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From the Editors

The enactment of the Tax Cuts and Jobs Act (TCJA) left little untouched in the world of private equity, and it will be some time before its effects are fully known. In this issue of the Private Equity Report, we take a close look at the topics that should be at the top of firm agendas.

Key Aspects of Partnership Tax Reform: The Good, the (Not So) Bad and the Ugly

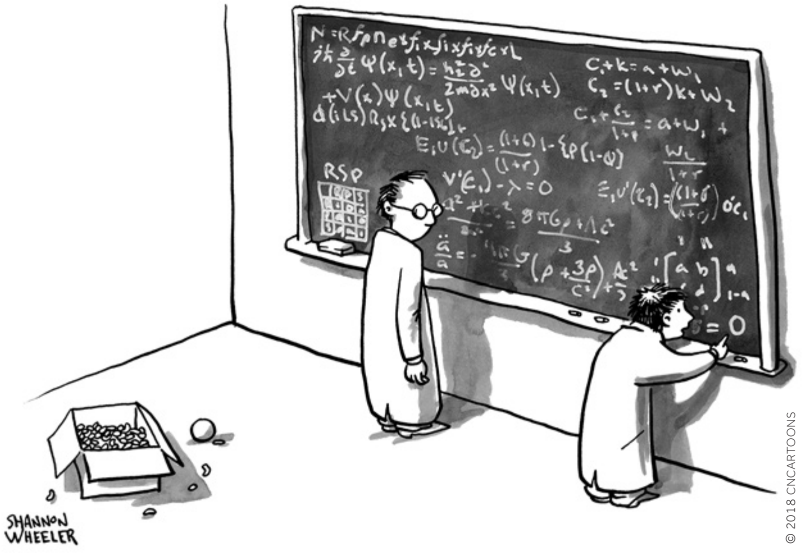
The TCJA's hefty changes to taxation involving partnerships are a natural preoccupation of the private equity industry and there is plenty over which to ruminate, including the resolution of the carried interest issue, the introduction of the Qualified Business Interest deduction and the new withholding regime on the sale of partnership interest by non-U.S. partners.

Corporate Tax Reform

The permanent reduction of the corporate tax rate and bonus depreciation means more capital for investment, but it also affects M&A valuations, the value of tax assets and optimal portfolio capital structure—all of which require private equity firms to rethink their models and strategies.

Tax Reform and the Insurance Industry

The insurance industry knew from the beginning of last year's successful tax reform efforts that it was likely to be giving up some of its traditional advantages. While this expectation turned out to



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"You're right — the shipping isn't free. They've folded the expense into the cost of the item."

be correct, most insurance companies are viewing the new law as a net plus—but with plenty of specifics affecting different firms differently.

GILTI by Association: Tax Reform in the International Arena

The TCJA brings fundamental changes to the United States' approach to cross-border taxation. The Controlled Foreign Corporation regime is expanded, there is a new base erosion tax with which to contend, and a new treatment of foreign earnings that will significantly affect the flow of capital within corporations with international holdings.

We hope you find these articles to be useful resources for navigating this new tax landscape.

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Key Aspects of Partnership Tax Reform: the Good, the (Not So) Bad and the Ugly

Similar to the movie, the enactment of the Tax Cuts and Jobs Act (TCJA) featured strong personalities in conflict, had real money at stake, left a wake of destruction and, in the end, left everyone wondering whether they should be happy or unsettled with the outcome. This article breaks down the TCJA's key changes to partnership taxation that impact the private equity industry, namely, the introduction of the "qualified business income" (QBI) deduction (the Good), the change to the taxation of carried interest (the (not so) Bad) and the re-imposition of tax on non-US partners on their sale of an interest in a partnership that has "effectively connected income" (ECI), along with the introduction of a new withholding regime to enforce it (the Ugly). In addition to explaining these changes (including some subsequent developments since the TCJA's enactment), we discuss their impact on the private equity industry and consider whether private equity firms should be cheering or booing now that some of the dust has settled.

> "While the change from one year to three years is significant and will likely impact some of the carry earned by most sponsors of private equity funds and may impact most of the carry earned by other sponsors (*e.g.*, credit funds with shorter term holding periods), carried interest will continue to enjoy long-term capital gains to a large extent."

The (Not So) Bad—Changes to the Taxation of Carried Interest

Overview of the Taxation of Carried Interest. Carried interest is an interest in the future profits of a partnership that is granted to a partner in exchange for services. It represents an entitlement to the allocations and distributions of a partnership's income based on the terms of the partnership agreement. Carried interest does not inherently generate long-term capital gain treatment. Rather, the tax treatment depends entirely on the type of investments and income earned by the partnership. For most private equity funds that hold investments for over a year, income realized by the fund from dispositions represents long-term capital gain, entitling individual partners to favorable capital gains rates. Prior to the TCJA, this entitlement extended to carry recipients.

A Change Long in the Making. The taxation of carried interest has been a hot political issue for decades and became a part of everyday conversations as a result of the 2012 presidential campaign of Mitt Romney. One of President Trump's campaign themes also focused on amending the taxation of carried interest. Many have called for closing the carried interest "loophole," arguing that carried interest received by investment managers represents compensation (subject to ordinary income) rather than an investment interest in a partnership (subject to taxation based on the income of the partnership itself). Although prior proposals generally aimed at ending the "loophole" by taxing all or a portion of the income allocated to the carried interest recipient as ordinary income regardless of the character of the partnership's income, the TCJA's change to the treatment of carried interest was ultimately quite novel and significantly more limited.

"Overall, while the TCJA's new carried interest regime is undoubtedly a negative development for private equity personnel, it is widely viewed as not significantly impacting the industry."

TCJA Regime. The TCJA (in newly enacted Section 1061 of the Internal Revenue Code (Code)) requires a three-year holding period for capital gains income allocated to a carried interest recipient to qualify for the preferential tax rates associated with long-term capital gains. The rule applies to partnership interests transferred in connection with the performance of substantial services to an "applicable trade or business." The regime does not apply to income recognized with respect to any capital invested by a carry recipient. The three-year holding period rule generally applies at the partnership's investment level, requiring the partnership to satisfy the three-year holding period for any capital gain recognized by the partnership and allocated to the carried interest recipient in order for the recipient to qualify for the preferential rates. While the change from one year to three years is significant and will likely impact some of the carry earned by most sponsors of private equity funds and may impact most of the carry earned by other sponsors (*e.g.*, credit funds with shorter term holding periods), carried interest will continue to enjoy long-term capital gains to a large extent. In addition, there are some important exemptions that may allow sponsors to mitigate the impacts of the new regime.

The regime as drafted only applies to capital gains, so certain dividend income ("qualified dividend income" (QDI)) that also currently qualifies for the same preferential rates as long-term capital gains should still be eligible for the preferential rates, irrespective of the partnership's holding period at the time of the dividend. This makes dividends and leverage recapitalizations much more attractive options for carry recipients. The new regime also does not appear to cover gains from the sale of property used in a business, and it is unclear how the rule will apply to certain other types of income (*e.g.*, the treatment of capital gains dividends from real estate investment trusts (REITs)). Other strategies available include making distributions in kind to the carry recipient, if possible, and structuring follow-ons and dispositions of follow-ons in a manner that maximizes qualifying income. Private equity sponsors will need to manage their fiduciary obligations to their investors with their own interests.

Additionally, the nature of a typical private equity fund's investment cycle (*e.g.*, investments generally made upfront, held for a number of years and disposed of over time), private equity economics (which typically include a preferred return) and the detailed mechanics of how taxable income is allocated to partners all have the potential to mitigate the applicability of the new regime.

Many private equity firms have already added or are considering adding mechanics in their economic arrangements that allow them to waive carry if the recipients of carried interest would be allocated short-term capital gain and to elect to take such waived allocation from another investment. However, it is currently unclear how such waivers need to be implemented in order to be effective and may likely require that the waived allocation only be taken to the extent of any appreciation from assets after the waiver, so the carried interest recipients are taking economic risk that such appreciation does not arise.

Overall, while the TCJA's new carried interest regime is undoubtedly a negative development for private equity personnel, it is widely viewed as not significantly impacting the industry. On a positive note, now that the carried interest "loophole" has been addressed, the TCJA may have actually removed some uncertainty that has been looming over the industry for many years.

The Good—Qualified Business Income Deduction

One of the major themes of the Republican Party's tax reform plan from its inception has been tax cuts for small businesses, many of which operate in partnership form. The TCJA enacted Section 199A of the Code (currently only effective through 2025), which provides for a 20% deduction on QBI and, when combined with the slightly lower top marginal individual tax rate of 37%, has brought the effective top marginal tax rate on such income down to 29.6% (from 39.6% prior to the TCJA). The IRS recently issued proposed regulations on the QBI deduction. (More information is available at https://www.debevoise.com/insights/publications/2018/08/irs-releases-eagerly-awaited-guidance.)

The deduction is only available to noncorporate taxpayers that are owners of sole proprietorships and other fiscally transparent tax entities including partnerships and S-corporations. The deduction applies only to ordinary business income from a US business. The deduction is capped at 50% of W-2 wages paid by the business or, if higher, 25% of the W-2 wages plus 2.5% of the cost of tangible depreciable property used in the business. The deduction is not available to income earned from a "specified trade or business," which includes income from a manager of a private equity fund. Management fees earned by a fund manager will therefore generally not qualify for the QDI deduction.[1] The W-2 wage cap and specified trade or business exclusion do not apply to taxpayers below certain inflation-adjusted income thresholds (for 2018, $315,000 for joint filers and $157,000 for individual filers, and fully phasing in at $415,000 and $207,500, respectively).

Although the QBI deduction will not apply to management company profits, it will nevertheless be relevant to the private equity industry for portfolio companies that are in pass-through form and meet the criteria. First, investment professionals will get the benefit of this deduction with respect to their ordinary income allocations from such investments in respect of their capital and carried interest. Second, and perhaps more importantly, the QBI deduction may present a planning opportunity to structure compensation arrangements for senior management personnel of such investments in a tax-efficient manner by granting them a profits interest in the business. Unfortunately, the proposed regulations have limited the ability to convert bonus and other compensation plans to equity arrangements to take advantage of the QBI deduction. Additionally, the new QBI regime will require more extensive tax accounting and may complicate discussions with lenders on the appropriate amount that may be distributed out of the business as a tax distribution.

The Ugly—Re-introduction of ECI Tax on the Sale of a Partnership Interest and a New Withholding Regime

Tax Court Decision Overturned. Less than a year ago, non-US taxpayers, and by extension the private equity industry, were cheering when the US Tax Court rejected the IRS's longstanding position that a non-US partner's gain on the sale of an interest in a partnership with ECI is subject to US federal income tax.[2] The ruling set into motion a frenzy of discussions on how private equity funds could adjust their go-forward blocker structures and restructure their existing blocker structures. In our Fall 2017 Private Equity Report,[3] we discussed this case and suggested caution given the likelihood of the case being overturned either on appeal or through regulation or codification. Caution was the right approach.

[1] Section 199A, through the incorporation of Section 1202(e)(3) of the Code, also included a catch-all exclusion for "any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees." The proposed Treasury regulations fortunately narrowed the scope of this exclusion. *See* Prop. Treas. Reg. § 1.199A-5(b)(2)(xiv).

[2] *See Grecian Magnesite Mining, Industrial & Shipping Co., S.A. v. Commissioner*, 149 T.C. No. 3 (July 13, 2017), *available at* https://www.ustaxcourt.gov/UstcInOp/OpinionViewer.aspx?ID=11322.

[3] *The Private Equity Report*, Fall 2017, Vol. 17, No.2.

New Withholding Regime. The TCJA not only codified the IRS's original position, but it also introduced a new withholding regime on the sale of the partnership interest. Fortunately, some of the sting has (at least temporarily) been relieved in the form of recently announced interim Treasury and IRS guidance that taxpayers may rely on until regulations are issued.[4]

The new withholding regime requires a 10% withholding on the amount realized on the sale by a non-US seller of a partnership interest if any portion of the gain would be treated as ECI. Initially, this is an obligation of the buyer; however, the TCJA also imposed a secondary withholding obligation on the partnership itself if the buyer does not properly withhold. The recent guidance suspended the partnership obligation for now, but Treasury has indicated that this relief may be temporary.

Exceptions to the Withholding Regime

The Treasury and IRS guidance provides a number of important, but limited, exceptions to the withholding regime summarized below. More fulsome discussion of the guidance is provided in our client update.[5]

First, the guidance confirms that US sellers can avoid withholding by providing a Form W-9. However, it does not appear as though a non-US partnership with US partners can pass through their Form W-9s to avoid withholding on their share of the proceeds.

The guidance also provides a 25% *de minimis* exception. No withholding is required if either (1) the seller can certify that its share of ECI represented less than 25% of its share of partnership income in each of the three prior taxable years or (2) the partnership can certify that if it sold all its assets, less than 25% of the gains would be ECI. However, general partners may be hesitant in providing such certifications as the first option requires the seller to have been a partner during the three prior taxable years and the latter option opens up the partnership and the individual signing the certification to potential liability.

If withholding applies, it is imposed on 10% of the amount realized on the sale of the partnership interest. The amount realized generally includes any cash and other proceeds plus the seller's share of partnership liabilities (which the buyer and seller generally do not know at the time of a transfer of a private equity fund interest). Fortunately, the recent Treasury guidance also provides some clarity.

Similar to the certifications above, either (1) the seller can certify its share of partnership liabilities based on its most recent Schedule K-1 or (2) the partnership can certify the seller's share of partnership liabilities. The partner certification is likely only available for transfers that occur in the summer and fall months because a Schedule K-1 is only valid for this purpose for ten months from the end of the prior tax year.

If the buyer is not provided with a certification of an exemption from withholding or a certification as to the amount of liabilities to be taken into account, the buyer must withhold all the cash proceeds.

Even though private equity funds themselves are not currently subject to these transfer rules (other than on redemptions), private equity funds must become familiar with these rules and develop their practice for handling certification and information requests from investors.

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[4] IRS Notice 2018-29.

[5] New Guidance on Withholding on Sales of Partnership Interests, April 4, 2018.

Corporate Tax Reform

> "However, the lower tax rate also reduces the value of a corporation's tax assets, such as net operating loss (NOL) carryovers, capital loss carryovers and basis in depreciable or amortizable property, and increases the after-tax cost of purchasing new property."

Introduction

The first quarter of 2018 was marked by some of America's largest corporations recording multibillion-dollar write-downs. Write-downs of such magnitude ordinarily might signal concern, but these write-downs were the result of a simple number change in the tax code—a reduction in the federal corporate income tax rate from 35% to 21%. Multinationals, particularly financial institutions, had billions of dollars in deferred tax assets on their books stemming from the financial crisis. The new corporate tax rate reduced the expected tax savings from deferred tax assets, resulting in the need to report a one-time charge.

This change and others in the Tax Cuts and Jobs Act (TCJA) have gripped the attention of companies from Main Street to Wall Street, who quickly found themselves navigating a new and uncharted body of tax law. In this article, we take a look at a couple of the corporate tax changes that are expected to have a significant impact on the private equity industry.

Corporate Tax Rate

As noted above, perhaps the most important change in the TCJA is the permanent reduction of the corporate tax rate from 35% to 21% and the elimination of the corporate alternative minimum tax (AMT). At its core, this means that US corporations will pay less tax on their profits, leaving them with more money to reinvest in the business, pay employees or return to shareholders. However, the lower tax rate also reduces the value of a corporation's tax assets, such as net operating loss (NOL) carryovers, capital loss carryovers and basis in depreciable or amortizable property and increases the after-tax cost of purchasing new property. At the prior 35% tax rate, each dollar of investment in new depreciable or amortizable property resulted in 35 cents of federal tax savings over time. At the new 21% tax rate, this savings decreases to 21 cents on the dollar.

From an M&A perspective, the lower corporate tax rate is likely to result in increased portfolio company valuations. This increase is somewhat tempered by the decrease in the value of so-called "transaction tax benefits." A seller is often able to deliver valuable tax assets to a buyer in connection with the sale of a corporate portfolio company. These tax assets include not only tax assets existing at the time of the M&A transaction, but also new tax assets generated from the transaction itself, such as deductions on account of change-of-control payments, repayment of indebtedness and fees paid for financial and legal advisors. The reduction of the corporate tax rate decreases the value of these assets to the portfolio company and thus the amount of money a buyer may be willing to pay for the assets. In an exit transaction structured as an IPO, sponsors are increasingly entering into tax receivable agreements, under which they are typically entitled to receive around 85% of the tax savings of the company from specified tax assets, calculated on a hypothetical with-or-without basis. The reduction of the corporate tax rate likewise has the effect of decreasing the expected payouts under such tax receivable agreements.

Depreciation of Tangible Property

Bonus depreciation has been in the tax code for nearly 20 years, but historically it has been of limited relevance to the private equity industry because it only applied to the acquisition of property that was newly placed in service. The TCJA made a fundamental change to the bonus depreciation regime by allowing a business to expense 100% of the cost of qualifying property in the first year and by extending the provision to apply to used property that is acquired from an unrelated party by purchase (in addition to new property).

With the new rules come new planning opportunities for private equity sponsors. Under prior law, the sale of assets comprising a trade or business was generally undesirable because of double taxation. The TCJA reduced the tax impact significantly by reducing the corporate-level tax to the seller and providing immediate expensing of certain tangible property to the buyer. In appropriate cases (*e.g.*, the corporation has NOLs or significant basis in tangible property that has not been depreciated), asset sales may result in an overall tax savings to buyers and sellers. A sponsor selling a portfolio company in flow-through form, such as an operating partnership, should be able to deliver immediate expensing to a buyer with respect to the portion of its tax basis step-up in the partnership interest that is attributable to the portfolio company's qualifying tangible property. In either case, a buyer that can benefit from the depreciation deductions may be willing to share part of the benefit with the sponsor through an increase in the purchase price. The new bonus depreciation regime also impacts the importance of purchase price allocations in asset deals, with an increased focus on allocating consideration to tangible assets eligible for immediate expensing, as opposed to intangible assets that generally continue to be amortized ratably over 15 years.

> "With the new rules come new planning opportunities for private equity sponsors."

Net Operating Losses

Before the TCJA, a corporation could carry back NOLs for two years and carry forward NOLs for 20 years. The new rules, applicable to NOLs arising in 2018 or later, eliminate the carryback and permit NOLs to be carried forward indefinitely. In addition, NOLs may now only offset up to a maximum of 80% of taxable income, thereby creating a "semi-AMT." NOLs in excess of the 80% limitation continue to be carried forward.

As discussed above, the reduction in the corporate tax rate reduces the value of a company's tax assets including NOLs. The elimination of the carryback may also make it more difficult for a sponsor selling a portfolio company or blocker corporation with NOL carryovers to receive value because buyers often take the position that NOL carryovers (and other tax asset carryovers) are hard to value since their ability to be used following the transaction is speculative.

Because NOL carryovers can only reduce 80% of taxable income, a portfolio company with losses may actually find it more advantageous to delay deductions to a future year in which it expects to be profitable, because deductions incurred in the profitable year can reduce taxable income on a dollar-for-dollar basis (as opposed to 80 cents on each dollar for deductions incurred in an earlier year that result in a NOL carryover to the profitable year). Alternatively, the company may be able to offer another party tax benefits in an appropriately structured transaction. For example, a company that is considering a capital expenditure for new property may instead choose to enter into a long-term lease with a profitable lessor for the same property. The lessor may be willing to share part of the tax benefits of ownership of the property with the portfolio company through a reduction in the lease amounts, resulting in a situation where both parties benefit.

Limitations on Business Interest Deductions

Debt generally has a lower cost of capital than equity due to its ability to act as a "tax shield" for a company. Interest payments on debt (unlike distributions on stock or redemptions of stock) are generally deductible for tax purposes, subject to limitations. The TCJA replaced existing earnings stripping rules with a new limitation on interest expense deductions that is not tied to excessive debt-to-equity ratios or related party payments. Interest expense, including from related-party and third-party debt, generally may now be deducted to the extent of interest income plus 30% of adjusted taxable income. Any interest expense in excess of the limitation is carried forward indefinitely.

This new limitation on interest expense deductions may impact the desired mix of debt and equity in the capital structure of a portfolio company or the ideal amount of leverage for a blocker corporation. Importantly, leverage remains a valuable tool for both tax and commercial reasons, but the ideal amount of leverage needs to be carefully modeled in light of the new limitation. There is some incentive to use leverage in excess of the limitation: the nondeductible portion can be carried forward as a tax asset and can also reduce the corporation's earnings and profits for tax purposes, which may cause an otherwise taxable dividend to be treated as a tax-free return of capital. Moreover, repayment of principal provides a means to repatriate cash from the corporation tax-free and without any withholding taxes. Excess interest expense carryovers are subject to the same usage limitations following a change of control transaction as NOL carryovers and capital loss carryovers.

In modeling the ideal leverage for a portfolio company or blocker corporation, one important detail to take into account is the change in the calculation of adjusted taxable income from an EBITDA proxy to an EBIT proxy beginning in 2022. A company with significant amounts of depreciation or amortization will have a significantly smaller limitation beginning in 2022 and thus may notice a significant decrease in the amount of interest expense it is able to deduct each year. Accordingly, the new limitation may also raise timing considerations with respect to a company's leverage. A company that expects to have a significantly smaller limitation in 2022 may choose to prepay a portion of its debt at the end of 2021 or may structure a portion of its debt to mature at the end of 2021.

Looking Forward

The IRS has stated that implementation of the new tax law is their "highest priority" in their five-year strategic plan that was released on May 23, 2018, and any forthcoming guidance has the potential to significantly shape the impact of the new law on sponsors and on their portfolio companies. Although many areas of uncertainty remain, sponsors should model the impact of the new law on their existing businesses and consider any planning opportunities the new law may offer for future deals.

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Tax Reform and the Insurance Industry

> “The Tax Cuts and Jobs Act (TCJA) dramatically lowered the headline corporate tax rate, but it also included revenue-raising changes to a number of insurance-specific tax rules and targeted certain non-US insurance companies and cross-border transactions.”

Insurance companies went into the tax reform process hoping to emerge winners, or at least to avoid being big losers. Like most businesses, they stood to benefit significantly from Congress’ planned reductions to the corporate tax rate. However, the money to pay for the rate cut needed to come from somewhere, and the industry, which benefits from special tax rules for both insurance companies and their customers, had been flagged as a target in prior reform proposals. The Tax Cuts and Jobs Act (TCJA) dramatically lowered the headline corporate tax rate, but it also included revenue-raising changes to a number of insurance-specific tax rules and targeted certain non-US insurance companies and cross-border transactions. Weighing the good and the bad, insurance companies generally have reported the effect of the TCJA as a net plus. However, not all taxpayers were affected equally, and parties evaluating a transaction in the insurance space should carefully consider the impact of the various changes on an insurance company’s particular tax profile.

Rate Reduction

The reduction of the corporate tax rate from 35% to 21% and elimination of the corporate alternative minimum tax generally will improve after-tax earnings of domestic insurers. Although it is difficult to complain about a rate cut, the reduction does carry negative knock-on effects for some taxpayers. First, the lower rate creates a one-time haircut to the value of deferred tax assets. This reduces valuations and, if the diminished tax asset was being used to satisfy regulatory balance sheet requirements, could require the insurer to obtain more expensive financing to replace the asset. On the other hand, the rate change also reduced deferred tax liabilities, and many insurers have reported large GAAP financial statement benefits. Second, the National Association of Insurance Commissioners is implementing changes to the “risk-based capital” (RBC) formula to reflect the lower corporate tax rate. RBC is a key measure of an insurance company’s required capital cushion and currently uses a fixed 35% rate to estimate the offsetting tax impact of the incurrence of a particular risk. Changing these rules to move to the 21% rate could adversely affect RBC levels. To the extent that RBC levels are reduced across the industry as a result of the change, it is unclear whether the market will accept a lower baseline ratio or require insurers to maintain more capital. Perhaps most importantly, it also is not clear whether the market ultimately will require some or all of the rate benefit to be passed onto policyholders in the form of more favorable pricing for new policies. For existing business, the benefit generally should stay with the insurance company.

> “Even with the changes, many insurers are reporting expected effective tax rates that are lower than the 21% headline rate, preserving their advantage.”

Domestic Changes

US insurance companies operate under a special tax regime that takes into account the particular character of the industry. For example, life insurance companies may deduct increases to their reserves supporting future claim payouts, whereas a typical corporation would not have a deduction until the underlying liability becomes fixed. The TCJA made numerous technical changes to the special rules that apply to insurance companies, reflecting a view that the prior tax regime was overly generous. Even with the changes, many insurers are reporting expected effective tax rates that are lower than the 21% headline rate, preserving their advantage. However, each company’s sensitivity to the impact of each change will depend on its business and history.

NOLS. Life insurers can no longer carry back net operating losses (NOLs) and can use NOLs to offset only 80% of income, placing them under the same rules that currently apply to other corporations. These changes tend to reduce the value of NOLs, which are tax assets. In particular, the loss of carryback potential makes it more difficult to use NOLs to satisfy regulatory capital requirements, as NOLs are less likely to be monetized in the short term. Property and casualty (P&C) companies successfully argued that carrybacks were essential given the volatility of catastrophe and other types of insurance they write. As a result, P&C companies can still carry NOLs back two years and forward 20 years, as under prior law.

Reserves. Life insurers’ deduction for increases to reserves associated with their insurance contracts is fixed at 92.81% of the statutory reserve under the TCJA. This generally will lower deductions as compared with the prior approach, causing a timing tax cost that is reversed as the reserve runs off. The effect may be particularly significant for lines of business that operate with high reserves and thin profit margins. To mitigate the effects of this change, a phase-in provision applies to existing reserves over eight years. P&C companies will also make some tax payments sooner than under prior law as a result of changes to their deductions for unpaid losses.

DAC. Changes to the tax deferred acquisition cost (DAC) rules will also accelerate tax payments by companies that write or reinsure life, annuity and certain accident and health policies, by increasing the tax DAC rates and increasing the amortization period from 10 to 15 years.

Dividends Received Deduction. Tax reform simplified the tax rules for life insurance companies’ investment income. Their dividends received deduction (DRD) is now set at 70% of investment income from dividends, replacing complex “proration” rules that disallowed a portion of the deduction. This change may be helpful or harmful for a given life insurance company, depending on how the prior rules played out for it. The 70% approach generally is seen as a positive for the industry; prior to the enactment of the TCJA, some conservative buyers evaluating M&A deals had modeled total loss of the deduction. Relatedly, rules that prorate a portion of P&C companies’ deductions for tax-exempt interest, DRD and cash value of insurance were tightened, partially offsetting the benefit of the rate reduction. Unlike the changes to the reserve and DAC rules, these changes create a permanent difference in tax liability.

International Changes

Base Erosion. The Base Erosion and Anti-Abuse Tax (BEAT) limits the ability of US companies to reduce taxable income through deductible payments to offshore affiliates. The BEAT rules specifically target premiums paid to non-US reinsurers. Many groups with cross-border reinsurance transactions have restructured operations to mitigate the BEAT. One option is for the US insurer to seek to recapture business reinsured offshore. Another is to have the affiliated reinsurer elect to be taxed as a US company (a so-called "953(d) election"), which turns off the BEAT but also takes away any US tax benefit associated with the reinsurance. Buyers should diligence what measures are being taken by insurers, particularly those which previously utilized quota share treaties to reinsure significant amounts of US business offshore, and understand the projected effect on effective tax rates.

CFC/GILTI. Tax reform significantly increased the potential for income derived by foreign subsidiaries to be currently included in US owners' income, both by expanding the existing controlled foreign corporation (CFC) rules and by adding the new "global intangible low-taxed income" (GILTI) regime. (See *GILTI by Association: Tax Reform in the International Arena* on page 13 for a more detailed discussion.) Voting cutbacks, which are commonly employed in the non-US insurance space, no longer work to prevent CFC inclusions because the CFC rules now apply to US shareholders that own 10% or more of a foreign company by vote or by value (previously only voting power was tested). In addition, insurers who relied on the "same country" exception to the CFC income rules for local business must now treat that business as generating GILTI, even if *highly* taxed. In general, virtually all of the income of a non-US insurance business (including asset management activities) will be taxed currently to a US 10% shareholder under either the old CFC "subpart F" rules or the new GILTI rules, although lower rates apply to GILTI.

PFICs. Tax reform has made it harder to meet the exemption from classification as a "passive foreign investment company" (PFIC) for active insurance companies, increasing the risk of adverse tax treatment for US owners (including carried interest recipients). To qualify, insurance companies must now carry specified insurance liabilities (loss and loss adjustment expenses and certain life and health reserves) that are in excess of 25% of balance sheet assets. Unearned premiums are not counted toward the liability test, potentially harming even active P&C companies that write volatile business such as catastrophe insurance. While targeted at so-called "Hedge Fund Re" structures where an alternative asset manager forms an insurance company in order to manage its investment assets, the application of the new rule is uncertain, and many companies are still evaluating whether they expect to constitute a PFIC in 2018. A private equity sponsor considering an acquisition of a non-US insurer should scrutinize its side letter obligations with respect to PFICs, which may require requesting information that the company is unwilling to provide.

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GILTI by Association: Tax Reform in the International Arena

“The TCJA marks a fundamental shift in the US international tax regime, offering planning opportunities for private equity funds while also creating a number of new complexities and traps for the unwary.”

The Tax Cuts and Jobs Act (TCJA) significantly revised the taxation of cross-border enterprises and transactions, changing not only statutory details, but also, in many cases, affecting fundamental principles and incentives. This article summarizes some of the most significant changes to cross-border taxation relevant to private equity transactions, focusing on four areas—the scope of the “controlled foreign corporation” (CFC) regime, the treatment of cross-border payments, the “toll charge” imposed to transition from the old system of taxing US owners to the new system under the TCJA and the current taxation of US owners of a CFC under the new and subtly named “GILTI” regime. The TCJA marks a fundamental shift in the US international tax regime, offering planning opportunities for private equity funds while also creating a number of new complexities and traps for the unwary.

Changes to the Controlled Foreign Corporation Regime

One of the most far-reaching changes to the taxation of non-US companies under the TCJA is the expansion of the CFC regime. A CFC is a foreign corporation that is more than 50% owned by US persons that directly or indirectly own at least 10% of the stock of the corporation (10% US Shareholders). The TCJA dramatically expands the “attribution” rules such that a US corporation owned by a foreign parent can cause other foreign companies owned by the same parent to be treated as CFCs. Further, under the TCJA, 10% US Shareholders now include US shareholders owning 10% or more of the value (as opposed to just voting power, which was the case under prior law) of a foreign corporation’s stock. 10% US Shareholders may be required to include CFC income for US tax purposes.

These changes effectively mean that almost all non-US corporations in multinational structures will be CFCs. Under the TCJA, the key question for investors will be whether a foreign corporation has any 10% US Shareholders, rather than whether the corporation is a CFC, likely resulting in more funds using non-US structures to avoid the broad scope of these rules.

The BEAT Goes On

Prior to the TCJA, a US corporation could deduct payments, such as interest and royalties, made to foreign affiliates. Although there were some limitations on claiming such deductions, the limitations were generally lax. The regime incentivized inversion transactions, in which a US company would first became a subsidiary of a foreign company and then make large deductible payments to the foreign company, thereby stripping taxable earnings out of the United States.

The TCJA introduced a new "Base Erosion and Anti-Abuse Tax," commonly known as the "BEAT," to curtail earnings-stripping transactions. The BEAT only applies to corporations with average annual gross receipts over a rolling three-year period of $500 million or more and that engage in more than *de minimis* earnings-stripping transactions.

The BEAT is an add-on tax to the regular tax and is similar in function to the corporate alternative minimum tax that was repealed by the TCJA. It is equal to the excess of 5% (10% starting in 2019 and increasing to 12.5% after 2025) of the corporation's "modified taxable income" (MTI) over the corporation's regular tax liability. MTI is the corporation's regular taxable income after adding back certain deductible payments made to related foreign parties (applying a 25% test for relatedness).

To illustrate, suppose a US company with income of $1,000M makes a $600M royalty payment in 2019 to a related foreign party, thereby reducing taxable income to $400M. The BEAT and total tax are determined as follows:

> Regular tax liability: 21% ($1,000M-$600M) = $84M
>
> MTI: $400M (eroded tax base) + $600M (base erosion payment) = $1,000M
>
> BEAT: 10% of $1,000M (MTI) - $84M (regular tax) = $16M
>
> Total tax: $84M (regular tax) + $16M (BEAT) = $100M

The example illustrates that the royalty reduces US tax to a certain extent (from 21% of $1,000M, or $210M, to $100M), but cannot reduce US tax below $100M. In other words, absent the BEAT, the $600M royalty payment would have reduced the US tax liability by 21% of $600M, or by $126M. The BEAT adds back $16M of tax, making approximately $76M of the royalty ineffective to reduce US tax.

The BEAT appears only to take into account the gross deductible payment to the foreign recipient, as opposed to the net amount after subtracting the amount *received from* the foreign company. As a result, the BEAT may put a large strain on US companies that engage in cross-licensing with related foreign companies and, in certain cases, incentivizes US companies to enter into licenses with unrelated foreign companies because the BEAT only applies to deductible-related party payments.

Repatriation Tax

The TCJA allows foreign earnings to be brought back into the United States tax-free by granting a deduction for dividends received by a US corporation from a 10% owned foreign subsidiary. This represents an effort fundamentally to shift the US corporate tax system from "worldwide" taxation of non-US earnings to a "territorial" system under which the United States generally does not tax such earnings (although, as discussed below, the TCJA also includes new "GILTI" rules that significantly undercut the "territorial" nature of the post-TCJA regime). The TCJA also includes a one-time "toll charge," or deemed repatriation tax, on untaxed foreign earnings of a CFC or foreign corporation with a 10% US corporate owner. This serves as a transition rule for earnings generated under the old system.

Specifically, the TCJA requires certain US owners of a CFC subject to the toll charge to include an amount equal to the previously undistributed earnings of the CFC in income for 2017 or 2018, even if no actual distributions are made. However, this one-time inclusion is generally taxed at reduced rates of 8% for foreign earnings held in illiquid assets and 15.5% for foreign earnings held in cash and cash equivalents. Further, the taxpayer may elect to pay the resulting tax liability over eight years in increasing installments.

Earnings subject to the toll charge may be repatriated without being subject to further US tax. Thus, a US portfolio company with CFC subsidiaries will be able to access those offshore earnings in a way not previously feasible. Such cash may be used for any purpose, including repayment of debt, dividends, share buybacks, investments in their US businesses and add-on acquisitions.

On the buy-side, the fact that the repatriation tax will usually be paid in installments over eight years will add some complexity to acquisitions of US companies with significant foreign operations. Sponsors should take into account future installments of the toll charge, imposed on pre-transaction earnings, when pricing and negotiating acquisitions of such companies.

Foreign Earnings Found GILTI

Before the TCJA, US owners of CFCs could generally defer paying US tax on offshore earnings until repatriation, with the exception of "Subpart F" income—generally, passive income. The TCJA fundamentally revises the taxation of such companies by introducing a new category of income (called "GILTI") that is taxed in the United States whether or not repatriated. In other words, the United States has moved from a system of general deferral of foreign income to a system of general inclusion of foreign income, and private equity buyers should take this into account when pricing deals.

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GILTI is, in broad terms, defined as net offshore income (excluding Subpart F income) in excess of a deemed 10% return on the basis in certain tangible assets. GILTI included by a US corporation is taxed at a significantly reduced rate: 10.5% through 2025 and 13.125% thereafter.

Taken together, GILTI and Subpart F require close to full inclusion of offshore earnings in US taxable income on a current basis, rather than the limited inclusion required under prior law. The GILTI rules are particularly harmful to 10% US Shareholders that are not corporations because they receive neither the benefit of the lower rates nor the ability to use foreign tax credits. The stated goal of this dramatic change is to discourage the transfer of high-margin businesses offshore.

The GILTI regime's goals are reinforced by a corresponding reduced rate applicable to "foreign derived intangible income" or FDII—income earned by a US corporation from selling property or providing services to foreigners in excess of a "routine" return of 10% on the corporation's investment in depreciable tangible property. FDII enjoys an effective lower tax rate of 13.125% until 2025 and 16.406% thereafter. The GILTI tax rates are equal to 80% of the FDII rates and reflect that GILTI may be subject to foreign taxes, only 80% of which are creditable against the GILTI tax.

Taxation of GILTI and FDII will significantly affect the incentives driving portfolio company structures. For example, it may be beneficial in certain cases to hold non-US businesses under a domestic corporation to qualify for the reduced rate on GILTI and the benefit of tax-free repatriation. Further, elections under Section 338(g) of the Internal Revenue Code may offer benefits to US corporate sellers of CFCs by converting taxable gain on a stock sale into lower-taxed GILTI generated by a deemed asset sale.

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