TOP TAX ISSUES KEEPING DEAL – MAKERS UP AT NIGHT

CohnReznick
ADVISORY • ASSURANCE • TAX

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CohnReznick LLP

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AGENDA

- State and local tax risk management
- Business Interest Deduction Limitation (163J)
- Carried Interest Update/Waterfall Planning
- Management Fee Waivers
- Net Operating Losses
- Excess Business Loss Limitation
- Schedule K-1 Updates

STATE AND LOCAL TAXES

STATE AND LOCAL TAX RISK MANAGEMENT

State Tax Climate Today

- State tax rules are more complex and burdensome than ever before
- Laws vary widely across the country and can even vary within a state
- Almost impossible to keep up with the volume of state and local jurisdictions and rapidly-changing rules
- Recent adoption of “economic nexus” rules significantly drives up risks and costs of compliance

STATE AND LOCAL TAX RISK MANAGEMENT

Private Equity Funds

- Common to deal with federal and state tax issues during the due diligence process
- State tax exposures may lead to significant consequences
- Successor Liability
  - New owners can inherit the liabilities of an acquired company
  - Liabilities can go back to when the company first started doing business
  - Compounded interest and penalties can be significant
- Sales tax exposures
  - Certain sales tax exposures can be inherited by new owners, even in an asset deal

STATE AND LOCAL TAX RISK MANAGEMENT

Private Equity Funds

- No one likes surprises!
  - Don't wait until the due diligence process to identify risks
  - State tax exposures can be mitigated, but not overnight
    - Ex: Nexus studies, Voluntary Disclosure Agreements
- Know the state tax rules, especially in the states with significant revenue
- Evaluate all portfolio companies from a state tax perspective early and regularly, and take necessary steps to mitigate any portfolio company exposure(s)
- New Acquisitions
  - Understand any successor liability and adjust terms accordingly
  - Rectify state tax exposures as soon as possible
  - Ensure timely, accurate compliance (especially for s/u and gross-receipts taxes)

STATE AND LOCAL TAX RISK MANAGEMENT

Portfolio Companies

- Tend to be growing businesses

- As the business grows:
  - Risk increases
    - New jurisdictions
    - New products and services
    - Additional rules to comply with
    - Ever changing state (and local) tax rules

STATE AND LOCAL TAX RISK MANAGEMENT

Portfolio Companies

- Nexus
  - The biggest state tax risk facing most multi-state businesses today (especially growth companies)
  - The potential consequences of failing to manage compliance with state tax nexus laws and regulations, including taxability rules, can be crippling
  - Rules have changed dramatically in the past year
  - Most exposures can be mitigated if timely identified
  - Businesses, especially growing businesses, should regularly ensure that they are properly filing required returns and assessing/collecting required taxes
  - Every year do a nexus review and research for changes in taxability and nexus rules

STATE AND LOCAL TAX RISK MANAGEMENT

Portfolio Companies

- Other Challenges
  - Taxability rules for Sales tax
  - Sourcing rules for Income tax
  - Gross receipts taxes
  - State (and local) laws vary widely!
  - State tax departments are increasingly aggressive
- As the business grows, it is important to manage cost increases

STATE AND LOCAL TAX RISK MANAGEMENT

Investors

- Managing the investors’ risk starts with the portfolio company
  - Tax compliance by portfolio company
  - Proper application of sourcing rules
- If Investors want to minimize state tax filings, options exist
  - But be aware of varying state rules regarding “Composite” returns
- Fund managers play a key role in keeping investors happy

STATE AND LOCAL TAX RISK MANAGEMENT

What Do You Need to Know?

- Today's state tax climate presents heightened complexity and risk for all taxpayers (also increased tax compliance costs)
- Managing risk starts with your Portfolio Companies
  - Are you filing returns everywhere you should be?
  - Are you compliant with the sales taxability rules in all filing jurisdictions?
  - Are you properly sourcing sales for income tax purposes?
- The fund and investors are directly impacted by the portfolio company
  - Good planning and diligence with the portfolio company reduces risk for the fund and its investors
- Be Proactive, Not Reactive!
  - Mitigate any potential issues well before a purchase or sale
  - Don't wait for due diligence to discover exposures

BUSINESS INTEREST DEDUCTION LIMITATION (163J)

BUSINESS INTEREST DEDUCTION LIMITATION

- Limitation on business interest expense deduction for corporations and flow-through entities
- Taxpayer’s interest expense will be limited to 30% of the entity’s adjusted taxable income (ATI)
- Disallowed interest is carried over as business interest to the succeeding tax year.
- Exception for taxpayers with average annual gross receipts of less than $25 million for the last three preceding tax years.

CARRIED INTEREST UPDATE / WATERFALL PLANNING

CARRIED INTEREST

- Compensation to general partner for its services to the fund
- Profits interest
- Typical carry percentage is 20%

SECTION 1061- CARRIED INTEREST HOLDING PERIOD

- Tax Cuts and Jobs Act modified the treatment of carried interest by lengthening the required holding period for sales of assets held directly or indirectly by the fund from one year to three years.

- Any gains from sales prior to meeting the three-year holding period will be treated as short-term gains.

- Three-year rule is not applicable to corporations that hold partnership interests.

MANAGING UNCERTAINTY

- Many aspects of IRC Section 1061 are still unclear as the Treasury has yet to publish regulations on the topic. The IRS has announced that regulations on this topic are expected this month (January 2020).

- There has always been debate about weather the current taxation of carried interest is fair. While 1061 was a compromise, many feel it did not go far enough. Federal legislators introduced the Carried Interest Fairness Act of 2019, which proposes taxing all carried interest at ordinary income rates. While current passage of the act is slim, the issue will likely gain traction as we move closer to the 2020 elections.

PLANNING STRATEGIES

Waterfall Planning

- Understand your agreement and how taxable income is allocated.
  - European Model
  - American Model
- Timing of the Carry
- Characterization of Income
  - Ordinary Income
  - Capital Gain: Long-Term or Short-Term
    - Section 1061

OPPORTUNITIES TO CREATE VALUE

- Cash Flow Planning
- Tax Distribution Provisions in the LPA
- Estimates for Investors
- Holding Period Considerations
- Management Fee Waivers

MANAGEMENT FEE WAIVERS

PLANNING STRATEGIES

Management Fee Waivers

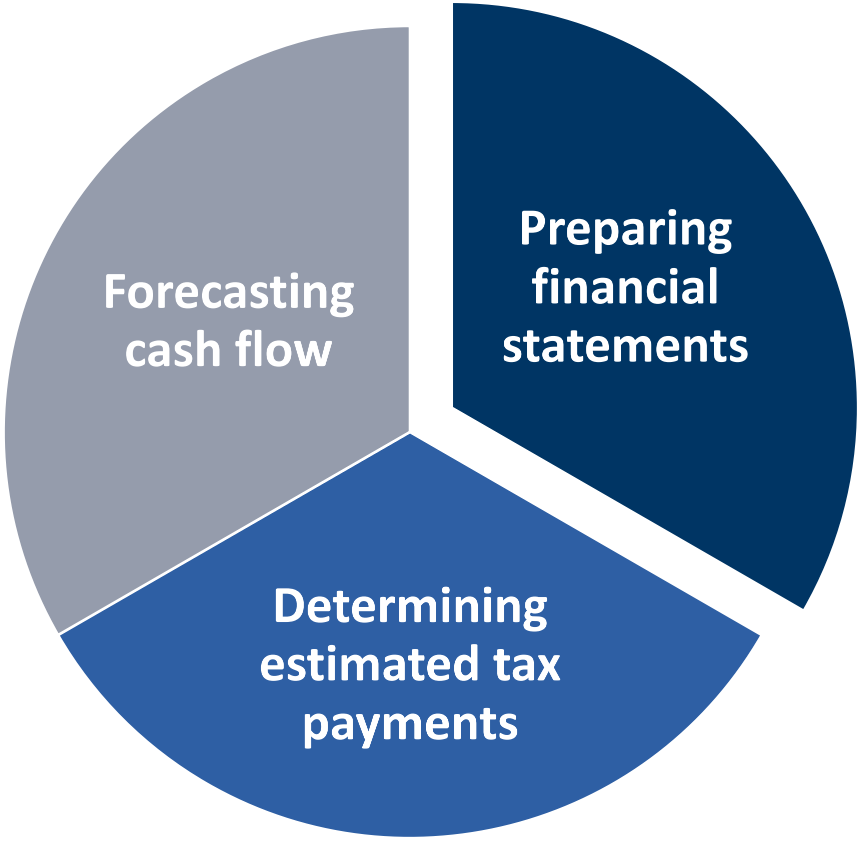
- Could be used to make capital commitments with pre-tax dollars
- Potential conversion of ordinary income to capital gain income
- Need to reconsider these arrangements after implementation of IRC 1061

LOSS LIMITATIONS

NET OPERATING LOSS LIMITATION

- NOL usage is limited to 80% of taxable income
- NOL Carryback was eliminated in 2018
- NOL can be carried forward indefinitely

Potential Pitfalls



EXCESS BUSINESS LOSS LIMITATION

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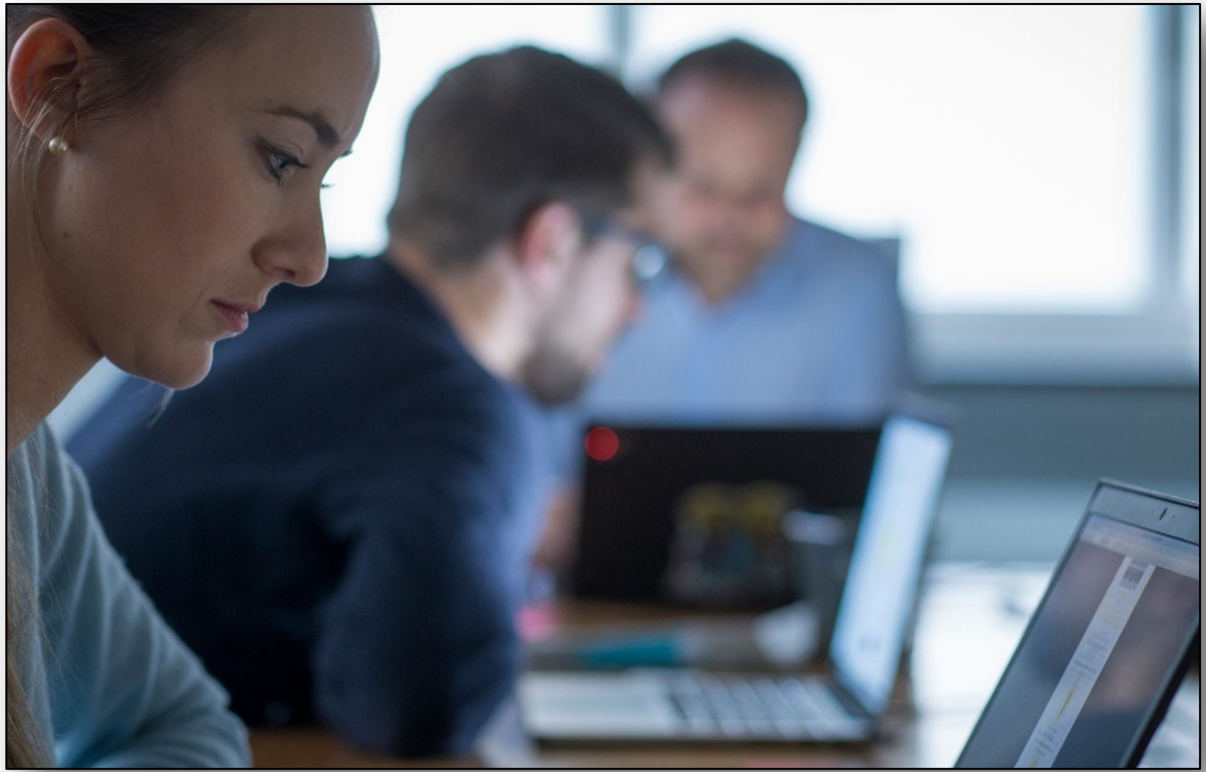
- Excess of the aggregate deductions over gross income and gains of a taxpayer attributable to all trades or business in excess of $500,000 (MFJ) or $250,000 (Single)



SCHEDULE K-1 UPDATES

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- Tax Basis Capital Reporting – Deferred until 2020
- Disregarded Entity Reporting
- Guaranteed Payment Breakout
  - Services
  - Capital
- Net Unrecognized Section 704(c) Gain or Loss Reporting
- Multiple Activities Specification for At-Risk and Passive Activity purposes

QUESTIONS/ CONCLUDING DISCUSSION

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