Provisions affecting private equity funds in tax reform bills—House bill and Senate Finance Committee bill

November 22, 2017

The U.S. House of Representatives on November 16, 2017, passed H.R. 1, the "Tax Cuts and Jobs Act." The Senate Finance Committee also on November 16, 2017, approved its version of the bill.

This report provides a summary and observations regarding certain provisions affecting private equity funds, fund sponsors, and fund investors in the "Tax Cuts and Jobs Act" as approved by the House (the "House Bill"), and by the Senate Finance Committee (the "SFC Bill").

In accordance with traditional Senate Finance Committee practice, the SFC Bill was approved based on detailed summaries of the relevant provisions. Legislative language was released on November 20, 2017. Note that many of the SFC Bill provisions affecting individuals generally expire after December 31, 2025. Therefore, under the SFC Bill, the affected provisions of the Internal Revenue Code would, as of such date, revert to their form as in effect prior to January 1, 2018 (absent future legislative action).

This summary is not intended to be a comprehensive listing of all provisions in the House Bill and/or the SFC Bill that may be relevant to a fund, or its sponsors, investors, or portfolio companies, based on its particular circumstances. The principal provisions addressed by this report are those relating to:

- Carried interest
- Special rates for individuals for income earned through partnerships
- Corporate rate reduction
- Limitations on interest deductibility
- Corporate tax attributes, including expensing, net operating losses ("NOLs"), and repeal of the corporate alternative minimum tax ("AMT")
- U.S. international tax, including:
    - Participation exemption for dividends from foreign subsidiaries
    - Minimum tax on certain low-taxed foreign earnings
    - Anti-base erosion taxes on payments to foreign affiliates
    - Transition tax on accumulated foreign earnings (the "Repatriation Tax")
    - Treatment of sales of interests by foreign partners in certain U.S. trade or business partnerships
    - Limitations on deductions for certain hybrid payments
- Tax-exempt investors

Documents

House Bill

- Read text of the House Bill [PDF 1 MB] (447 pages)
- Read the Ways and Means Committee report [PDF 8.2 MB] (994 pages) on the House Bill
- Read JCX-54-17 – Estimated Revenue Effects of Bill Ordered Reported by Ways and Means (House Bill)

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- Read JCX-55-17 - Distributional effects of the House Bill [PDF 86 KB] (seven pages)
- KPMG's initial analysis and observations [PDF 1.8 MB] regarding the House Bill (119 pages)

SFC Bill

- Read text of SFC bill [PDF 843 KB] (515 pages) released November 20
- Read a description [PDF 986 KB] (253 pages) of the "mark" for the SFC Bill prepared by the Joint Committee on Taxation (JCT), as modified [PDF 663 KB] on November 14, 2017 (103 pages) and amended [PDF 104 KB] on November 16, 2017 (five pages)
- JCX-59-17 – Revenue estimate of the SFC Bill (10 pages)
- JCX-58R-17 - Distribution effects of the SFC Bill (seven pages)
- KPMG's preliminary analysis and observations [PDF 1.3 MB] regarding the SFC Bill (171 pages)

CARRIED INTEREST

The House Bill would address the tax treatment of carried interest by requiring an asset holding period of greater than three years to qualify for long-term capital gain treatment with respect to an "applicable partnership interest." Although not expressly stated in the provision, it is possible that this three-year holding period requirement applies to a sale of the applicable partnership interest itself, as well as to sales of assets held (directly or indirectly) by the applicable partnership.

The provision defines an applicable partnership interest as a partnership interest that is transferred to, or held by, a taxpayer in connection with the performance of substantial services by the taxpayer, or a related person, in any "applicable trade or business." An applicable trade or business is an activity that is conducted on a regular, continuous, and substantial basis and which consists, in whole or in part, of: (1) raising or returning capital; and (2) either (a) investing in or disposing of "specified assets" (or identifying such specified assets for investing or disposition), or (b) developing specified assets. Specified assets include securities, commodities, real estate held for rental or investment, cash or cash equivalents, options or derivative contracts with respect to the forgoing assets, or an interest in a partnership to the extent of the partnership's interest in the forgoing assets. According to the explanation accompanying the House Bill, "developing specified assets" occurs if representations are made to investors, lenders, regulators, or others that the value, price, or yield of a portfolio business may be enhanced or increased in connection with the service provider's choices or actions. Services provided as an employee of an applicable trade or business are taken into account for this purpose, but merely voting owned shares is not.

An applicable partnership interest would not include a capital interest that provides the partner with a right to share in partnership capital commensurate with: (1) the amount of capital contributed (determined at the time of receipt of the partnership interest): or (2) the value of the interest included in income under section 83 upon receipt or vesting.

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The three-year holding period does not apply to income or gain attributable to any asset not held for portfolio investment on behalf of "third-party investors." This provision would seem to exclude gain from the intangible asset value associated with a sponsor's investment management business from the application of these rules.

Finally, the House Bill provision carves applicable partnership interests out of the application of section 83.

The House Bill's carried interest provision would be effective for tax years beginning after December 31, 2017. Thus, there would be no grandfathering for applicable partnership interests held as of the effective date of such legislation.

The SFC Bill includes a carried interest proposal that is substantially similar to the House Bill, except that it does not carve applicable partnership interests out of section 83. Instead, the SFC Bill version states that the amount that would be subject to the short-term holding period under the provision "shall be treated as short-term capital gain, notwithstanding section 83 or any election in effect under section 83(b)."

KPMG observation

A typical private equity fund would generally be expected to hold most of its investments for more than three years, and to the extent this is the case, long-term capital gain treatment of carried interest with respect to such investments would apparently remain available. There will, however, be situations in which the holding period of particular investments could be shorter than three years.

The provision only impacts the tax treatment of gains on the disposition of assets held for less than three years. The treatment of other items of income that flow through to a holder of an applicable partnership interest at preferred rates, such as qualified dividend income, would not be affected. Further, it would appear that income from assets that have a statutorily prescribed long-term holding period are not subject to the extended holding period under this provision.

This provision would require that funds track and report a separate category of income (shorter-than-three-year holding period) to the extent relevant to a partners receiving a distributive share of such income.

Because the House Bill carves out applicable partnership interests from section 83, it would not be possible to make an election under section 83(b) with respect to the grant of an unvested partnership interest. Under the SFC Bill, there is language indicating that short-term capital gain treatment will result "notwithstanding section 83 or any election in effect under section 83(b)." This language may be intended to indicate that, as with the House Bill, the new carried interest provision would apply to the exclusion of section 83 with respect to an applicable partnership interest. The SFC Bill language, however, is different, and the placement of the language implies a potentially narrower scope in

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providing only that section 83 does not override the recast to short-term capital gain for capital assets held less than three years. In any event, the SFC Bill does not make clear how disregarding section 83 and section 83(b) elections would impact the determination of whether there is long-term or short-term gain under section 1222.

PROVISIONS REGARDING BUSINESS INCOME OF INDIVIDUALS

The House Bill would create a new 25% maximum rate for business income of individuals from sole proprietorships, partnerships, and S corporations. This new rate generally would apply to all net business income from passive business activities and to the "capital percentage" of net business income from active business activities, applying the material participation rules to determine whether activities are passive or active.

For income from active businesses, other than certain service businesses, the capital percentage generally would be 30% unless an owner elects to use an alternate method to determine the capital percentage. The alternate method essentially would allow the 25% rate to apply to a deemed return (short-term AFR plus 7%) on the owner's share of the adjusted tax basis of the partnership's tangible depreciable and real property that is used in its trade or business (determined without regard to bonus depreciation and section 179 expensing).

Service businesses, including, for example, law, accounting, consulting, financial service and brokerage firms and those who invest, trade or deal in certain securities, partnership interests, or commodities ("specified service activities") generally would not benefit from the 25% rate because their deemed capital percentage would be zero unless they were able to prove a capital percentage of at least 10%.

The SFC Bill takes a different approach to providing a reduced passthrough rate. It includes a provision that generally would allow an individual taxpayer a deduction for 17.4% of the individual's qualified business income from a partnership, S corporation, or sole proprietorship. Qualified business income generally includes only items included in taxable income that are effectively connected with a U.S. trade or business, other than specified service trades or businesses. Qualified income does not include reasonable compensation, section 707(c) guaranteed payments or, to the extent provided in regulations, section 707(a) payments to the taxpayer for services rendered with respect to the qualified trade or business. The deduction generally would be limited to 50% of the taxpayer's pro rata or allocable share of W-2 wages attributable to qualified business income paid by the partnership, S corporation, or sole proprietorship (with an exception applicable to taxpayers with income not exceeding $500,000 for a married taxpayer, filing jointly). For this purpose, a partner's or S corporation shareholder's allocable share of W-2 wages is determined in the same manner as the partner's or shareholder's allocable share of wage expense, which for an S corporation shareholder would be his or her pro rata share. If the amount of qualified business income for a tax year were less than zero (*i.e.*, a loss), the loss would be treated as a loss reducing qualified business income in the next tax year.

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A qualified business generally would be any trade or business other than a "specified service trade or business." A specified service trade or business is any trade or business activity involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business the principal asset of which is the reputation or skill of one or more of its employees, and including investing and investment management, trading, or dealing in securities, partnership interests, or commodities. The deduction may apply to income from a specified service trade or business if the taxpayer's taxable income does not exceed $500,000 (for married individuals filing jointly) and is phased out over the next $100,000.

The SFC Bill provision lowers the threshold for triggering accuracy-related penalties for taxpayers claiming a deduction under this provision to impose a penalty when an understatement exceeds the greater of 5% of the tax required to be shown on the return or $5,000, down from 10%.

The proposal would be effective for tax years beginning after December 31, 2017. This provision is among the individual provisions that are scheduled to sunset in 2025 in the SFC Bill.

KPMG observation

Both the House Bill approach and the SFC Bill approach would effectively reduce the tax rate applicable to certain business income of individuals. The extent of the benefit of the SFC Bill approach depends upon the applicable tax rate, but for the highest bracket taxpayers, would reduce the rate to 31.8%, at best, as compared to the 25% rate under the House Bill. In addition, the deduction under the SFC Bill is based only on domestic business income and the available deduction is generally limited to 50% of a taxpayer's allocable share of wages paid attributable to the domestic business income, potentially further reducing the net benefit of the deduction.

Both approaches limit or preclude the ability to benefit from the lower rate or deduction in the case of certain service business activities. However, while the SFC Bill approach generally does not apply to specified service businesses (other than an exception based upon certain income thresholds), the House Bill may permit such activities to benefit from the reduced rate where the taxpayer does not materially participate, or where the taxpayer is able to establish a capital percentage that is 10% or higher.

House Bill—Impact on private equity funds

It appears that active partners in management companies are unlikely to benefit from the reduced rate with respect to their distributive share of management fee income because such income is likely to be treated as attributable to specified services activities. Although management companies do not often have passive partners, any such partner would seem to potentially benefit from the reduced rate under the House Bill.

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Active partners of a general partner entity possibly could benefit from the lower rate under the House Bill on the capital percentage of their distributive shares from the fund's partnership portfolio companies that are engaged in a trade or business other than a specified service activity. Investment type income that flows up from the portfolio company would continue to be taxed at the current rates for such income. Passive partners of a general partner entity would benefit from the lower rate on all of their net business income from such a portfolio company. To determine whether such partners are active or passive, the section 469 material participation tests would apply and would take into account activities carried on by an individual through other entities, including for example, through the management company.

Individual limited partners who do not materially participate in a portfolio company's activities generally would benefit from the reduced rate on the entire amount of the qualified business income flowing through the private equity fund from the portfolio company.

SFC Bill—Impact on private equity funds

Individual partners in management companies likely would not qualify for the deduction under the SFC Bill (other than pursuant to the exception for income not exceeding the thresholds). Whether a partner is active or passive is not relevant under this approach.

Individual partners of a general partner entity, or individual limited partners, could benefit from the deduction on domestic qualified business income that flows up from the fund's partnership portfolio companies that are engaged in a trade or business (other than a specified service activity, and with regard to income other than investment type income such as long-term and short-term capital gain). However, if such income exceeds $500,000 (for married filing jointly) then it would be subject to the 50% wage limitation. If the portfolio company does not pay any wages or have any domestic qualified income, no benefit would seem to result.

CORPORATE RATE REDUCTION

Both the House Bill and the SFC Bill would eliminate the progressive corporate tax rate structure, currently imposing a maximum U.S. corporate tax rate of 35%, and replace it with a flat tax rate of 20%.

Both proposals would also adjust the corporate dividends received deduction ("DRD") to reflect the lower corporate tax by reducing the 80% deduction for dividends received from 20%-owned corporations to 65%, and reducing the 70% rate applicable to less than 20%-owned corporations to 50%. As a result of these changes, dividends from 20%-owned corporations would be taxed at a rate of 7% and dividends from less than 20%- owned corporations would be taxed at 10% rate.

Under the House Bill, the new 20% corporate rate (and the DRD changes) would be effective for tax years beginning after December 31, 2017, while the SFC Bill would defer

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the corporate tax rate reduction (and DRD changes) for a year, with the 20% rate becoming effective for tax years beginning after December 31, 2018.

KPMG observation

The potential lowering of the corporate tax rate to 20% would affect portfolio company cash flows and should be taken into account in planning for potential acquisitions. It will also affect negotiations over the value of a potential portfolio company's tax attributes, including attributes (such as asset basis "step-up") arising in connection with an acquisition.

To the extent that fund managers are unlikely to qualify for the lower passthrough rates on management fee income, the significant lowering of the corporate rate to 20% may cause fund sponsors to undertake a choice of entity analysis as to whether it would be advantageous to convert management companies currently treated as partnerships into corporations.

INTEREST DEDUCTIBILITY

The House Bill and the SFC Bill each include two separate and independent limitations on the deduction of net interest expense.

30% limitation

Both the House Bill and SFC Bill would disallow a taxpayer's deductions for business interest expense to the extent such deductions would exceed 30% of adjusted taxable income. However, adjusted taxable income is defined differently in the two bills. Under the House Bill, adjusted taxable income is similar to EBITDA. Under the SFC Bill, adjusted taxable income is similar to EBIT. As a result, the SFC Bill limitation is generally materially more restrictive. Certain taxpayers, including regulated public utilities and real estate businesses, would not be subject to the limitation.

In the case of a partnership, the 30% limitation on net interest expense is applied at the partnership level, and business interest deductions that are allowed would be taken into account in determining the non-separately stated taxable income or loss of the partnership. Any unused limitation at the partnership level (*i.e.,* the "excess amount") would be allocated to the partners who then could use that excess amount in computing the amount of business interest they can deduct, subject to the applicable limitations on deductibility at the partner level. For purposes of applying the business interest deductibility limitation at the partner level, a partner's share of non-separately stated taxable income or loss from the partnership would be ignored in calculating the partner's adjusted taxable income. This is intended to prevent partners from "double-counting" the partnership's income or loss that determined deductibility at the partnership level.

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Base erosion limitations

Under the House Bill, in the case of a U.S. corporation that is a member of an "international financial reporting group" (or "IFRG"), the U.S. corporation's interest expense deduction would be limited under a formula that is generally intended to impose a cap to the extent that the U.S. corporation's share of the group's global net interest expense exceeds 110% of the U.S. corporation's share of the group's EBITDA. An IFRG is defined as any group of entities that in the current year: (1) includes at least one foreign corporation that is engaged in a trade or business in the United States, or at least one U.S. corporation and one foreign corporation; (2) prepares consolidated financial statements; and (3) has (taking into account in the aggregate all entities in the group) annual global gross receipts of more than $100 million for the three-reporting-year period ending with the current year. For purposes of applying this limitation, corporations that are members of a U.S. consolidated group of corporations are treated as a single corporation.

The Senate Finance Committee Bill takes a more balance sheet-oriented approach under which interest expense deductions of U.S. corporations that are members of a worldwide affiliated group ("WAG") are reduced to the extent that such U.S. corporate WAG members (treated for this purpose as a single member) have a ratio of debt to equity that exceeds 110% of the ratio of debt to equity for the WAG. The WAG is defined as one or more chains of corporations connected through 50% or greater stock ownership with a common parent corporation.

To the extent that both the 30% limitation and the base erosion limitations are applicable with respect to a particular taxpayer, the more restrictive limitation applies under each of the House Bill and the SFC Bill.

Disallowed interest expense under either provision may be carried forward for up to five tax years under the House Bill and indefinitely under the SFC Bill.

KPMG observation

The limitation on the deductibility of business interest expense is likely to impact the tax-efficiency of the LBO business model, although the effect of this change should be considered in tandem with other changes, including the reduction in corporate rates and 100% expensing.

The proposal is also likely to impact the ability to use leverage to reduce the U.S. tax drag on blocker corporations that are commonly used to protect foreign and tax-exempt investors from realizing effectively connected and unrelated business taxable income ("UBTI"). Together with the corporate rate change, it may also affect decisions as to the optimal jurisdiction for borrowing for portfolio companies that operate in multiple jurisdictions.

The 30% limitation applies only to business interest expense, meaning that fund-level

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debt for funds not engaged in a trade or business should as to partners who are individuals generally remain subject to the investment interest expense limitations.

Although it is not entirely clear, it appears that the base erosion limitations generally would apply separately to a fund and each of the portfolio investments in the fund's portfolio. The House Bill approach would turn on whether a fund and its portfolio companies are treated as members of a single IFRG. This, in turn, depends on whether the fund prepares consolidated financial statements with its portfolio companies. To the extent that a fund treats its portfolio companies as financial investments for book purposes and does not consolidate with them, it appears that different portfolio companies would not be treated as part of the same IFRG notwithstanding their common ownership. Under the SFC Bill, only corporations are WAG members. Because funds are typically organized as partnerships, they generally would not be included in a WAG and their common ownership of portfolio companies would not cause separate portfolio companies to be combined into a single WAG. The SFC Bill does provide authority to issue regulations to carry out the purposes of its base erosion limitation, including to address the treatment of partnerships, although it is not clear that this regulatory authority would extend to including a partnership parent entity as part of a WAG.

PROVISIONS RELATED TO CORPORATE TAX ATTRIBUTES

Expensing

Both the House Bill and the SFC Bill expand bonus depreciation by allowing taxpayers to fully and immediately expense 100% of the cost of qualified property—generally tangible depreciable property with a depreciable life of 20 years or less—acquired and placed in service after September 27, 2017, and before January 1, 2023.

The House Bill would also expand the property that is eligible for this immediate expensing by repealing the requirement that the original use of the property begin with the taxpayer. Instead, the property would be eligible for the additional depreciation if it is the taxpayer's first use.

The House Bill and the SFC Bill generally provide that assets used in businesses that are excepted from the 30% limitation on the deductibility of net interest expense—most notably, certain regulated public utilities and real estate businesses (with the exception for real estate businesses being elective in the SFC Bill)—are not eligible for 100% expensing.

KPMG observation

If adopted, the expansion of expensing in the House Bill is likely to increase the incentives for private equity buyers to structure business acquisitions as actual or deemed (*e.g.*, pursuant to a section 338 election) asset purchases rather than stock purchases, at least in the case of asset-intensive businesses. In particular, the extension of the bonus depreciation rules to "first use" rather than "original use" property would mean that asset

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buyers may be able to immediately expense a significant portion of the purchase price. Immediate expensing would not, however, apply to intangible assets (in particular, goodwill), which some had hoped for based on the earlier House Blueprint, and the SFC Bill would retain the “original use” standard.

The expansion of expensing under the House Bill or the SFC Bill is likely to result in (or increase) book-tax differences, and will generally result in creation of deferred tax liabilities for book purposes.

Net Operating Losses

Both the House Bill and SFC Bill would: (1) repeal almost all NOL carrybacks (with exceptions for property and casualty insurance companies and farming losses in the SFC Bill); (2) limit the ability to utilize NOLs to 90% of a corporation’s taxable income for a tax year; and (3) allow taxpayers to carry NOLs forward indefinitely. The House Bill would also allow carried forward NOLs to be increased by an interest factor (the annual short-term federal rate plus 4%). The SFC Bill does not provide for such adjustments.

The effective date provisions relating the new NOL provisions are intricate. In very general terms, the SFC Bill provides more generous treatment for pre-existing NOLs by not subjecting them to the 90% of taxable income limitation, while the House Bill is more generous in allowing the annual increase, although it restricts that annual increase to newly generated NOLs.

More specifically, the provisions in the House Bill allowing indefinite carryovers and restricting carrybacks would apply to losses arising in tax years beginning after December 31, 2017, while those provisions in the SFC Bill would apply to losses arising in tax years ending after December 31, 2017. The annual increase provision in the House Bill would apply to NOLs arising in and carried over to tax years beginning after December 31, 2017. Under the House Bill, the 90% limitation would apply to tax years beginning after December 31, 2017, while under the SFC Bill that limitation would apply only to losses arising in tax years beginning after that date. However, under the SFC Bill, the percentage of a corporation’s taxable income that could be offset by NOLs each year would decline to 80% for tax years beginning after December 31, 2022, but could revert to 90% for tax years beginning after December 31, 2025, if aggregate federal revenues from October 1, 2017, through September 30, 2026, exceed a specified amount.

Repeal of Corporate AMT

Both the House Bill and SFC Bill would repeal the corporate AMT effective for tax years beginning after December 31, 2017. Any AMT credit carryovers to tax years after that date generally could be utilized to the extent of the taxpayer’s regular tax liability (as reduced by certain other credits). In addition, both the House Bill and the SFC Bill would provide a refund to the extent that AMT credit carryovers exceed regular tax liability (as reduced by certain other credits). Under the House Bill, the refund would be 50% of the excess AMT credit carryovers for tax years beginning in 2019, 2020, and 2021, with 100%

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refundable in 2022. The SFC Bill would accelerate the ability to obtain refunds by one year, with 50% of the excess AMT credit carryovers being refundable in 2018, 2019, and 2020, with 100% being refundable in 2021.

KPMG observation

For portfolio companies with significant corporate AMT credit carryovers, the generous rules in the House Bill and the SFC Bill with respect to such carryovers would allow the full use of those credits to reduce or eliminate regular tax liability, and potentially to obtain tax refunds, thereby improving after-tax cash flows. AMT credit carryovers may also be a consideration in evaluating potential acquisitions, although potential limitations arising from the acquisition itself should be taken into account in that context.

More generally, the NOL and AMT provisions, and potentially the expensing provisions if the House Bill proposal is adopted, will impact how buyers and sellers value tax attributes in a potential transaction. Financial bidders such as private equity firms often determine the value of attributes (whether or not separately stated in a bid) by calculating the net present value of the cash tax savings expected to result over their intended holding period. However, because the value of tax attributes is dependent upon cash tax savings and taxable income projections, other provisions of the bills must be also be considered for this purpose, including particularly the proposed reduced corporate tax rate of 20% and the proposed interest expense deduction limitations.

INTERNATIONAL PROVISIONS

Participation Exemption

Both the House Bill and SFC Bill would provide a domestic corporation that is a U.S. shareholder (as defined in section 951(b)) of a foreign corporation a 100% dividends received deduction ("DRD") for the foreign-source portion of dividends received from the foreign corporation, effectively implementing a participation exemption regime. On the other hand and as discussed below, both the House Bill and SFC Bill would impose a current U.S. tax at a reduced rate on a broad swath of the foreign earnings of a controlled foreign corporation ("CFC"). Taken together, these provisions effectively end the "lockout" effect of the current deferral system, in which foreign earnings of a foreign subsidiary other than subpart F income is subject to residual U.S. tax when repatriated.

In addition to owning 10% of the voting power of the foreign corporation, a domestic corporation would need to satisfy a holding period requirement to qualify for the DRD (6 months under the House Bill; one year under the SFC Bill). The House Bill also includes an anti-conduit provision to be eligible for the DRD, while the SFC Bill includes an anti-"hybrid" provision under which the DRD would not be available if a deduction or other tax benefit were received with respect to the dividend for foreign tax purposes.

The House Bill and SFC Bill also would amend Code section 956 to exclude U.S. corporate shareholders of CFCs from having a current income inclusion with respect to

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investments in U.S. property made by a CFC. Code section 956 would continue to apply to individual U.S. shareholders.

KPMG observation

As a result of elimination of the lockout effect, current planning to effect the repatriation of cash from foreign operations to a U.S. portfolio company would no longer be required, as foreign earnings could effectively be repatriated without incurring incremental U.S. tax. Repeal of section 956 would also simplify credit agreement negotiations because cross-guarantees or pledges of CFC stock would no longer trigger U.S. income inclusions under section 956 for U.S. corporations.

Minimum Tax – Tax on "Foreign High Return Amount" (House Bill) or "Global Intangible Low-Tax Income" (SFC Bill)

Both the House Bill and the SFC Bill would impose current U.S. taxation on earnings of CFCs above a "routine return," subject to certain exemptions.

The House Bill would impose tax annually on a U.S. shareholder's pro rata share of the foreign high return amount (the "FHRA"). The tax would be imposed on 50% of the U.S. shareholder's share of the FHRA, resulting in an effective rate of 10% for corporate U.S. shareholders on this income. In general terms, the FHRA is the excess of (i) the aggregate net income of all CFCs (net of any net losses of CFCs) with certain exceptions over (ii) a routine return (which would fluctuate with interest rates, but currently would be approximately 8%) on the aggregate amount of the U.S. tax bases of all CFCs in depreciable tangible property used in the production of such income. The routine return would be reduced by the aggregate interest expense paid or accrued by the CFCs.

The SFC Bill would require a U.S. shareholder to include in income annually its "global intangible low-taxed income" ("GILTI"). In general, GILTI would be the excess of the U.S. shareholder's pro rata share of its CFCs' net income, with certain exceptions, over 10% of its pro rata share of the adjusted bases of the CFCs' depreciable tangible property used in the production of such income. A corporate U.S. shareholder may be allowed a deduction equal to 50% of the GILTI, which would as in the House Bill result in a 10% effective rate for such income. However, non-corporate U.S. shareholders would not be eligible for the 50% deduction, and apparently would be taxed on GILTI at the otherwise generally applicable rates.

A corporate U.S. shareholder would in addition be eligible to use 80% of its deemed paid foreign tax credits against the FHRA or GILTI, as applicable. Because of this, a corporate U.S. shareholder generally would not pay residual U.S. tax if the foreign effective tax rate on the FHRA or GILTI is greater than 12.5%, which is the reason the provision is sometimes referred to as a minimum tax.

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KPMG observation

The minimum tax can be expected to have a significant impact on U.S. portfolio companies that have foreign subsidiaries. Funds should consider the tax in planning for current acquisitions to make sure that pricing appropriately accounts for the potential tax liability.

For U.S investors, the provision ends deferral with respect to the FHRA or GILTI, as applicable, but in many cases would tax the income at a reduced amount, so the impact on U.S. investors' appetite for investments in CFCs will depend on the expected return profile of the investment.

The minimum tax would apply to both corporate and non-corporate U.S. shareholders of CFCs, and accordingly could include funds or fund partners that directly or indirectly own stock in foreign portfolio companies classified as CFCs. Under the House Bill, individual U.S. shareholders would receive the benefit of the 50% reduction in the inclusion, which reduces the effective rate. Under the SFC Bill, the deduction against GILTI applies only to corporate U.S. shareholders, so for individuals GILTI would be included at the normal rate.

Anti-Base Erosion Provision – Excise Tax on Payments to Foreign Affiliates (House Bill) and Base Erosion Anti-Abuse Tax (SFC Bill)

The House Bill would impose a tax on certain payments by U.S. corporations to foreign affiliates that are members of its IFRG by imposing a new excise tax on such payments if the amount of such payments by the group exceeds $100 million. The new tax is extremely broad in scope, applying to virtually every form of payment that would give rise to a deduction, be included in cost of goods sold, or be included in the basis of a depreciable or amortizable asset. The only exceptions are for: (1) interest; (2) payments for actively traded commodities or publicly traded securities and related hedges; (3) "FDAP" payments subject to 30% U.S. withholding tax (with a proportionate amount exempt if the payment is subject to reduced withholding); and (4) payments for services that are charged at cost (*i.e.,* no markup) under the services cost method in Reg. section 1.482-9(b).

The excise tax would be imposed at a rate of 20%, thus effectively denying the benefit of a deduction for covered payments unless the foreign recipient elects to treat the payment as income effectively connected with a U.S. trade or business (ECI) and as income attributable to a permanent establishment for tax treaty purposes. If the election is not made and the excise tax is paid, it is not deductible from the domestic corporation's taxable income. If the election is made, the foreign recipient's tax is computed under special rules based on "deemed expenses" and with a partial foreign tax credit.

The provision would apply to payments made on or after December 31, 2018, thereby affording taxpayers at least a one-year transition period.

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The SFC Bill's corollary to the excise tax proposal is a new base-erosion focused minimum tax (the "BEAT") that differs in several key respects from the House proposal.

The BEAT applies to domestic corporations that are not taxed on a flow-through basis (that is, not S Corps, RICs, or REITs), are part of a group with at least $500 million of annual gross receipts (over a three-year averaging period), and which have base erosion payments that exceed a certain threshold.

The BEAT targets base erosion payments that generally are amounts paid or incurred by the taxpayer to foreign related parties for which a deduction is allowable, including amounts paid in connection with the acquisition of depreciable or amortizable property from the related party. Base erosion payments include interest (interest deductions disallowed under the 30% limitation and base erosion limitation are treated first as paid to unrelated parties), but do not include amounts includible in cost of goods sold, amounts subject to full U.S. withholding tax, or services charged at cost. The BEAT equals the excess of 10% (12.5% for 2026 and later years) of the taxpayer's taxable income, determined with the base erosion payments added back, over the corporation's regular income tax liability reduced by any credits, other than the research credit, allowed in that year.

KPMG observation

Payments to unrelated parties are not subject to either the House Bill's excise tax provision or the SFC Bill BEAT, so the provisions do not appear to impact foreign companies that sell into the United States without a U.S. taxable presence (either a U.S. subsidiary or taxable branch), either because they use third-party distributors or because they sell directly to U.S. consumers without creating an income tax nexus. Note, however, that there is an express grant of regulatory authority in the House Bill to "prevent the avoidance of the purposes of this subsection through the use of conduit transactions or by other means." Service fees (such as subadvisory fees) paid by a domestic corporation to foreign related parties also would be subject to the excise tax or the BEAT, although most management companies probably will not be subject to the proposals because they are treated as partnerships for U.S. tax purposes and may not meet the thresholds under the provision. Funds should assess the potential exposure of domestic portfolio companies with foreign affiliates and ensure that pricing takes into account the potential liability from these provisions.

The provisions presumably are intended to be applied in full notwithstanding U.S. treaty obligations.

Repatriation Tax

As a transition to the new U.S. international tax regime, the House Bill and SFC Bill would provide that a U.S. shareholder of certain foreign corporations must include in income, for the foreign corporation's last tax year beginning before January 1, 2018, the U.S. shareholder's share of the foreign corporation's accumulated post-1986 deferred foreign

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income. The House Bill and SFC Bill have different measurement dates for accumulated post-1986 deferred foreign income (November 2, 2017, or December 31, 2017, under the House Bill; November 9, 2017, or December 31, 2017, under the SFC Bill), but the mechanics of the inclusion are broadly similar in the two bills.

Amounts included under the House Bill "Repatriation Tax" provision would, after taking into account a dividends received deduction, generally be taxable at a 14% rate to the extent attributable to amounts held in cash or cash equivalents and at a 7% rate otherwise. The rates under the SFC Bill are 10% and 5%, respectively. A U.S. shareholder can claim a foreign tax credit for a portion of the foreign income taxes associated with its income inclusion. A taxpayer can elect to pay this tax over an eight-year period with the liability apportioned over that period in equal installments under the House Bill or in accordance with a more back-loaded payment schedule under the SFC Bill.

The SFC Bill includes an anti-inversion rule not present in the House Bill under which certain corporations that undertake an inversion during the 10-year period following the enactment of the Senate bill would be retroactively subject to tax on the full mandatory inclusion amount at a 35% tax rate, with no reduction for credits.

KPMG observation

The definition of "U.S. shareholder" includes not only domestic corporate shareholders of foreign corporations, but also domestic partnerships and individuals that directly, indirectly, or constructively own 10% or more of a foreign corporation's voting power. As a result, under both the House Bill and the SFC Bill, U.S. funds and U.S. fund partners may be exposed to income inclusions under the Repatriation Tax even though going forward the participation exemption regime for dividends from foreign subsidiaries will only apply to U.S. corporate shareholders. Non-U.S. funds may need to footnote amounts related to income inclusions to their U.S. partners that own more than 10% of the fund. These amounts or footnotes would generally be reflected on 2017 tax returns, so private equity funds should start planning now in case this passes.

The Repatriation Tax would clearly be an issue for U.S. portfolio companies that have foreign corporate subsidiaries. Funds should assess the potential exposure of such portfolio companies and whether measures are available to reduce that exposure, although the November 2 measurement date in the House Bill and the November 9 measurement date in the SFC Bill can be expected to significantly constrain available options.

In addition, funds should consider the Repatriation Tax in planning for current acquisitions to make sure that pricing and other contractual provisions appropriately account for potential Repatriation Tax liability. If the Repatriation Tax is enacted, going forward acquisitions should similarly take into account and appropriately allocate the burden of the tax, which may be payable over an eight-year period, between the buyer and seller. This places increased significance on making Section 338(g) elections to eliminate earnings and profits when buying non-U.S. corporations prior to December 31, 2017.

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Tax Gain on Sale of a Partnership Interest on Look-Through Basis

The SFC Bill would require that the gain or loss from the sale or exchange of a partnership interest be treated as effectively connected with a U.S. trade or business to the extent that the transferor partner would have been allocated effectively connected gain or loss if the partnership had sold all of its assets at fair market value on the date of the exchange. For this purpose, the gain or loss from the hypothetical asset sale by the partnership is allocated to interests in the partnership in the same manner as nonseparately stated items of income or loss. The provision contains a coordination rule for gain that is taxable under the Foreign Investment in Real Property Tax Act (FIRPTA).

The SFC Bill would also require the transferee of a partnership interest to withhold 10% of the amount realized on a sale or exchange of the interest unless the transferor certifies that it is not a nonresident alien individual or foreign corporation. If the transferee fails to withhold the correct amount, the SFC Bill would impose an obligation on the partnership to deduct and withhold from distributions to the transferee partner an amount equal to the amount the transferee failed to withhold.

This provision would be effective for sales and exchanges of partnership interests on or after November 27, 2017.

There is no corresponding provision in the House Bill.

KPMG observation

The provision in the SFC Bill is intended to codify the IRS position in Revenue Ruling 91-32, which much like the SFC Bill proposal held that a foreign partner's capital gain or loss on a sale of a partnership interest is treated as effectively connected with a U.S. trade or business to the extent that the sale of the underlying assets by the partnership would have resulted in the foreign partner recognizing effectively connected income. Revenue Ruling 91-32 has been controversial since its issuance due to questions about whether its holding is adequately supported by existing authority, and earlier this year the U.S. Tax Court refused to follow it in a case involving the redemption of a foreign partner's interest by a U.S. partnership.[1]

The provision would impact funds that invest, directly or indirectly through other partnerships, in portfolio companies classified as partnerships that are engaged in a U.S. trade or business, and foreign partners in such funds. Under the proposal, foreign partners in such funds would be subject to U.S. tax if they were to transfer their fund interests, and the funds, whether U.S. or foreign, would be required to treat the appropriate amount of gain or loss from a sale of an interest in such a portfolio company as effectively connected to a U.S. trade or business and withhold on this amount (under section 1446) with respect to any foreign partners.

[1] *Grecian Magnesite Mining, Industrial & Shipping Co. v. Commissioner*, 149 T.C. No. 3 (July 2017).

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The withholding regime included in the proposal also would have significant implications for funds as well as fund partners. The only exception to 10% withholding under the proposal is if the transferor certifies it is not a foreign corporation or nonresident alien individual. Presumably, the reason transferee withholding is not required with respect to a partnership transferor is because the section 1446 withholding regime should apply in those circumstances. However, the provision would also require that a partnership withhold from distributions to the transferee partner any amount that the transferee partner failed to withhold when the partnership interest was acquired from the transferor partner. This requires the partnership to determine whether there was sufficient withholding, and in some cases can raise questions as to the amount realized on which withholding should be applied.

Finally, the reason for the requirement to allocate gains on a hypothetical sale of assets in the same manner as nonseparately stated income or loss is unclear. Partnerships may have different sharing ratios in operating income and gains from the sale of assets used in the trade or business. As such, using the ratio of nonseparately stated income to determine the amount of gain or loss on the sale of partnership interest that is effectively connected with a U.S. trade or business could yield different results from the effectively connected gains or losses allocated to a partner from an actual sale of assets by the partnership.

Limit Deduction of Certain Related Party Amounts Paid or Accrued in Hybrid Transactions or with Hybrid Entities

The SFC Bill would disallow a deduction for any interest or royalty paid or accrued to a related party pursuant to a hybrid transaction or by, or to, a hybrid entity if: (1) there is no corresponding income inclusion to the related party under local tax law; or (2) such related party is allowed a deduction with respect to the payment under local tax law, subject to certain exceptions.

A hybrid transaction is any transaction or instrument under which one or more payments are treated as interest or royalties for federal income tax purposes but are not treated as such under the local tax law of the recipient. A hybrid entity is one that is treated as fiscally transparent for federal income tax purposes (e.g., a disregarded entity or partnership) but not for purposes of the foreign country of which the entity is resident or is subject to tax (hybrid entity), or an entity that is treated as fiscally transparent for foreign tax law purposes but not for Federal income tax purposes (reverse hybrid entity).

The SFC Bill also would grant the Secretary authority to issue regulations or other guidance necessary or appropriate to carry out the purposes of the proposal, including denying deductions for conduit arrangements that involve a hybrid transaction or a hybrid entity and applying the proposal to foreign branches.

The provision would be effective for tax years beginning after 2017 and does not appear to contain grandfathering rules.

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KPMG observation

The provision in the SFC Bill incorporates many of the recommendations issued pursuant to Action 2 of the OECD BEPS project (BEPS Recommendations), and would address the use of hybrid instruments and payments to and from reverse hybrids and disregarded payors. If the provision is enacted into law, funds will need to examine their structures for hybrid instruments and entities that may be subject to the provision. The provision does not appear to be limited to interest or royalties paid by a U.S. payor and may apply to payments made by a U.S. person, to a U.S. person, or between foreign related parties.

Other portions of the BEPS Recommendations may be implemented through Treasury regulations. These provisions could include rules that apply to imported mismatch arrangements, branch structures, and deductible dividends that are excluded pursuant to a participation exemption.

PROVISIONS AFFECTING TAX-EXEMPT INVESTORS

Under the House Bill, the unrelated business income tax (UBIT) would apply to state and local government entities, including state pension plans. According to a Ways and Means Committee summary of the bill, current law is unclear as to whether certain state and local entities, including public pension plans, that are tax-exempt under section 501(a) and exclude income by reason of section 115(1) (so-called “super tax-exempts”) are subject to the UBIT, and the purpose of this provision is to “clarify” the law in this regard.

Although the SFC Bill does not contain a similar provision as the House Bill subjecting super tax-exempts to UBTI, it does include a provision that may be significant for fund structures that would preclude a tax-exempt organization from utilizing UBTI losses from one unrelated trade or business to offset UBTI from another unrelated trade or business. However, losses from one unrelated trade or business arising in tax years beginning before January 1, 2018, may be carried over to years after such date and could be used to offset UBTI from other unrelated trade or businesses.

KPMG observation

The House Bill provision could have a significant impact on the manner in which state pension funds invest in private equity funds. It may require that future investments be structured, and potentially also that existing investments be restructured, to protect state pension funds from realizing UBTI, including through the use of blocker structures.

OTHER MISCELLANEOUS PROVISIONS

The House Bill and the SFC Bill include various other provisions that could impact planning and compliance for private equity funds, including but not limited to the following:

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- The House bill would repeal the technical termination of partnerships, which occurs under current law if within a 12-month period there is a sale or exchange of 50% or more of the total interest in partnership capital and profits.

- The SFC Bill proposes to modify the definition of substantial built-in loss by adding a rule that would require mandatory basis adjustments in partnership assets if the transferee of a partnership interest would be allocated a net loss in excess of $250,000 upon a hypothetical sale of all the partnership's assets in a fully taxable transaction immediately after the transfer of the partnership interest.

- The House Bill would repeal Code section 118 (which currently provides that a corporation does not recognize income on its receipt of a capital contribution) and add a new provision that would generally include in gross income any contribution to the capital of a corporation, other than in exchange for stock of such corporation. The exception for cases in which stock is received applies only to the extent that the fair market value of the money or other property does not exceed the fair market value of the stock received in the exchange. Similar rules would apply to entities other than corporations, including partnerships.

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