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Private Equity Funds—Certain Measures in New Tax Law Affecting Funds and Investors

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The president today signed the new tax law (H.R. 1). There are two international tax provisions that, for calendar year taxpayers, are effective as of **January 1, 2017** (technically, the last tax year beginning before January 1, 2018). When taken together, these provisions raise new material tax exposures and reporting obligations for private equity funds and their direct and indirect U.S. investors.

Repeal of section 958(b)(4)

First, the repeal of section 958(b)(4) has immediate effect. Therefore, starting with 2017, there is a significant expansion of the number of very standard private equity fund fact patterns which will result in the following:

- Direct and indirect US investors (e.g., U.S. feeder funds, U.S. fund-of-fund investors, other large U.S. investors) being classified as “United States shareholders” under section 951(b) (“US Shareholders”) (even if each such investor’s actual direct or indirect ownership interest in the fund is less than 10%);
- Foreign portfolio companies being classified as “controlled foreign corporations” under section 957 (“CFCs”); and
- U.S. investors (large and small) that hold interests in newly classified U.S. Shareholders that are pass-through entities being subject to Subpart F exposures and reporting obligations

Prior to repeal, section 958(b)(4) prohibited “downward” attribution of stock ownership from a foreign person to a U.S. person. Due to the repeal of section 958(b)(4), stock owned (directly, indirectly or constructively) by a foreign person will be attributed downward (i) to any U.S. partnership in which that foreign person has <u>any</u> interest and (ii) to any U.S. corporation in which that foreign person’s ownership interest is at least 50%.

Therefore, for example, when testing the CFC status of any foreign corporation (“ForCo”) that is owned by any foreign partnership or foreign corporation (the “PE Fund”), the PE Fund’s ownership interest in ForCo stock can be attributed (i) upward to the fund’s direct and indirect foreign investors under section 318(a)(2) (partnership to partner and corporation to 10%+ shareholder attribution) then (ii) downward from each such foreign investor to <u>any</u> U.S. partnership in which such investor is a partner and any U.S. corporation in which such investor has 50% or greater interest. As a result, downward attribution could be to a U.S. partnership or U.S. corporation that has absolutely no legal or economic interest in or other relationship with the PE Fund or ForCo and the U.S. entity that is attributed stock ownership due to downward attribution could be counted as a US Shareholder for purposes of testing ForCo’s CFC status. Furthermore, due to the so-called “bump-up” rule prescribed under section 958(b)(2), certain direct and indirect U.S. investors in the PE Fund could end up being classified as US Shareholders of a CFC even if the actual direct or indirect interest of each such investor in ForCo is less than 10%.

Note that the legislative history provides that the repeal of section 958(b)(4) is not intended to cause a foreign corporation to be treated as a CFC with respect to a US Shareholder as a result of downward attribution of ownership under section 318(a)(3) to a U.S. person that is not a "related person" (within the meaning of section 954(d)(3)) to such US Shareholder. However, the actual statutory language does not support the limited application that the legislative history describes. Therefore, it is possible that Treasury may conclude that it lacks authority to limit the scope through regulations and that a legislative correction would, thus, be required to implement the policy described in the legislative history. In the absence of regulations or a technical correction, it seems difficult at best to read the existing statutory language as consistent with the intent expressed in the legislative history.

New section 965

Second, the "mandatory repatriation" rules of new section 965, which also take effect immediately, trigger consequences that range from extremely "mild" to extremely "severe", depending on the exact fact pattern. Section 965 applies to each foreign corporation's last tax year which begins before January 1, 2018. Therefore, for calendar year foreign corporations, section 965 is effective for 2017.

Under section 965, very generally, the subpart F income of each "specified foreign corporation" ("SFC") will be increased by the SFC's accumulated post-1986 deferred foreign income (generally, post-1986 E&P accumulated while the foreign corporation was a SFC, but excluding earnings and profits ("E&P") attributable to effectively connected income and previously taxed sub-part F income). A foreign corporation is an SFC if either (i) it is a CFC **or** (ii) it has at least one domestic corporation that is a US Shareholder.

Therefore, generally, in the private equity fund context, the potential consequences under section 965 appear to be as follows:

- If a foreign corporation has SFC status solely because it is classified as a CFC (i.e., it did not have any domestic corporation as a US Shareholder at any time during the post-1986 period), then only E&P accumulated during the current year would be counted under section 965; but
- If the SFC had any domestic corporation as a US Shareholder at any time during the post-1986 period then, for purposes of section 965, E&P for the current year and any other period in which it was classified as an SFC (i.e., because of having a domestic corporation as a US Shareholder) must be counted.

Additional considerations

Finally, of course, CFC status would trigger various other consequences under existing law, such as the following:

- Current tax on subpart F income as defined under current law which includes (among other things):
  - Foreign personal holding company income (“FPHCI”)
  - Various types of foreign base company income (“FBCI”)
- Current tax on Global Intangible Low-Taxed Income (“GILTI”) (a new category of Subpart F income added by H.R. 1), generally beginning in 2018
- Section 1248
  - Conversion of gain from disposition of stock in a CFC or former CFC into dividend, generally, to the extent of E&P accumulated while the U.S. person was a US Shareholder and the foreign corporation was a CFC
- Information reporting
  - Form 5471 reporting
  - Form 926 reporting

KPMG observation

In view of the above, fund and investor taxpayers may wish to consider taking certain action steps, such as the following, beginning immediately:

1. Every foreign private equity fund with greater-than-50% (direct, indirect or constructive) ownership interests in foreign portfolio companies should perform an appropriate level of due diligence and analysis of the potential CFC status of its existing foreign portfolio companies. In some cases, this might require investor-level confirmation of the existence and/or non-existence of certain facts that could trigger CFC status of fund’s foreign portfolio companies and Subpart F and information reporting consequences to the fund’s direct and indirect U.S. investors.

2. The following categories of U.S. investors (including U.S.-domiciled fund-of-fund investors) in foreign private equity funds need to perform an appropriate level of due diligence regarding the potential CFC status of foreign portfolio companies in offshore private equity funds in which they invest:

   - 10%-or-greater U.S. investors in any offshore private equity fund that holds any greater-than-50% interest in any foreign portfolio company; and
   - U.S. investors in any US investor described immediately above that is a flow-through entity

3. If a foreign portfolio company is determined to be a CFC by reason of the new law, then further analysis should be performed to assess the scope of exposure with respect to each of the following:

   a) Mandatory repatriation

- Determine whether SFC status is triggered solely due to CFC status or, alternatively, by reason of having a domestic corporation as a US Shareholder at some point during the post-1986 period

b) Sub-part F income
   - FPHC, FBCI and other current categories
   - GILTI

c) E&P calculations for purposes of section 1248 (among others)

KPMG tax professionals can assist with the following (among other things):

- Analyzing the potential CFC status of foreign portfolio companies and the US Shareholder status of direct, indirect and constructive owners of stock in such companies

- Using the KPMG Tax Reform Modeling Tool to evaluate the likely impacts on foreign portfolio companies, fund entities and direct and indirect investors of CFC status, including accumulated post-1986 deferred foreign income which is relevant under Sec. 965 and GILTI)

- Calculating each CFC’s current and accumulated earnings and profits

- Tax information reporting

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