cash, including accumulated and likely future earnings, being available to be repatriated (e.g., for debt service) at low or no incremental tax cost without significant tax planning being required
- Repatriation tax holiday is only likely to be done in connection with international tax reform
- Selected tax planning to consider to minimize potential tax on deemed repatriation:

Foreign tax credits

- Various planning to use existing credits
- Distribution of high-tax earnings

E&P reduction

- Built-in loss and deficit planning
- Accounting method changes (accelerate deductions)
- Granite Trust transactions

E&P shifting

- Foreign affiliates acquire CFC preferred stock
- Related party stock sales (section 304 transactions and D reorganizations with boot)

Cash versus non-cash

- Eliminate cash and equivalents (includes accounts receivable)
- Accelerate purchases (including add-ons) to use cash

Fund investment decisions

- Take potential rate reductions into account in general portfolio planning, including planning for potential exits
- As reform approaches and becomes more certain, consider deferring sale dates and/or the use of installment sales with respect to pending deals to qualify for reduced rates on exit
- Potential flexibility to use repatriated funds, including as a possible source of financing for new or add-on acquisitions, if applicable

Portfolio companies

- Evaluate changes to value chain arrangements in light of territorial system and border adjustments
- Discontinue measures to develop IP offshore rather than in U.S. and consider re-domiciliation of previously offshored IP or other assets/businesses?
- Consider impact of full expensing on whether to carry assets on the balance sheet as opposed to, for example, entering into sale-leasebacks to raise cash for debt service, funding acquisitions, etc.

Things to do now

- Model variations of cash flow impact on potential targets and existing portfolio companies
- Conduct E&P studies to determine the amount of anticipated repatriation tax
- Evaluate opportunities to reduce E&P or otherwise reduce repatriation tax
- Consider accounting method changes to accelerate deductions/defer income

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Summary of significant proposed tax reform changes

Significant proposed tax reform changes

Proposal	Proposed new rules	Existing rules	Potential impact
Tax rates	**Ordinary income:** 33% maximum rate for individuals; 20% for corporations (15% under Trump campaign proposal); 25% on active income from a sole proprietorship or pass-through entity **Capital gain/dividends:** 16.5% under Blueprint (also for interest); 20% under Trump campaign proposal **Net investment income tax:** Eliminate	**Ordinary income:** 39.6% maximum rate for individuals and 35% for corporations **Capital gain/dividends:** 20% maximum rate **Net investment income tax:** 3.8%	Cash flow increase for impact of reduced tax rates Investments through pass-through entities likely remain preferred
Interest deductibility	**Blueprint:** Only available to extent of interest income (with special rules for banks, insurance companies, etc.) Indefinite carryforward	Available, subject to certain limitations	Cash flow reduction for impact of lost tax deduction
CapEx deductions	**Blueprint:** Immediate expensing of investments in tangible property (other than land) and intangible assets **Trump:** U.S. manufacturers may elect full expensing and lose interest deductibility	Tangible property (other than land) and intangible assets generally subject to depreciation and amortization	Cash flow increase due to accelerated tax deductions

Significant proposed tax reform changes (2)

Proposal	Proposed new rules	Existing rules	Potential deal impact
Repatriation	**Blueprint:** Accumulated foreign earnings taxed at 8.75% to the extent held in cash or cash equivalents or 3.5% for other assets **Trump:** One-time repatriation tax at 10%	U.S. tax on foreign earnings of subsidiaries deferred until repatriated, subject to exceptions	Additional flexibility to use foreign cash to service U.S. cash needs
Territorial tax with border adjustments	**Blueprint:** Move toward a destination-based system where income from goods and services is taxed based on the location of consumption (tax on imports, not exports). Dividends from foreign subsidiaries exempt from tax.	U.S. corporations taxed on worldwide income	Possible increase in taxes for large importers Possible decrease in taxes for large exporters
Net operating losses	**Blueprint:** Carried forward indefinitely (indexed for inflation); no carryback Utilization limited to 90% of taxable income	Carryback two years; Carryforward 20 years	May cause taxpayers to be subject to current federal cash taxes

Thank you!

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