Private Equity Transactions After the Tax Cuts and Jobs Act (TJCA)

January 15, 2019

Chair: David R. Sicular: Paul, Weiss Rifkind, Wharton & Garrison LLP
Erik H. Corwin: KPMG LLP
Sara B. Zablotney: Kirkland & Ellis LLP

GILTI AND OTHER CFC CONSIDERATIONS

2

Basic GILTI

Basic Rule: §951A	▯ Each 10% US Shareholder (as defined under Code §951(b)) of a CFC pays current tax on its share of GILTI ("global intangible low-taxed income") ▯ GILTI is generally the excess of the US Shareholder's share of net CFC tested income over its net deemed tangible income return ("NDTIR") ▯ Amounts included as GILTI treated as PTI when actually distributed in cash
CFC Tested Income/Loss	▯ 10% US Shareholder's pro rata share of (x) gross income of CFC (other than ECI, subpart F income and certain other exclusions) over (y) allowable deductions (calculated on US principles)
NDTIR	▯ 10% of the US Shareholder's pro rata share of the adjusted tax basis of the CFC's qualified business asset investment ("QBAI", basically tangible property) less the CFC's interest expense amount ▯ Interest expense amount calculated under US principles (including new Code §163(j))
Code §250 Deduction	▯ Corporate 10% US Shareholders may deduct 50% of GILTI amount until 2026, 37.5% of GILTI thereafter. This can result in a notional ETR on GILTI of 10.5% pre-2026 and 13.125% post-2026, as reduced by foreign taxes
Foreign Tax Credits	▯ Under Code §904(d) there is a special "use it or lose it" FTC basket, generally intended to require tax if foreign tax rate < 13.125% ▯ Because of lack of carryforward and the way expenses may be allocated to the basket, income subject to high foreign tax may still create GILTI liability

3

Basic GILTI (continued)

GILTI and Individuals	▯ US individuals pay tax on GILTI inclusion at individual ordinary income rates (no deemed paid FTCs) and Code §250 deduction not available
Individuals, GILTI and §962	▯ 10% US Shareholders that are individuals can elect to pay tax as if a corporation on GILTI, subpart F income ▯ 21% rate, not 37% on CFC income, and deemed paid FTC available, BUT availability of §250 deduction unlikely, absent favorable guidance ▯ Subsequent distribution of PTI or gain on sale taxed at individual rates to the extent of excess of distribution/gain over tax paid at corporate rates (therefore tax can exceed a 50% ETR). Dividend rate is apparently the non-qualified dividend rate, unless CFC is a qualified foreign corporation for purposes of Code §1(h)(11) ▯ Applies to all CFCs of which the US person is a US shareholder. No cherrypicking! ▯ Election made on a year-by-year basis

4

Partnerships: GILTI in the Aggregate or by Entity Prop. Reg. §1.951A-5

Domestic Partnerships

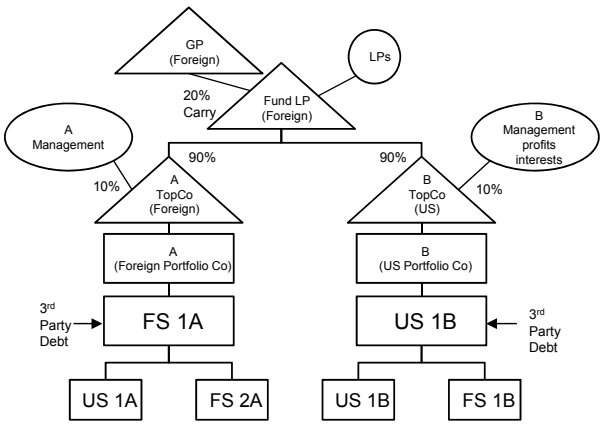
- Partnership's ownership amount is relevant for determining whether foreign corporation is a CFC.
- Prop. Reg. §1.951A-5 adopts a hybrid entity/aggregate approach for GILTI purposes.
- If a US partner is not a US Shareholder of any partnership CFC, then the partnership calculates a single GILTI inclusion amount with respect to all partnership CFCs and allocates such amount per the partnership agreement.
- If a US partner is a US shareholder with respect to any of the partnership CFCs, then the GILTI inclusion is determined at the partner level with respect to that CFC.
- If the US partner is a US shareholder with respect to some (but not all) of the partnership's CFCs, the US partner's inclusion under the prior bullet point is adjusted such that (i) for CFCs with respect to which US partner is a US shareholder, GILTI determined at partner level, and (ii) for CFCs with respect to which US partner is not a US shareholder, US partner takes into account distributive share of partnership GILTI.

Foreign Partnerships

- Pure aggregate theory applies.

5

Case Study 1: Amazing Case of the Appearing CFCs

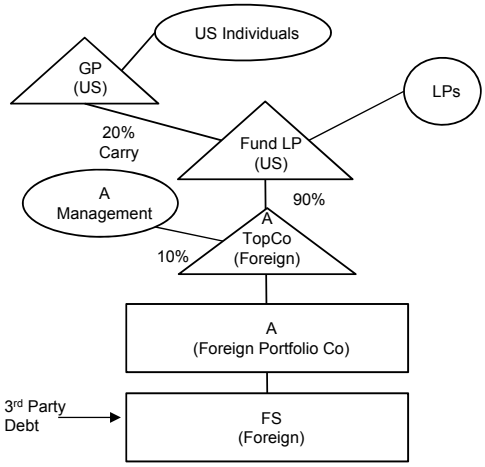


- Because of operation of attribution rules under §958, each of A, FS1A and FS2A are CFCs.
  - Fund owns 90% of A TopCo, and therefore is attributed its proportionate share of the stock of A and its subsidiaries (Code §318(a)(2)(A))
  - Under Code §958(b)(2), if a person owns more than 50% of the total combined voting power of all classes of voting stock of a corporation, that person is considered as owning 100% of the stock of such corporation, resulting in Fund being treated as owning 100% of the voting stock of A and its subsidiaries. Stock owned by a partner (Fund) is treated as owned by the partnership (B TopCo) under Code §318(a)(3)(A).
  - Under Code §318(a)(3)(C), if a person owns 50% or more of the value of a corporation, then the corporation is treated as owning the stock owned (directly, indirectly or by attribution) by such person, resulting in B being treated as owning 100% of the voting stock of A and its subsidiaries, resulting in A, FS 1A, and FS 2A being treated as CFCs
- So What?
  - Are there any taxable US persons who are 10% US shareholders of FS1A and FS2A (e.g., carry partners? HNW LPs)?
  - If so, not only sub-F, but GILTI inclusions! This could be a nasty shock for US individuals
  - How to solve
  - Best bet is not to be a definitional US shareholder
  - §951(b) now bases US shareholder status on 10% ownership of vote OR value

*** Note**: Recent legislative proposals would restore pre-TCJA attribution rules and change results of Case Study

6

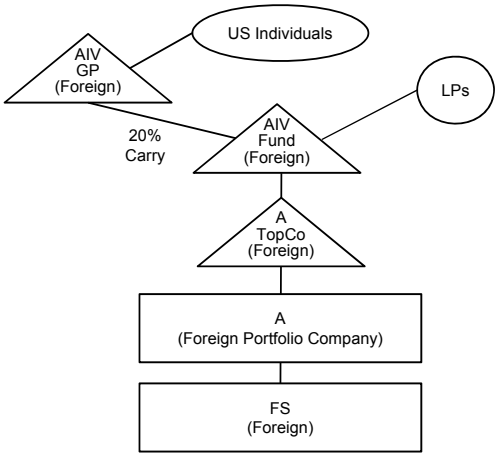
Case Study 2: Got AIVs?



- Assume a domestic fund with a limited mandate to make foreign investments is looking to structure its first outbound investment
- Absent any further structuring:
  1) Each of A and FS will be CFCs
  2) Under Code §958(a)(2) and Treas. Reg. §1.958-1(b), Fund is treated as owning 90% of A
  3) Under Prop. Reg. §1.951A-5(b)(2), Fund allocates distributive share of GILTI to each partner that is not a 10% US shareholder of A
  4) Under Prop. Reg. §1.951A-5(c), any 10% US shareholder is treated as actually owning A stock attributed to it for purposes of calculating its GILTI inclusion, and its distributive share of the Fund's GILTI amount is determined without regard to the GILTI income with respect to A. See Prop. Reg. §1.951A-5(g) Ex 3
  5) Prop. Reg. §1.951A-5(d) provides that for tiered domestic partnerships if an upper tier partnership is treated as a 10% US shareholder it is treated as actually owning the stock attributed it under §958 for purposes of applying these rules. See Prop. Reg. §1.951A-5(g) Ex 4

7

Case Study 2: Got AIVs?



<u>Potential Solution 1</u>: Can Fund form a non-US AIV structure in parallel to its existing structure so that the picture looks more like Case Study 1?

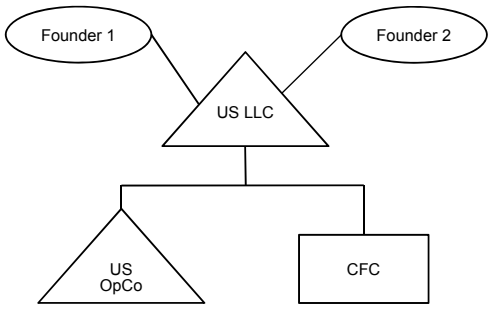
1) Get the benefit of favorable rules for attribution through foreign partnerships
2) Taxable LPs that are also 10% US shareholders of A through attribution still will have GILTI inclusions (same as Case Study 1)
3) Not all Funds have AIV capability
4) A and FS may still be definitional CFCs.

<u>Note</u>: The application of the rules in determining who is a 10% US shareholder under Section 951(b), and determining the ownership amount in A for any particular year is unclear given the complexity of Fund waterfalls. It is not certain how to apply the rules where a partner's interest shifts over time, e.g., as a waterfall moves into carry. Consider application in deal by deal waterfalls. Also consider application of rules where there are multiple CFCs.

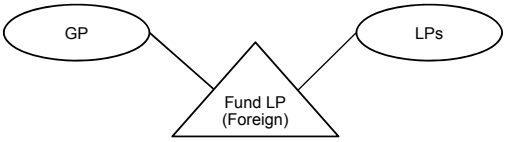
8

Case Study 3: To Block or Not to Block

Target



Fund

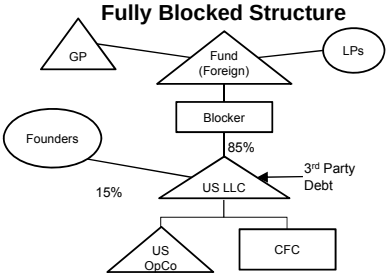


- Target is a US flow-through with substantial offshore operations conducted through CFC
- Founder 1 and Founder 2 will each roll over 7.5% on a tax-deferred basis.
- Fund documents allow partially blocked investments using a "pop-out AIV" structure.

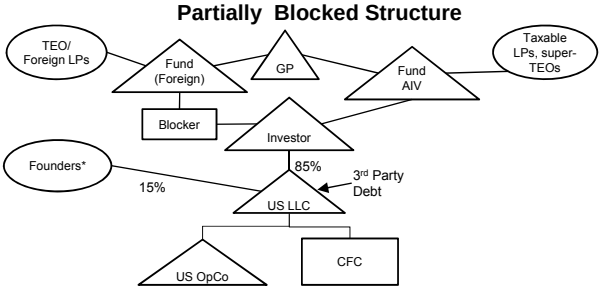
9

Case Study 3: To Block or Not to Block

Fully Blocked Structure



Partially Blocked Structure

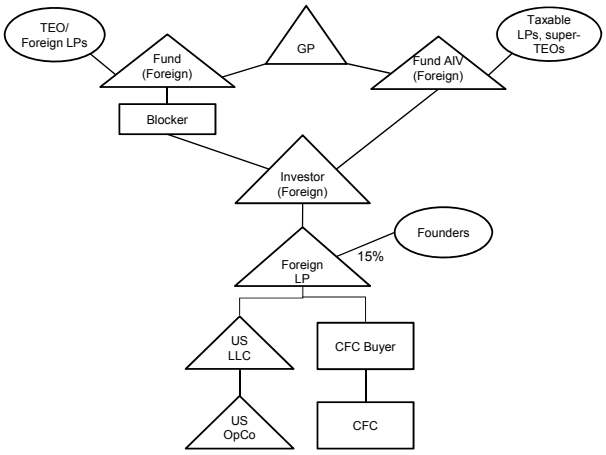


- Question 1: What do GILTI inclusions look like for taxable US investors?
- Question 2: Can CFC be checked open prior to sale, and is that a better result?
- Question 3: What is the ongoing benefit of flow through structure?
- Question 4: Taking into account §163(j) and its effect on GILTI, can situation be improved through debt placement?
  - Proposed §163(j) regulations apply Code §163(j) limitation for purposes of GILTI
  - Note that for asset-heavy businesses, debt at CFCs may have effect of increasing NDTIR due to decreased interest expense at CFC under §163(j)

* Founders may prefer to be blocked/need to be rolled into single structure

10

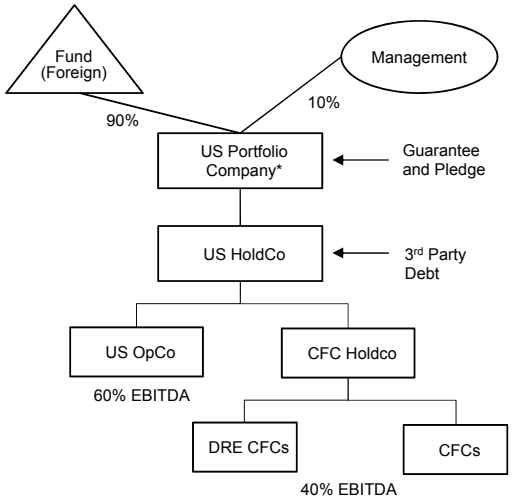
Case Study 3: To Block or Not to Block



- IF CFC is large enough, consider "out from under" planning
- May be efficient to purchase CFC directly from Target, prior to purchase of Target/US OpCo
- In certain circumstances, a Code §338(g) election may be available with respect to CFC
- Financing, operational and other considerations must be carefully evaluated

11

Case Study 4



- Lenders request CFC Holdco guarantee 3rd Party debt and that its stock be pledged (as well as its assets) in support of the debt. They claim that US Holdco should be indifferent from a US tax perspective under current law. Should the deal team agree?
  - Lender position: CFC Holdco's E&P is functionally being included annually under Code §951 and Code §951A rules. To the extent not already included, a 100% DRD is available to US HoldCo in respect of repatriation of cash under Code §245A. In addition, proposed regulations provide a §245A deduction for Code §956 inclusions.
  - Borrower position: Potentially meaningful gaps between Code §951, §951A and § 956. Proposed regulations addressing Code §956 inclusions remain subject to change pending finalization and in any event may not always apply with respect to borrower CFCs (e.g., due to holding period limitations).

* Debt Finance lawyers usually want more holdcos

12

SECTION 956 AND SECTION 245A

13

Code §956 – An Ancient History Lesson?

- Pre-TJCA, Code §956 guarded against "effective repatriation" of the E&P of a CFC, including by requiring an income inclusion if > 66.66% of the voting stock or any of the assets of the CFC were used as credit support for the obligations of a US person
- Post-TJCA
  - Code §245A allows a 100% DRD for certain dividends received by a US corporation from a "specified 10-percent-owned foreign corporation" (CFCs and other foreign corporations as to which a US corporation owns 10% or more, by vote or value)
  - §245A, taken alone, does not allow the DRD for amounts included under §951(a)(1)(B) as a result of §956 investments, and TCJA did not otherwise repeal §956
  - Accordingly, actual dividends may be distributed from a CFC to a US corporation effectively tax-free, while "deemed dividends" under §956 (which presumably exists only to prevent avoiding tax on effective repatriation of untaxed earnings) still subject to taxation under §951(a)

14

Prop. Reg. §1.956-1 Further Limits §956

- Under the Proposed Regulations, the Code §956 inclusion, as would have been calculated prior to the Proposed Regulations (the "tentative section 956 amount"), is reduced by:
  - "… the amount of the deduction under section 245A that the shareholder would be allowed if the shareholder received as a distribution from the [CFC] an amount equal to the tentative section 956 amount with respect to such share on the last day during the taxable year on which the foreign corporation is a [CFC] (hypothetical distribution)…" (Prop. Reg. §1.956-1(a)(2)(i))
- Where CFC stock is owned indirectly:
  - Code §245A(e) (the hybrid dividend limitation) is applied as if the distribution is made through each entity in the chain
  - The other provisions of (Code) §245A (e.g., determination of foreign-source portion of dividends) are applied as if the US shareholder owned the CFC directly

15

Brief Explanation of Code §245A

- Code §245A provides a 100% DRD for the foreign-source portion of dividends received by a US corporate shareholder of a "specified 10% foreign corporation"
- "Foreign-source portion of dividend" = $\frac{\text{(Foreign corporation's undistributed foreign earnings)}}{\text{(Foreign corporation's total undistributed earnings)}}$
- Foreign corp's undistributed foreign earnings = Total undistributed earnings - ECI - Dividends received from an 80%-owned domestic corp
- Foreign corp's total undistributed earnings = All earnings for the tax year (without reduction for dividends distributed during the tax year)
- §245A DRD is not allowed for
  - Distributions to non-corporate shareholders, RICs, or REITs
  - Hybrid dividends (i.e., dividends fully or partially deductible under foreign tax laws applicable to the CFC in question)
  - Dividends or stock which do not meet the holding period requirements of Code §246(c), as modified
    - Must be held for more than 365 days during the 731-day period beginning on the date that begins 365 days before the ex-dividend date
  - Non- "foreign source portion" of any dividends (i.e., dividends attributable to ECI or dividends from a lower-tier domestic corporation (sandwich structures))

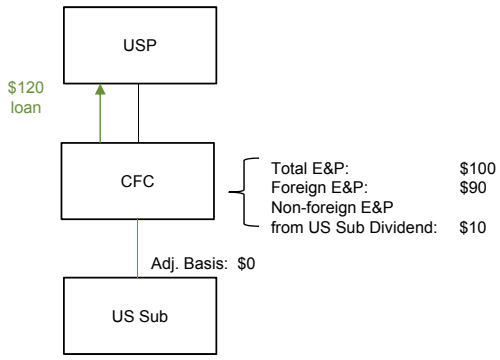
16

Application of Prop. Reg. §1.956-1

- Example 1 (Prop. Reg. §1.956-1(a)(3)(i)): USP owns 100% of CFC, which owns 100% of US Sub. USP has historic E&P of $100, $90 of which is foreign source and $10 of which is US source. In addition CFC has loaned $120 to USP. Assume USP satisfies §246(c) holding period requirement with respect to CFC, CFC does not receive any deduction for dividends distributed under the foreign jurisdiction tax laws to which it is subject, and none of the E&P is PTI.
- USP's "aggregate tentative §956 amount" = $100 (lesser of CFC's US property($120), and applicable earnings ($100))
- USP's §245A deduction = $90

$$\frac{\text{Foreign corporation's undistributed foreign earnings } \$90}{\text{Foreign corporation's total undistributed earnings } \$100}$$

- USP §956 inclusion = $10.*

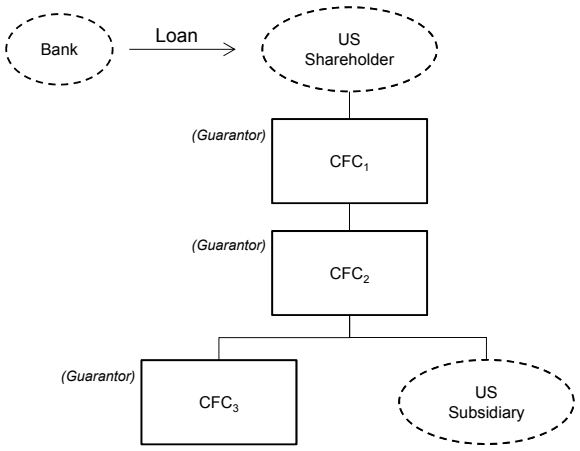


*Whether taxpayer actually includes under §956 or instead §951(a), with the §956 inclusion being treated as PTI under §959(c) depends on whether non-foreign E&P from US Sub dividend current or accumulated.

17

Application of Prop. Reg. §1.956-1 – Guarantee Example

- CFC1, CFC2 and CFC3 guarantee U.S shareholder borrowing
- Code §956 inclusion may still result:
  - If US shareholder is not a domestic corporation (§962 election doesn't give access to §245A)
  - If CFCs are funded with hybrid instruments (e.g., if CFC2 is funded with CPECs, E&P of CFC2 and CFC3 may be included under §956)
  - For non-foreign-source portion of E&P (e.g., portion of CFC2 earnings from US subsidiary (or ECI, if flow-through))
  - If CFC3 does not satisfy holding priod requirement (i.e., if not held for 365 day period, including post-inclusion)
    - Holding-period test is applied as if directly held (shorter of holding period in CFC1 and CFC3 is used)
    - May have significant untaxed E&P if acquired from a foreign parent with no §338 election
  - In addition, foreign law may impose significant restrictions on subsidiary guarantees, require guarantee fees, etc.



18

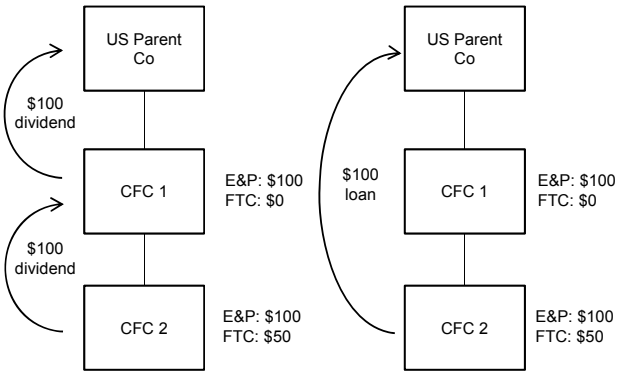
Code §956 Is Not Yet Dead

- Code §956 in general applies only to previously untaxed earnings and profits of a CFC, and historic E&P of historic CFCs generally will now have been previously taxed by virtue of Code §965
- Going forward, the new GILTI tax will apply to almost all other E&P
- Possible remaining sources of untaxed earnings and profits
  - E&P corresponding to 10% return on QBAI, which is excluded from GILTI
  - Subpart F income covered by the high-tax exception, thus not subject to tax under subpart F or GILTI
  - Income that would have been subject to tax under GILTI but for offsets in respect of losses of another CFC
  - US-source ECI (excluded from subpart F income and GILTI)
  - Pre-acquisition E&P of a foreign corporation that was not cleared out on the purchase (e.g., no Code §338 election) or by §965
  - E&P in excess of taxable income (as determined for purposes of GILTI)

19

Prop. Reg. §1.956-1 – Anti-Abuse Rule?

- Dividend up the chain would combine CFC 2's high tax E&P with CFC 1's low-tax E&P, diluting foreign tax credits received by US Parent Co
- Direct "hopscotch" loan from CFC2 to USP bypasses CFC1's high-tax pool, thereby enhancing US Parent Co's foreign tax credits
- Former Code §960(c) was enacted in 2010 to prevent this result by taking into account the lesser of actual or deemed distributed foreign tax credits, but has been repealed by TCJA
- Prop. Reg. §1.956-1 limits the return of "hopscotch" planning by, in this example, eliminating a §951(a) inclusion (and thus §960 deemed paid credits) if §245A is available
- Prop. Reg. §1.960-2(b)(1) denies a Code §960 credit with respect to Code §956 inclusions.



20

Prop. Reg. §1.956-1 Additional Considerations

- Actual distributions may be subject to Code §1059 if stock is not held for at least 2 years, resulting in basis reduction; in contrast, it does not appear that a reduced Code §956 amount would implicate Code § 1059
- Application through partnerships
  - Legislative history indicates Code §245A deduction is available to US corporations owning CFCs through a partnership, to the extent the domestic corporation is a US shareholder
  - The US corporation may still have a Code §956 inclusion
- The rules against hybrid dividends apply if a hybrid dividend exists anywhere in a tiered-CFC structure; thus, where Code §951 inclusion is preferable (e.g., where earnings and profits are subject to a high foreign tax rate), there may be an opportunity to avoid the application of Prop. Reg. §1.956-1 by interposing a CFC resident in a jurisdiction that allows partial or full deductions for dividends paid
- Prop. Reg. §1.956-1(g)(4)
  - The effective date for these changes will be the date of the Treasury Decision adopting these regulations as final
  - Will apply to CFC taxable years beginning on or after such date
  - Taxpayers may elect treatment under the former or new regulations until such date

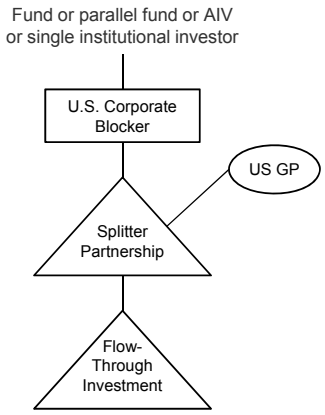
21

BLOCKER STRUCTURING CONSIDERATIONS

22

Inbound Planning: Impact of Tax Reform on Blocker Structuring

- Blockers are a common feature of private equity structures
  - Used to protect foreign and tax-exempt investors from recognition of ECI and UBTI from flow-through investments
- Various structures
  - Blocking above or below the fund
  - AIVs/parallel funds/individual blockers for each investor
  - GP carry above or below blocker
  - Leveraged or not



23

Tax reform changes affecting blockers – Overview

Tax reform changes affecting taxation of blockers

- The good news
  - Rate reduction – corporate rate reduced to 21%
  - Full expensing (section 168(k)) – 100% deduction for the cost of qualified property acquired and placed in service after 9/27/2017 and before 1/1/2023
    - Phase down in 20% increments from 2023 to 2026
    - Applies to used property if it is the taxpayer's first use and not acquired from a related party
    - Under proposed regulations, available for section 743(b) adjustments
  - Repeal of corporate AMT
- The bad news
  - NOL changes
    - NOL utilization limited to 80% of a corporation's taxable income (applies to NOLs arising in taxable years beginning after December 31, 2017)
    - Repeals almost all NOL carrybacks; taxpayers may carry NOLs forward indefinitely (applies to NOLs arising in taxable years ending after December 31, 2017)
  - Section 163(j) limitation on interest deductibility
  - Section 267A – Denial of deductions for related party amounts paid in hybrid transactions or with hybrid entities

24

Implications for Blockers – Rate Reduction

Lower rate reduces tax cost on blocked taxable income (21% rather than 35%)

- If tax distributions are based on highest individual rate, will over-distribute to blockers
  - Possible business issue?
  - Changes to credit agreements to reflect this?
- Planning for excess distributed cash?
  - Blocker leverage helps here?

25

Implications for Blockers – Rate Reduction

What about the accumulated earnings tax ("AET")?

- 20% corporate level tax that may be imposed on a corporation "formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed"
  - Tax base is accumulated taxable income, which is taxable income with certain adjustments, including an accumulated earnings "credit" that generally provides a reduction for earnings retained for the "reasonable needs of the business"
  - But if a corporation is a "mere holding or investment company":
    - That is prima facie evidence of the prohibited purpose
    - Accumulated earnings credit limited to excess of $250,000 over the accumulated e&p of the corporation at the end of the prior year
- Regulations refer to avoidance the "individual income tax" as the touchstone
  - See PLR 9709034 and PLR 9422028 AET does not apply when there is no possibility of U.S. individual tax up the chain even if dividends were paid
  - Implications for blockers wholly owned by institutional investors?
- In a 2016 Chief Counsel Advice, IRS takes the position that a corporation formed to hold partnership interests is a mere holding/investment company that is subject to AET notwithstanding lack of ability to cause the partnerships to make distributions

26

Section 163(j) Limit on Interest Deductibility

Under section 163(j), no deduction is allowable for net business interest expense in excess of 30% of "adjusted taxable income"

- Adjusted taxable income is generally similar to EBITDA for taxable years beginning after December 31, 2017, and before January 1, 2022; similar to EBIT thereafter
  - *BUT* based on tax amounts so may diverge from book EBITDA/EBIT
- Disallowed interest expense may be carried forward indefinitely (subject to section 382 in the case of a change in ownership for corporations)
- Exemptions for certain categories of taxpayers:
  - Certain public utilities, floor plan financing indebtedness, and taxpayers with average annual gross receipts not exceeding $25 million
  - At election of taxpayer – real estate businesses and farming businesses
- Applies to business interest; investment interest remains subject to existing rules
  - Proposed regulations – All corporate interest expense and income is business interest

27

Section 163(j) Limit on Interest Deductibility

For entities classified as partnerships, the 30% limitation is determined at the partnership level

- Business interest deductions that are allowed are taken into account in determining the non-separately stated taxable income or loss of the partnership
- Interest disallowed at the partnership level ("excess business interest" or "EBI") is passed through to the partners and is "freed up" for potential deduction in future years (i.e., treated as paid or accrued) to the extent the partnership generates (and allocates to such partners) more adjusted taxable income than it needs to deduct the full amount of its business interest expense ("excess taxable income" or "ETI") or excess business interest income
- Partner's distributive share of partnership items is ignored in determining partner-level adjusted taxable income, except that ETI is included in the partner's adjusted taxable income
  - Net business interest income (if any) allocated to the partner by the partnership is also taken into account in determining a partner's 163(j) limitation
- A partner generally reduces the basis of its partnership interest by the amount of any EBI allocated to it, but that basis reduction is reversed to the extent of the EBI that remains not treated as "paid or accrued" (*compare* "allowed as a deduction") at the time of a disposition of the partnership interest

28

Section 163(j) Limit on Interest Deductibility

Key points for partnerships

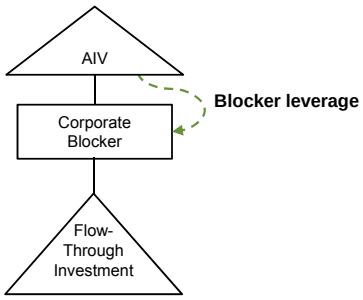
- Entity by entity approach for freeing up interest expense disallowed at the partnership level
- Although $100 of excess taxable income allocated to a partner allows $100 of previously disallowed excess business interest from the partnership to be treated as paid or accrued and eligible for deduction, the amount deductible will be based on 30% of the partner's adjusted taxable income plus its net business interest income
- Proposed regulations reserve on EBI and basis adjustments in tiered partnership arrangements; comments requested

29

Blocker Level Interest Deductions – Section 163(j)

Leveraging a blocker that holds only an interest in a single partnership – section 163(j) considerations

- Interest expense deductions on blocker-level debt generally allowable during the hold period only to the extent that ETI and/or net business interest income is allocated to the blocker by the partnership
  - Compare: disallowed interest expense carryforwards v. NOLs
- What if the flow through portfolio company is conducting a business that is eligible for a section 163(j) exception (e.g., electing real property trade or business)?
  - See Prop. Reg. § 1.163(j)-10(c)(5)(ii)(A)(2)(i)



30

Section 267A – Statute

- Legislative history indicates that section 267A is inspired, at least in part, by BEPS and Action 2
- Disallows deductions for interest and royalty payments
  - Made to a related party pursuant to a hybrid transaction, or
  - By, or to, a hybrid entity
- For section 267A to apply there must be both a:
  - "Disqualified Related Party Amount"; and
  - "Hybrid Transaction" or "Hybrid Entity"
- Broad grant of regulatory authority – see section 267A(e)

31

Section 267A – Statute

Disqualified Related Party Amount

- Interest or royalty paid or accrued to a related party;
- To the extent that the payment is either:
  - **Not included** in income ***under the tax law of the*** country of which such related party is a resident or subject to tax;
  - Or such related party is **allowed a deduction** with respect to such amount
- Related party means a related person as defined in section 954(d)(3) □ more than 50% vote or value

Hybrid Transaction -- Any transaction, series of transactions, agreement, or instrument one or more payments with respect to which are treated as interest or royalties for US federal tax purposes and which are not so treated for purposes [of] the tax law of the foreign country of which the recipient of such payment is resident for tax purposes or is subject to tax.

Hybrid Entity – Entity that is:

- Fiscally transparent for USFIT purposes but not for purposes of the tax law of the foreign country of which the entity is resident or subject to tax, **or**
- Fiscally transparent for purposes of the tax law of the foreign country of which the entity is resident or subject to tax but not for USFIT purposes

32

Section 267A Proposed Regulations

Touchstone of proposed regulations is to address "deduction/no-income" situations where that result would otherwise arise from hybridity of a payment or the recipient entity

- A "specified party's" deduction for any interest or royalty paid or accrued (a "specified payment") will be disallowed only to the extent the specified payment is
  - A disqualified hybrid amount,
  - A disqualified imported mismatch amount, or
  - A specified payment to which the anti-avoidance rule applies
- Specified party means a tax resident of the U.S., a CFC (other than a CFC as to which there is no section 958(a) U.S. shareholder), or a U.S. taxable branch

33

Section 267A Proposed Regulations

Disqualified hybrid amounts include certain

- Hybrid transaction payments
- Disregarded payments
- Deemed branch payments
- Payments to reverse hybrids
- Branch mismatch payments

34

Section 267A Proposed Regulations

Hybrid transaction payments

- A payment made pursuant to a hybrid transaction is a disqualified hybrid amount to the extent that (i) a specified recipient of the payment does not include the payment in income, and (ii) the specified recipient's no-inclusion is a result of the payment being made pursuant to the hybrid transaction
- Hybrid transaction – Any transaction, series of transactions, agreement, or instrument one or more payments with respect to which are treated as interest or royalties for USFIT purposes but are not so treated for purposes of the tax law of a specified recipient of the payment
- Timing differences – A specified payment is made pursuant to a hybrid transaction if the taxable year in which a specified recipient recognizes the payment under its tax law ends more than 36 months after the end of the taxable year in which the specified party would be allowed a deduction for the payment under U.S. tax law
- Specified recipient means, with respect to a specified payment, any tax resident that derives the payment under its tax law or any taxable branch to which the payment is attributable under its tax law
  - *Important – There may be more than one specified recipient with respect to a specified payment*

35

Section 267A Proposed Regulations

Disregarded payments

- The excess of the sum of a specified party's disregarded payments for a taxable year over its dual inclusion income for the taxable year is a disqualified related party amount
- A disregarded payment is a specified payment to the extent that, under the tax law of a tax resident or taxable branch to which the payment is made, the payment is not regarded and, were the payment to be regarded under such tax law, the tax resident or taxable branch would include the payment in income
- Also applies if under the tax law of the tax resident or taxable branch, the tax resident or taxable branch would be eligible for a deduction or similar offset under a foreign consolidation, fiscal unity, loss sharing or similar regime
- Dual inclusion income is the excess of
  - The sum of the specified party's items of income or gain for USFIT purposes that are included in the income of the tax resident or taxable branch to which the disregarded payments are made, over
  - The sum of the specified party's items of deduction or loss for USFIT purposes (other than deductions for disregarded payments) to the extent the items of deduction or loss are allowable under the tax law of the tax resident or taxable branch to which the disregarded payments are made

36

Section 267A Proposed Regulations

Reverse hybrids

- A payment to a reverse hybrid is a disqualified hybrid amount to the extent that an investor of the reverse hybrid does not include the payment in income and the investor's non-inclusion is a result of the payment being made to the reverse hybrid
- Reverse hybrid – An entity, regardless of whether domestic or foreign, that is fiscally transparent under the tax law of the country in which it is created, organized, or otherwise established but not fiscally transparent under the tax law of an investor in that entity
- Indirect payments – A specified payment made to an entity an interest of which is directly or indirectly owned by a reverse hybrid is considered made to the reverse hybrid to the extent that, under the tax law of an investor of the reverse hybrid, the entity to which the payment is made (and all intermediate entities) is fiscally transparent

37

Section 267A Proposed Regulations

Relatedness requirement

- A specified recipient, a tax resident to which a specified payment is made, an investor, or a home office is generally taken into account for purposes of the foregoing rules only if it is related to the specified party
  - Relatedness defined by reference to section 954(d)(3) (more than 50%)
  - Determined by treating the specified party as a CFC, the tax resident or taxable branch as a person, and tax residents that are DREs and taxable branches as corporations
- This relatedness limitation does not apply to a "structured arrangement" – an arrangement with respect to which one or more specified payments would be a disqualified hybrid amount or a disqualified imported mismatch amount if the specified payment were analyzed without regard to the relatedness limitation (a "hybrid mismatch") if
  - The hybrid mismatch is priced into the terms of the arrangement, or
  - The hybrid mismatch is a principal purpose of the arrangement

38

Section 267A Proposed Regulations

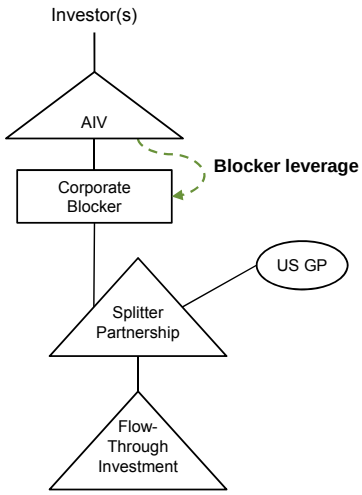
Disqualified imported mismatch amount

- A specified payment is a "disqualified imported mismatch amount" to the extent that, under the "set-off" rules, the income attributable to the payment is directly or indirectly offset by a "hybrid deduction" incurred by a tax resident or taxable branch that is related to the specified party (or that is a party to a structured arrangement pursuant to which the payment is made)
- Hybrid deduction a deduction allowed to the tax resident or taxable branch under its tax law for an amount paid or accrued that is interest or a royalty to the extent that a deduction for the amount would be disallowed if such tax law contained rules substantially similar to the proposed regulations (e.g., if the amount were a hybrid transaction, as defined)
- Set off rules turn on the extent to which the payment is considered to directly or indirectly "fund" the hybrid deduction

39

Blocker Level Interest Deductions – Section 267A

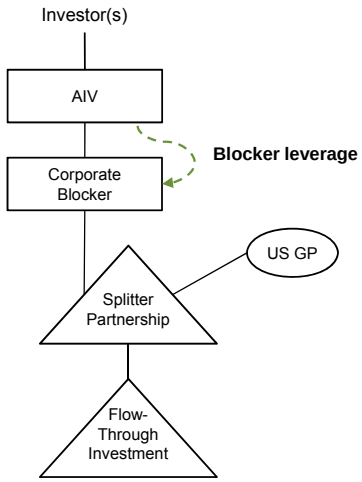
- AIV is a partnership for purposes of the tax law of its residence jurisdiction
- Depending on the facts, deductions for blocker interest may be denied under section 267A if
  - AIV is a corporation for purposes of the tax law applicable to investor(s) (reverse hybrid)
  - The interest payments are not included in income by investor(s) under such tax law (hybrid transaction)
  - Other possibilities?
- Does AIV's classification for US tax purposes matter under the proposed regulations?



40

Blocker Level Interest Deductions – Section 267A

- Is it enough to know that AIV is a corporation that treats the blocker's interest payments as income for purposes of its residence jurisdiction's tax law to avoid interest deductions on blocker debt being denied under section 267A? (Hint: No.)
- Does AIV's classification for US tax purposes matter under the proposed regulations?



41

Implications for Blockers – Exit Scenarios

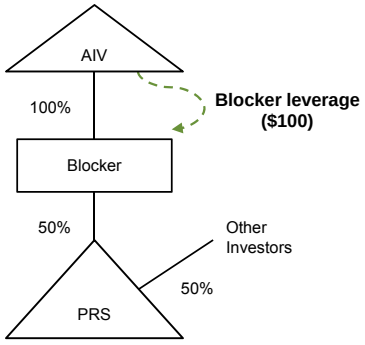
- Sale of blocker
  - Minimizes U.S. tax for blocker investors, but what if preferable for other investors to sell partnership assets?
  - Effect on purchase price of (a) embedded blocker tax liability/lack of step up to buyer, and/or (b) value of the blocker's disallowed interest carryforwards or NOLs (taking into account section 382 limitation from sale)?
- Sale of partnership interest
  - May free up disallowed blocker-level debt deductions, but apparently will not free up EBI allocated to the blocker by the partnership
  - Downward basis adjustment for any EBI that was allocated to the blocker, and which has not been deemed paid or accrued as a result of a subsequent allocation of ETI, would be reversed at the time of sale (reduces capital gain or increases capital loss)
  - Limitation on ability of blocker to use post-2017 NOLs to offset sale gain
- Sale of partnership assets
  - ETI from sale frees up disallowed excess business interest that was previously allocated to the blocker by the partnership
    - BUT deductible only to the extent of 30% of the blocker's adjusted taxable income and business interest income
    - No reversal of downward basis adjustment for freed up interest that is not deductible due to 30% limitation
  - Allocation of ETI may also enable use of blocker-level interest deductions
  - Limitation on ability of blocker to use post-2017 NOLs to offset sale gain

42

Blocker Exit Example

Facts

- As of the end of year 1:
  - AIV has a basis of $100 in the stock of blocker and in addition owns a debt instrument issued by blocker with a $100 principal amount
  - Blocker has $30 of disallowed interest expense carryforwards
  - Blocker has been allocated EBI of $50 by PRS
  - Taking into account basis adjustments for EBI, Blocker has basis of $150 in PRS (without regard to section 752/partnership liabilities)
  - PRS has net basis of $300 in its assets
- Buyer wants to buy all of PRS at the beginning of year 2 for $800 and will assume PRS debt



43

Blocker Exit Example

- Sale of PRS assets (character issues ignored)
  - PRS has gain of $500; $250 is allocated to Blocker
  - Since no interest is deducted for Year 2 at the partnership level, the $250 allocation to Blocker is ETI
  - Basis adjustments to Blocker's interest in PRS
    - $250 upward adjustment for allocation of partnership level gain
    - ETI results in EBI being treated as paid or accrued, and as a result no reversal of downward adjustment in PRS for prior EBI allocation
    - Results in $400 basis in PRS interest
  - On the liquidating distribution of the $400 of sale proceeds, Blocker has no gain or loss with respect to its PRS interest
  - Blocker's $250 of ATI permits deduction of $75 of Blocker level interest (out of a total of $80 of interest treated as paid or accrued)
  - Blocker has $175 of income resulting in tax of $36.75
- What if sale price is $1100? Or $500?

44

Blocker Exit Example

- Sale of PRS interest (character issues ignored)
  - Because previously allocated EBI is not treated as paid or accrued, the prior $50 basis adjustment is reversed, resulting in Blocker having a $200 basis in its PRS interest
  - Blocker has gain of $200 with respect to its PRS interest on its sale for $400
  - Blocker's gain of $200 means that it has ATI of $200, permitting deduction of the $30 of previously disallowed Blocker-level interest expense
  - Giving effect to the $30 interest deduction, Blocker has $170 of income, resulting in a tax of $35.70
- What if sale price is $1100? Or $500?

45

Blocker Exit Example (Sale Price $1100)

- Sale of PRS assets (character issues ignored)
  - PRS has gain of $800; $400 is allocated to Blocker
  - Since no interest is deducted for Year 2 at the partnership level, the $400 allocation to Blocker is ETI
  - Basis adjustments to Blocker's interest in PRS
    - $400 upward adjustment for allocation of partnership level gain
    - ETI results in EBI being treated as paid or accrued, and as a result no reversal of downward adjustment in PRS for prior EBI allocation
    - Results in $550 basis in PRS interest
  - On the liquidating distribution of the $550 of sale proceeds, Blocker has no gain or loss with respect to its PRS interest
  - Blocker's $400 of ATI permits deduction of the $80 of Blocker level interest treated as paid or accrued
  - Blocker has $320 of income resulting in tax of $67.20

46

Blocker Exit Example (Sale Price $1100)

- Sale of PRS interest (character issues ignored)
  - Because previously allocated EBI is not treated as paid or accrued, the prior $50 basis adjustment is reversed, resulting in Blocker having a $200 basis in its PRS interest
  - Blocker has gain of $350 with respect to its PRS interest on its sale for $550
  - Blocker's gain of $350 means that it has ATI of $350, permitting deduction of the $30 of previously disallowed Blocker-level interest expense
  - Giving effect to the interest deduction, Blocker has $320 of income, resulting in a tax of $67.20

47

Blocker Exit Example (Sale Price $500)

- Sale of PRS assets (character issues ignored)
  - PRS has gain of $200; $100 is allocated to Blocker
  - Since no interest is deducted for Year 2 at the partnership level, the $100 allocation to Blocker is ETI
  - Basis adjustments to Blocker's interest in PRS
    - $100 upward adjustment for allocation of partnership level gain
    - ETI results in EBI being treated as paid or accrued, and as a result no reversal of downward adjustment in PRS for prior EBI allocation
    - Results in $250 basis in PRS interest
  - On the liquidating distribution of the $250 of sale proceeds, Blocker has no gain or loss with respect to its PRS interest
  - Blocker's $100 of ATI permits deduction of $30 of Blocker-level interest (out of $80 treated as paid or accrued)
  - Blocker has $70 of income resulting in tax of $14.70

48

Blocker Exit Example (Sale Price $500)

- Sale of PRS interest (character issues ignored)
  - Because previously allocated EBI is not treated as paid or accrued, the prior $50 basis adjustment is reversed, resulting in Blocker having a $200 basis in its PRS interest
  - Blocker has gain of $50 with respect to its PRS interest on its sale for $250
  - Blocker's gain of $50 means that it has ATI of $50, permitting deduction of $15 of previously disallowed Blocker-level interest expense
  - Giving effect to the interest deduction, Blocker has $35 of income, resulting in a tax of $7.35

49

Blocker Exit Example

- Sale of Blocker
  - No Blocker-level entity tax
    - Purchase price haircut for embedded tax liability/lack of step-up?
    - Value of Blocker attributes (e.g., disallowed interest carryforwards) to buyer taking into account section 382 limitation from sale?
  - Consider consequences to unblocked investors that might cause them to prefer to sell partnership assets rather than partnership interests
    - Character considerations Asset sale permits ordinary deduction for freed up EBI that becomes deductible v. basis adjustment with partnership interest sale reduces capital gain
    - Section 1061 considerations section 1231 property v. section 1221 property

50