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From Finance to Funds – How Tax Reform May Impact Borrowing and Investing For Private Equity

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The Tax Cuts and Jobs Act (TCJA) contains many provisions impacting the financing industry and transactions. As we noted in our **first installment**, the limitation on interest deductions (generally, to the sum of business interest income and 30% of taxable income) may make equity financings more attractive to companies that historically factored in the value of the tax benefit prior to such limit, and private equity funds may be better positioned to be equity investors than traditional banks. However, private equity funds also rely on debt financings for acquisitions as well as tax planning in order to reduce entity level tax through so-called blocker structures. Funds with foreign investors often utilize blocker corporations to “block” the taint of income that is considered to be (a) effectively connected with the conduct of a U.S. trade or business (ECI) for foreign investors and (b) unrelated business taxable income (UBTI) for tax-exempt investors. This is especially useful now, as the TCJA contains a provision codifying an earlier revenue ruling concluding that foreign investors are subject to U.S. federal income tax on the sale of an interest in a partnership or LLC to the extent that a partner or member would be allocated ECI income as the result of such sale by the partnership or LLC of its assets.

Prior to the TCJA, investor debt in the blocker would be subject to so-called earnings stripping rules – particularly in the case of single investor blockers, where the prohibited relationship more likely existed. These rules were meant to prevent domestic entities from avoiding taxation on income through the payment of excessive amounts of interest to a related foreign entity and generally would apply to limit such interest deductions by a corporation with a debt-to-equity ratio in excess of 1.5 to 1. However, the TCJA repealed the earnings stripping rules, and funds with blockers – particularly those that are leveraged to meet the old earnings stripping ratio – should be re-evaluating their structures in light of this change. While pre-TCJA tax law generally disfavored related party borrowing – both through earnings stripping and recharacterizing shareholder debt as equity (the latter of which still could occur, though possibly with less frequency) – the new, objective rule may provide as much additional flexibility as it does limitation by levelling the playing field for related parties (subject to other limits). At the same time, one of the largest drawback to using blockers, specifically the entity level tax to which they are subject, now is mitigated somewhat by the 40% decrease in the corporate tax rate (from 35% to 21%). Particularly where the investment strategy does not rely on dividend payments (also mitigating double taxation, and consistent with most funds’ planning), blockers actually may be a more attractive option following tax reform.

Generally, blockers are not necessary where funds invest in portfolio companies that are corporations or entities treated as corporations for tax purposes (though depending on the fund, a foreign or tax-exempt investor may not be able to be “blocked” only for ECI or UBTI investments). However, other provisions of the TCJA may have implications for private equity funds with substantial U.S. limited partner bases that invest in non-U.S. corporations, as such provisions affect the classification of such corporations as “controlled foreign corporations” (or CFCs). “United States shareholders” of CFCs are required to include their shares of certain types of the corporation’s income (subpart F income) if the corporation is a CFC. A CFC is a foreign corporation more than 50% of the voting power or value of which is owned by one or more said United Shareholders. A United States shareholder is a “United States person” (as defined for U.S. tax purposes) who directly, indirectly or constructively owns 10% or more of ***either*** the vote or value of the stock in a foreign corporation. This is a tremendous change from prior law, which only took into account voting power – under prior law, a United States person could own over 10% of the value of a corporation and not “count” as a United States shareholder. In addition, the TCJA allows for increased attribution of stock ownership from foreign persons to United States persons, by repealing the rule that “turned off” so-called downward attribution in certain circumstances where it would cause a United States person (including a corporation or partnership) to own stock held by a foreign person (including a shareholder or partner). When taken together, these changes mean, for example, that a foreign subsidiary that is more than 50% owned by a foreign corporation is now considered a CFC if the foreign parent also owns more than 50% of a domestic subsidiary, because the domestic subsidiary would be treated as owning the foreign subsidiary stock held by the common parent. Accordingly, entities that were not CFCs previously now may be considered as such under the TCJA. This could result in significant changes (and income recognition) for investors with respect to foreign portfolio companies held by funds, as many fund structures relied on the intricacies of the now-repealed or amended rules to avoid CFC status for portfolio company investments. For example, a fund with substantial U.S. ownership traditionally may have used a non-U.S. entity as the fund vehicle/alternative investment vehicle to invest in a non-U.S. corporation, but may find that the corporation now is a CFC notwithstanding such planning. Similarly, fund sponsors may have divided their interests in the fund general partner in reliance on the old rules. Given the lack of clarity in how the general partner’s carried interest (usually 20%) is measured when determining stock ownership, the changes to the rules may increase the likelihood that members of the general partner that are United States persons not only cause the portfolio company to be a CFC, but cause such members to include their deemed share of the CFC’s subpart F income in their own tax returns.

Moreover, funds with CFCs may be subject to the new Global Intangible Low-Taxed Income (or GILTI) rules (click **here** for more). As many commentators have noted, non-corporate shareholders of CFCs may be disproportionately impacted by the GILTI tax, since corporations will only be taxed at 50% of their new, lower tax rate (an effective rate of 10.5%) through 2025 and at 62.5% of the new tax rate (or 13.125%) beginning in 2026. Meanwhile, non-corporate taxpayers will have to pay 100% of their usual rate. As we noted in our first installment, the new GILTI rules are under intense scrutiny for their possibly unintended consequences, so we may see some of these issues impacting funds addressed as these provisions come under further study. Also, noncorporate shareholders, though subject to the new repatriation tax requiring a 10% U.S. shareholder of a specified foreign corporation to include in income its pro rata share of the foreign corporation’s earnings and profits that have not previously been subject to U.S. taxation, will not receive a dividends received deduction for actual distributions (click **here** for more). However, this may be mitigated in the private equity space where portfolio companies traditionally do not pay out dividends.

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