K&L GATES PRIVATE EQUITY FUNDS YEAR-IN-REVIEW – A LOOKBACK AT 2017 AND THE OUTLOOK FOR 2018

Date: 12 March 2018

U.S. Investment Management / Private Equity Funds / Tax Alert

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The global private equity fund industry remained strong in 2017, as both established and first-time fund managers launched new funds and deployed the capital of existing ones. We saw a diverse range of managers and strategies in the market, with investor appetite for private equity strategies remaining strong. Traditional private equity investors were active participants in the industry, along with less-traditional players seeking to explore private equity.

The U.S. private equity fund industry continued to be robust in 2017. Private equity firms in the United States closed on $232.7 billion across 247 funds, and recent annual fundraising continues to approach record levels. [1] While the largest private equity firms enjoyed the most significant inflows of funds, there were pockets of strength in a number of specific segments of the market. We are pleased to offer this overview of some of the more significant trends and developments in certain segments of the private equity fund industry in 2017, along with our outlook for this year.

FIRST-TIME FUND MANAGERS AND SEEDING ARRANGEMENTS

By Ed Dartley and Amanda Katlowitz

On a global basis, private equity funds saw a surge in assets under management in 2017, with 921 private equity funds reaching a final close and over $453 billion raised — the largest level of commitments in the past 10 years. [2] These new funds include a significant number of first-time fund managers, with 226 first-time funds reaching their final closing in 2017. [3] Given the continued interest in first-time fund managers in 2017, we expect the figure for first-time final closings to increase in 2018.

First-time fund managers present an attractive opportunity for many private equity fund investors because of the potential for strong returns and the ability to build a strong relationship for future growth with the manager. At the same time, with the number of existing private equity fund managers marketing new funds, competition for investor dollars has been intense, and not all investors have been willing to risk betting on a first-time manager without a proven track record of performance. For instance, in a 2017 Preqin survey, 41 percent of surveyed investors said that they would not invest in a first-time fund because of the importance of an established track record. [4] Yet, at the same time, 33 percent of investors in that same survey showed a preference for first-time funds, a strong indicator of the continued interest in this segment of the private equity industry. [5]

Some first-time managers succeed by presenting a differentiated strategy and limited opportunity to invest at the inception of a new fund. Others succeed by teaming up with one or more institutional investors who seed the manager and/or its fund for its initial fund launch.

In a competitive landscape, the right seeding arrangement can give a first-time manager the boost it needs early in the fundraising process. Not only can a seed investor's capital be critical for getting the scale sufficient to execute the manger's strategy, some seed investors have been able to bring a competitive advantage to the manager by virtue of their expertise or industry contacts. A seed investor's willingness to provide capital and support to a first-time manager can be seen as a significant vote of confidence in the manager's strategy and investing capabilities, helping overcome the reluctance regarding a first-time manager's lack of a "fund" track record, while at the same time lending credibility to the manager and the offering the opportunity for institutional mentoring.

In 2017, there was healthy interest from institutional investors looking to enter the emerging manager market for the first time by joining groups of "anchor investors" led by one or more seasoned seed investors. These newer entrants to the seeding industry have sought to reduce the risk of betting on a first-time manager by teaming up with an experienced seeder, with the expectation that this will be an advantage in the diligence process and in the manager's efforts to reach a successful initial and final closing. We view this as a positive development for both the seeding and first-time manager markets, providing an important comfort level that can lead to increased allocations by these institutional investors to this segment of the private equity industry.

The structure and approach of seeding arrangements with first-time managers in 2017 have been bespoke and customized, ranging from light-touch arrangements to more extensive joint venture-type relationships with extensive governance provisions. At the same time, certain hallmark features remain consistent across seed investment arrangements. The seed investor invariably provides the fund manager with a significant commitment of capital to the fund, typically early in the fundraising process, in order for the manager to reach a successful first closing. Initial commitments from seeders are typically substantial — anywhere from 10 to 33 percent of the overall target fund size. In such instances, the seed investor's capital provides an "anchor" for the manager to complete an initial launch of the fund.

In return, seed investors have typically received a share of the management fee and other fees (such as monitoring fees, transaction fees, and directors' fees) payable to the manager and a share of the carried interest allocated to the manager. These revenue-sharing arrangements have generally been structured through a contractual arrangement, an ownership interest in one of the fund manager entities, or a combination of both. Other rights typically granted to the seed investor have included the right to receive favorable economics in future funds launched by the manager, so that the seed investor achieves the benefit of taking the first-time risk on the manager's success. In 2017, as in prior years, the specific terms and duration of these future-fund seeder rights varied widely, sometimes measured by years and sometimes by threshold level of assets under management.

One approach for addressing the inherent risk in seeding arrangements with first-time managers has been through the seeders' acquisition of governance and control rights with respect to the manager's business and the funds being launched. While there is some level of negotiation, the core of these rights typically seeks to define and limit the manager's ability to deviate from the investment strategy, take on undue financial exposure, and make significant amendments to governing agreements of entities in the corporate structure, among others. At the fund level, this often will include the right to appoint one or more members to the limited partner advisory committee for the fund. Seed investors typically will obtain participation rights on the investment committee of the manager, often in the status of an observer but sometimes as a voting member of that committee. [6]

Given the strong interest in private equity generally and in first-time managers specifically, we anticipate continued interest in 2018 in both first-time managers and in seeding arrangements. In recent years, the universe of investors interested in first-time managers has expanded, and we expect to see investors such as family offices, insurance companies, non-U.S. institutional investors, and fund-of-funds managers continue to invest in this segment of the private equity industry and perhaps expand their exposure to it. While the field for new managers and investors interested in them is becoming more crowded, we believe that there is room for continued growth in the industry.

REAL ESTATE PRIVATE EQUITY FUNDS

By Robert McCarthy

In 2017, closed-end private real estate funds invested US$287 billion and reached US$811 billion in assets under management, both record amounts. The net asset value of closed-end real estate funds has now increased for 30 consecutive quarters. The expansion of the real estate fund industry in recent years reflects a robust post-financial crisis real estate market that has resulted in increased portfolio values, strong performance results, and access to greater amounts of capital.

This market has also generated new challenges for real estate fund managers, who are seeking to source attractive investment opportunities in an environment where valuations are high and competition for assets is intense. Following years of successful fundraising, fund managers are under pressure to deploy capital and maintain strong returns. Although fundraising levels are still high, the amount raised by closed-end private real estate funds decreased from US$126 billion in 2016 to US$111 billion in 2017.

Investors seeking higher returns continued to direct the majority of capital raised by private real estate funds to opportunistic and value-add strategies in 2017. However, there has been an increased focus of fund managers and investors on debt-focused strategies, reflected in an increase in the amount of capital raised by private real estate debt funds from US$22 billion in 2016 to US$28 billion in 2017. This trend is expected to continue, as investors seek to diversify portfolios and protect against downside risk in the face of increased interest rates and cyclical economic factors.

New fund managers continue to face challenges as capital is concentrated in fewer, larger real estate funds. Nonetheless, emerging managers have produced strong returns, and many such managers have been successful in turning current market conditions to their advantage by focusing on assets outside of the scope of larger funds seeking to deploy capital through the acquisition of portfolios and other large investments. In addition, institutional investor interest in partnering with new managers in joint ventures or seeding arrangements has been strong (see "First-Time Fund Managers and Seeding Arrangements" above), balancing out some of the challenges that new emerging managers face.

Real estate fund managers are continuing to invest in new technology platforms that allow them to analyze diverse sets of real estate investment data more efficiently. For instance, fund managers are utilizing predictive analytics in making investment decisions and relying on improved performance data in managing retail, industrial, and multifamily properties. Fund managers are also using new technology systems to provide reporting and back office functions, resulting in significant cost savings.

Fund managers are also increasingly utilizing complex fund structures to hold real estate and related assets (including debt investments) in an effort to accommodate investors with diverse tax and regulatory concerns. This trend is expected to continue, in particular as non-U.S. investors seek to take advantage of changes implemented by the Tax Cuts and Jobs Act of 2017. Real estate fund structures often include parallel vehicle structures and the use of specialized investment vehicles such as REITs, leveraged corporate blockers, and Delaware statutory trusts. While these structures provide tax benefits to investors and have expanded the pool of investors able to invest in real estate funds, the associated costs can represent a significant hurdle for emerging fund managers and could increase pressure on fund managers generally to produce returns that justify such costs.

The Tax Cuts and Jobs Act of 2017 increased the holding period for long-term capital gains with respect to gains attributable to carried interest from one year to three years. While real estate funds typically hold assets for a period of three years or longer, this change will further incentivize fund managers to focus on assets that are expected to meet the holding period.

INTERNATIONAL PRIVATE EQUITY FUNDS

By Bruce MacLennan and Todd Betke

With the accelerating growth in the global economy generally through 2017 and into 1Q 2018 — including tightening restrictions in some major sectors, such as China; declining opportunities in other sectors, such as the Middle East; and weakness in the UK outlook due to the uncertainties associated with Brexit — we are seeing traditional private equity investors in Asia and Europe, as well as sovereign wealth funds in the Middle East, looking farther afield for opportunities for deployment of their burgeoning cash reserves and a concomitant expansion of the varieties of alternative investment products being offered.

For example, some established Asian private equity fund managers that, until recently, had not looked beyond Asia for investment opportunities in the belief that the "Asian Millennium" would see Asian emerging economies experience the most future growth in an otherwise sluggish global economy, are now beginning to look to opportunities in the United States and Europe for stable growth private equity investments. Moreover, in 2017 and early 2018, we are seeing an increasing number of first-time private equity funds setting up shop in Singapore and the Cayman Islands for managers based in Singapore, Hong Kong, and, to a lesser extent, Tokyo, sourcing capital from those jurisdictions as well as China, Malaysia, and Indonesia. We have also seen private equity investment in India reach a record high of US$24.7 billion in 2017, reflecting a 50 percent increase in average deal value. At the same time, Indian private equity investments also generated record exit values of US$12.5 billion, exceeding the previous 2015 high by 40 percent. [7] This expansion is expected to continue in 2018 and beyond.

According to a Preqin survey conducted in December 2017, 53 percent of institutional investors globally plan to increase their allocation to private equity over the long term, and only 4 percent anticipate a decrease in their private equity allocation. Along with allocations to private debt (54 percent of investors plan to increase their allocations to this asset class) and infrastructure (55 percent of investors plan to increase their allocations to this asset class), private equity is positioned to experience the greatest growth of any asset class in the coming year, by far outstripping all other classes in global aggregate assets under management (US$2.829 trillion as of June

2017; private debt is the closest competitor at US$638 billion) and capital raised (US$453 billion during 2017; the closest competitor is again private debt, with US$107 billion in the same period). [8]

Notwithstanding a record-breaking year in 2017 for private equity fundraising, analysts believe that the battle for capital will remain fiercely competitive in 2018, with a record 2,296 private equity funds in the market as of January 2018 seeking an aggregate US$744 billion in capital, a 26 percent increase in the number of vehicles raising capital, and a 49 percent increase in the amount of capital targeted, over January 2017. Asia is second to the United States in regional density, with over a third of the capital sought (US$266 billion) and seven of the 10 largest funds seeking capital. Europe-focused funds accounted for US$99 billion and the rest of the world (aside from the United States) accounted for US$12 billion. [9] In addition to the competition for capital, deal flow is anticipated to be a major concern for managers in what is shaping up to be a flush market in 2018.

Managers and investors in Europe, Asia, and the Middle East are watching their counterparts in the United States for new developments in investment structures and trends in asset class allocations. One such trend is the longhold private equity fund (closed-end private equity funds with terms of 15–20 years and falling into one of two strategic categories: extended-life buyout vehicles, and low-leverage, low-IRR, cash flow-generating vehicles), which some analysts believe may provide a differentiated sourcing model and return profile attractive to middle-market managers seeking to expand the scope of their portfolios and hold their key sponsors to longer-term, more reliable relationships. Such innovative structuring is less prevalent among managers operating outside the United States than among the largest global managers with operations in the United States (some analysts [10] estimate that approximately US$20 billion has been raised for longhold vehicles by some of the largest private equity managers over the past several years), but foreign managers are monitoring developments. In Asian countries in particular, the longhold structure is compatible with societal attitudes toward investment generally and could potentially see acceptance as a viable private equity strategy. Moreover, in India, there has been an increased focus on buyouts, particularly in the real estate, technology, and financial services sectors, driven in part by the interest of pension and sovereign wealth funds in control transactions.

Overall, apart from the few pockets of uncertainty noted above, the outlook for international private equity is generally one of steady growth, with concomitant expansion in geographic focus and increased innovation in investment vehicles and products.

PRIVATE EQUITY REGULATORY HIGHLIGHTS

By Michael McGrath

In 2017, there was a continued focus on many of the same regulatory issues that have been top-of-mind for private equity managers over the past several years, including performance advertising, cybersecurity oversight, and the disclosure of conflicts of interest to fund investors, particularly with respect to the allocation of expenses.

Frequent Compliance Issues Identified by SEC Staff

As it has done in prior years, the Securities and Exchange Commission's (SEC) Office of Compliance Investigations and Examinations (OCIE) issued several Risk Alerts to highlight the most frequent compliance issues identified in its examinations of investment advisers. In February 2017, OCIE issued a Risk Alert that noted five general compliance topics frequently cited in examination deficiency letters.

Compliance Rule. The use of "off-the-shelf" compliance manuals that do not reflect advisers' individualized business practices was cited by SEC staff as a frequent compliance deficiency, as was the failure to conduct meaningful annual reviews.

Regulatory Filings. The staff noted several common inadequacies in required filings, including inaccuracies and late filings of Form ADV and Form PF.

Custody. The failure by many advisers to identify circumstances where they have "custody" of client assets for purposes of the Custody Rule was an important theme in 2017 (as discussed further below). Specific instances identified by the staff include advisers that have the power to dispose of client funds and advisers that act as general partners of private equity funds and other pooled investment vehicles.

Code of Ethics. The staff noted several common rule violations, including with respect to the identification of access persons, providing for a thorough review of personal trading activities and describing advisers' codes of ethics in Form ADV.

Books and Records. Advisers failed to maintain all records required under the Investment Advisers Act of 1940, committing errors in documentation, including fee schedules and client records, and failed to identify inconsistencies in required records.
Shortly after this Risk Alert was issued, the staff of the SEC's Division of Investment Management issued additional interpretive guidance regarding the Custody Rule, asserting a broad view of client arrangements that can result in investment advisers having "custody" of client assets. Although most private equity sponsors avoid the most onerous aspects of the Custody Rule by providing audited financials to fund limited partners, sponsors that also manage separate accounts and "funds-of-one" should consider whether they have "custody" of client assets in light of the staff's recent guidance and ensure that they are meeting all of their obligations under the Custody Rule.

Learn more about the staff's recent custody guidance here and about OCIE's 2018 examination priorities here.

Compliance Issues Related to Marketing and Advertising Practices

In September 2017, OCIE issued a separate Risk Alert focused exclusively on investment adviser advertising practices. The September alert also identified several frequently cited deficiencies, including:

- Misleading performance results, particularly the use of gross performance in circumstances that may be misleading;
- Misleading claims of compliance with certain voluntary performance standards, in particular, the CFA Institute's Global Investment Performance Standards (GIPS);
- Cherry-picked or otherwise misleading presentations of profitable investment selections;
- Inadequate compliance policies and procedures regarding the presentation of investment performance and other marketing activities; and
- Certain deficiencies identified as a result of OCIE's "touting initiative," including misleading third-party rankings, and the misleading use of professional designations and testimonials.

Investment performance presentation and other potentially misleading marketing practices are an area of perpetual concern for the SEC staff. In addition to the topics cited above, we have observed an increased interest from the examination staff in reviewing and verifying the records that substantiate performance claims in PPMs, presentation books, RFP responses, and other marketing materials. On the heels of several enforcement actions in recent years alleging failures by investment advisers to maintain these records, private equity sponsors may consider reviewing their recordkeeping practices to ensure that they have records to support all performance claims made to third parties. This is particularly important in situations where the sponsor does not capture records of the performance in the normal course of business, such as the presentation of model investment performance, unrealized performance based on third-party or internal valuation, and the performance of investments made at prior firms.

Our attorneys frequently speak on performance advertising and related marketing issues. Review our recent publications and upcoming events here.

Disclosure of Conflicts of Interest Related to Fund Expenses

In December, the SEC entered a settlement order against TPG alleging that the firm failed to provide sufficient disclosure regarding the acceleration of monitoring fees paid by portfolio companies. The settlement order was the latest in a series of recent enforcement proceedings related to inadequate disclosures regarding fee practices and other conflicts of interest to fund investors in the private equity fund context. The order against TPG is noteworthy because it restates the position taken by the SEC in recent actions that a private equity fund manager may not cure disclosure deficiencies that existed at the time a fund is launched through subsequent disclosures to investors or their representatives. According to the SEC, limited partners that did not have notice of a conflict at the time of their investment could not provide informed consent to the conflict. It is possible that after-the-fact ratification by an advisory committee or other limited partner representative would cure the deficiency, but whether this process would fully inoculate private equity fund managers against similar actions would depend on the specific facts and circumstances of the situation.

In light of this and other recent actions, fund sponsors should carefully consider whether their past and present disclosure practices adequately address conflicts related to the receipt of fees or other benefits in connection with its management of portfolio companies, including:

- Portfolio monitoring fees and the acceleration thereof;
- Discounts received by the manager from service providers in return for directing portfolio company business to those service providers, especially where the portfolio companies do not receive the full benefits of those discounts;
- Allocation of broken deal expenses;
- Allocation of expenses, including overhead, among funds, co-investments, the manager, and principal investment activities; and
- Recharacterizing management fees and other sources of revenue to avoid triggering fee offsets and/or "most favored nation" obligations.

Read our client alert for further information regarding the TPG action and conflicts of interest regarding the allocation of fees and expenses.

Cybersecurity

In 2017, the SEC continued to make cybersecurity a top priority. Following several cybersecurity risk alerts issued over the last three years, in August, OCIE issued a Risk Alert discussing its observations from recent cybersecurity examinations. While OCIE noted that investment advisers and broker-dealers had generally enhanced cybersecurity measures over the preceding years, it noted several outstanding concerns regarding cybersecurity preparedness, including that cybersecurity policies and procedures were not reasonably tailored to a firm's activities and that procedures often did not reflect actual practice. In light of this continued attention to cybersecurity matters, private equity sponsors may consider whether their existing cybersecurity policies reflect the following elements that OCIE considered to represent robust controls:

- Maintenance of an inventory of vendors, data, and information, including classifications of the risks, vulnerabilities, data, business consequences, and information regarding each vendor;
- Detailed cybersecurity-related instructions regarding items such as penetration test, security monitoring and system auditing, access rights, and reporting;
- Maintenance of prescriptive schedules and processes for testing data integrity and vulnerabilities;
- Established and enforced controls to access systems and data, including "acceptable use" policies and prompt termination of access for terminated employees;
- Mandatory cybersecurity training for all employees; and
- Involvement by senior management in vetting and approving cybersecurity policies and procedures.

Notably, cybersecurity is also listed as one of OCIE's 2018 exam priorities. For further information regarding the SEC staff's cybersecurity observations and their practical implications, see our client alert.

TAX ISSUES FOR PRIVATE EQUITY

By Adam Tejeda and Frank Dworak

In regard to taxation and private equity funds, 2017 was defined by the Tax Cuts and Jobs Act (the "Act") which was signed on December 22, 2017. While the Act will impact many types of taxpayers, some of the more significant changes are relevant to private equity funds. Fund managers and investors should consider the potential impact of the Act on the fund structures and underlying investments and determine whether any changes to fund investment strategies are warranted in light of the Act.

Fund and Management Company Issues

- Three-year holding period for long-term capital gains treatment for carried interests: The Act imposes a three-year holding period requirement to treat capital gains derived from carried interests as long-term capital gains (prior to the change, the holding period requirement was one year). The new rules apply to profits interests transferred or held in connection with the performance of substantial services in the trade or business of raising or returning capital and investing in, or disposing of, developing securities, commodities, debt instruments, options, derivatives, real estate held for investment, or any interest in a partnership to the extent of the partnership's interest in any of the foregoing assets. Thus, the provision is intended to apply to carried interests issued by private equity and other investment funds. The provision is effective for tax years beginning January 1, 2018. The carried interest provision does not grandfather existing profits interests, such that profits interests issued prior to January 1, 2018, will be subject to the new holding period requirement. If the provision applies, the affected capital gain is treated as a short-term capital gain, which is subject to tax at ordinary income rates.

- Miscellaneous itemized deductions eliminated: Under the Act, effective for tax years after December 31, 2017, and before January 1, 2026, miscellaneous itemized deductions, including investment management fees, will no longer be deductible for individuals, trusts, and estates.
- 20 percent pass-through income deduction: Effective for tax years beginning after December 31, 2017, and before January 1, 2026, the Act provides a new deduction for "qualified business income" (QBI) earned by individuals and certain trusts and estates through partnerships, S corporations, and sole proprietorships. Specifically, the Act permits a deduction of up to 20 percent of such income, thereby potentially reducing the top marginal U.S. federal income tax rate for such income from 37 percent to 29.6 percent. These new rules are somewhat complicated, but it should be stressed that QBI specifically excludes income derived from certain service businesses as well as income derived from investment management, trading, or dealing in securities, unless in the case of a specified service business a taxpayer's taxable income for the taxable year is less than an inflation-adjusted threshold amount (US$315,000 for married filing jointly taxpayers and US$157,500 for single filers, subject to a phase-out for income in excess of the threshold amount of US$100,000 for married filers or US$50,000 for single filers). However, operating income realized through a carried interest may be eligible for the deduction.
- Repatriation of existing offshore earnings: The Act imposes a one-time transition tax on certain foreign earnings through a deemed repatriation of such earnings. Under this provision, any 10 percent U.S. shareholder (by vote) of a foreign corporation as of December 31, 2017, must include in income for taxable year 2017 its proportionate share of the foreign corporation's undistributed earnings if such foreign corporation is a "controlled foreign corporation" [11] (CFC) or is a foreign corporation with at least one 10 percent U.S. corporate shareholder. In the case of a corporate shareholder, earnings held by the foreign corporation in cash or cash equivalents are subject to tax at a rate of 15.5 percent, and earnings invested in noncash assets are subject to tax at a rate of 8 percent. In the case of an individual, the rates of tax are approximately 17.5 percent for cash and cash equivalents and 9.05 percent for noncash assets. U.S. shareholders may elect to pay the tax without interest over an eight-year period. The deemed repatriation provision may result in phantom income for U.S. investors in a U.S. fund that held investments in non-U.S. corporations, as it may not be possible for the fund to compel a cash distribution from the foreign corporation to permit the fund to make a cash distribution to pay the tax. Fund managers should review their holdings in foreign corporations to determine whether the deemed repatriation rules will impact a fund's U.S. investors.
- Limitation on deductibility of state and local taxes: The Act generally limits an individual's ability to deduct state and local taxes to US$10,000 for income, property, and sales taxes through 2025.

Portfolio Company and Investment-Related Issues

- Lower corporate tax rates: Under the Act, the U.S. federal income tax rate of corporations has changed from a progressive rate schedule with a maximum rate of 35 percent to a flat rate of 21 percent. In addition, the corporate alternative minimum tax has been repealed. In general, these changes are effective for a corporation's first taxable year beginning after December 31, 2017.
- Limitation on the deductibility of business interest: Under the Act, for tax years beginning after December 31, 2017, the deduction for business interest will be limited to the sum of (1) business interest income for such year; (2) 30 percent of "adjusted taxable income" for such year (which cannot be less than zero); plus (3) floor plan financing interest for such year. "Adjusted taxable income" essentially refers to EBITDA (that is, earnings before interest, taxes, depreciation, and amortization) for taxable years before January 1, 2022, and EBIT (that is, earnings before interest and taxes) for taxable years beginning January 1, 2022. Business interest that is not deductible under these new rules generally may be carried forward indefinitely, except with respect to partnerships, which are subject to certain special rules. The new limitations on interest deductibility do not apply to a taxpayer whose average annual gross receipts for the three-year period ending with the prior tax year do not exceed US$25 million or to an electing real property trade or business (i.e., any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business).
- Immediate expensing: The Act provides for an immediate expense deduction (in lieu of capitalization and depreciation) for the cost of "qualified property" placed in service by the taxpayer after September 27, 2017, and before January 1, 2023. For this purpose, qualified property generally is tangible property (including computer hardware) with a recovery period of 20 years or less and certain computer software. After December 31, 2022, these new rules begin to phase-out.
- Net operating loss (NOL) limitations: The NOL deduction now is limited to 80 percent of taxable income, calculated without regard to the NOL deduction. In addition, the two-year carryback of NOLs generally has been repealed, but NOLs now may be carried forward indefinitely. These rules are effective for losses and NOLs arising in taxable years beginning after December 31, 2017.
- Gain on the sale of certain partnership interests by non-U.S. persons: Under the Act (consistent with the IRS's longstanding position), if a non-U.S. person disposes of an interest in a partnership engaged in a trade or business in the United States through a permanent establishment or fixed place of business, gain or loss on the disposition of such partnership interest is treated as effectively connected income (and thus subject to U.S. income tax) in proportion to the assets held by the partnership and used in the conduct of such U.S. trade or business. The buyer of an interest in a partnership that is engaged in a U.S. trade or business generally is required to withhold 10 percent of the purchase price of such partnership interest unless the seller provides an affidavit certifying its status as a U.S. person (similar to a FIRPTA certificate). If the buyer fails to withhold, then the partnership will be liable for the withholding. This provision applies to sales, exchanges, and dispositions of a partnership interest on or after November 27, 2017, though the withholding requirements apply only to sales, exchanges, and dispositions of a partnership interest after December 31, 2017.

Certain International Provisions

- Impact on the CFC regime: The Act maintained many of the provisions applicable to CFCs and significantly expanded the regime through the addition of a new class of income labeled "Global Intangible Low-Taxed Income" (GILTI). However, the Act made the following noteworthy revisions with regard to the CFC regime: (1) the Act expanded the definition of U.S. shareholder for purposes of the CFC rules to include a U.S. person that owns (directly, indirectly, or through attribution) 10 percent or more of the vote *or* value of a non-U.S. corporation's stock (prior to the Act, the test was based solely on vote); (2) the Act modified stock attribution rules for purposes of determining whether a non-U.S. corporation is a CFC such that stock owned by a non-U.S. person may be attributed to a U.S. person; and (3) the Act eliminated the requirement that a non-U.S. corporation must be a CFC for 30 days within a taxable year as a prerequisite to realizing Subpart F income (generally including various types of passive income, including dividends, interest, gains from the sale of stock or securities, gains from certain futures transactions in commodities, and foreign-based company sales and services income).
- Participation exemption: In general, the Act provides a U.S. corporate shareholder of a "specified 10 percent owned foreign corporation" with a 100 percent dividends received deduction for the foreign-source portion of the dividends received from such corporation (with the effect of exempting such dividend from U.S. federal income tax). A one-year holding period generally is required to qualify for the participation exemption. The participation exemption generally does not apply to gains realized on the sale of stock of a non-U.S. corporate subsidiary unless such gains are otherwise treated as a dividend under a separate provision of the Internal Revenue Code.
- GILTI: GILTI is a new type of income that may be taxed to U.S. shareholders of a CFC in a manner similar to the taxation of Subpart F income. GILTI generally includes all net operating income (taking into account allocable interest deductions) of a foreign corporation not otherwise taxed to U.S. shareholders in excess of a 10 percent return on the adjusted cost basis of the tangible assets of the company used in the production of such operating income. Any GILTI realized by a CFC is taxed to the U.S. shareholders of that CFC, whether or not the income is actually distributed to such U.S. shareholders. After accounting for a special deduction on GILTI available for U.S. corporate shareholders (excluding S corporations), the effective U.S. federal income tax rate to U.S. corporate shareholders on GILTI is 10.5 percent for taxable years beginning after December 31, 2017, and before January 1, 2026, and 13.125 percent for taxable years beginning after December 31, 2025. In addition, a U.S. corporate shareholder is eligible for an indirect foreign tax credit of 80 percent of the foreign taxes paid with respect to GILTI. On the other hand, any GILTI of an individual is subject to tax at regular income tax rates (a top rate of 40.8 percent in 2018 under the Act after accounting for the additional 3.8 percent tax that may apply to net investment income). Thus, any U.S. individual shareholder that would have realized (directly or indirectly through a pass-through) "qualified dividend income" (taxed at a maximum U.S. federal income tax rate of 23.8 percent after accounting for the additional 3.8 percent tax that may apply to net investment income) will be significantly worse off under the Act to the extent any CFC with respect to which it is a U.S. shareholder earns GILTI, whereas a U.S. corporate shareholder may fare better than under pre-Act rules since such GILTI will be subject to U.S. federal income tax at a rate substantially less than the previous top U.S. federal income tax rate of 35 percent.
- Foreign-derived intangible income: The Act added the foreign-derived intangible income (FDII) regime, which includes a 13.125 percent tax rate (increased to 16.41 percent in 2026) for a domestic corporation's

FDII. FDII generally is income related to services provided and goods sold by a U.S. corporation to foreign customers. The rules related to FDII apply to taxable years beginning after December 31, 2017.

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[1] Figures from Pitchbook 2017 Annual US PE Breakdown.

[2] Figures from Preqin 2018 Global Private Equity and Venture Capital Report.

[3] Figures from Preqin 2018 Global Private Equity and Venture Capital Report.

[4] Figures from Preqin 2018 Global Private Equity and Venture Capital Report.

[5] Figures from Preqin 2018 Global Private Equity and Venture Capital Report.

[6] For a more in-depth look at seeding arrangements, please see the following article available on the K&L Gates Hub: http://www.klgateshub.com/files/Publication/ea36247a-1733-497d-8811-dcc534177140/Presentation/PublicationAttachment/e6b23ab5-740f-4097-8167-dd2723156772/Seeding_Arrangements_Structure_Approach_and_the_Current%20Market.pdf.

[7] Figures from PWC and Venture Intelligence.

[8] Figures from Preqin 2018 Global Private Equity and Venture Capital Report.

[9] Figures from Preqin 2018 Global Private Equity and Venture Capital Report.

[10] Credit Suisse Private Fund Group.

[11] For purposes of the deemed repatriation rule, a CFC generally is a non-U.S. corporation more than 50 percent of the stock of which is owned by U.S. shareholders holding at least 10 percent of the CFC's voting stock.

KEY CONTACTS

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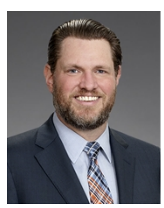

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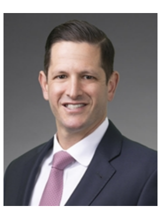

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