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Jobs and Growth Tax Relief Reconciliation Act of 2003 – Effect on Private Equity

Recent tax legislation may have important implications for the private equity industry. This memorandum touches on some of the more significant issues.

On May 23, 2003, the House and Senate each passed the Jobs and Growth Tax Relief Reconciliation Act of 2003 (the "Act"). The President is expected to sign the bill very shortly. As has been widely reported, the centerpieces of the bill are acceleration of the scheduled reductions in individual income tax rates (the top rate from 2003 forward will be 35%), and lowering of the tax rates for individuals on most dividends and long-term capital gains to 15%. The taxation of short-term capital gains and interest remains unchanged. The dividend and general rate changes are generally effective January 1, 2003; the capital gain change is effective for asset dispositions on or after May 6, 2003.[1]

In addition to reducing the individual tax burdens of most private equity industry participants, the Act changes some of the important tax principles that have guided many private equity deal structures. At the end of the day, however, the changes are changes of degree only; most of the tax issues that existed prior to the passage of the Act are still present, but with changed relative importance.

The dividend rules in the Act are substantially simpler than had been proposed by the Bush administration. There is no requirement that the dividend-paying corporation actually pay any corporate tax, and the new rules will apply to almost all dividends paid by U.S. corporations.[2] In

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[1] All of these provisions have "sunset dates" (2009 for dividend and capital gain changes, 2011 for rates generally). It is not possible to predict whether these will be extended (but, then, it has always been impossible to predict what the tax law will be five years in the future).

[2] Special rules apply for dividends from mutual funds and real estate investment trusts, and there are also certain exceptions for certain other dividends that are deductible to the paying corporation and rules coordinating the special dividend rate with investment interest deductions and foreign tax credit limitations. There are also limited anti-abuse provisions relating to holding periods (rules similar (but not identical) to those which now exist for the dividends received deduction)

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addition, the legislation extends dividend relief to dividends paid by certain foreign corporations, including foreign corporations eligible for benefits under most (but not all) comprehensive U.S. income tax treaties,[3] and certain other foreign corporations whose stock is publicly traded on U.S. markets.[4] Significantly, however, the bill provides no relief at all for foreign recipients of U.S.-source dividends.

The elimination of the rate difference between dividends and capital gains for individuals reduces, but does not eliminate, the importance of certain structuring issues that have been important to private equity investments. For example, in the past it has been considered quite important to avoid "phantom" dividend income on preferred stock investments, because that income would be taxed at a higher dividend rate, before the receipt of cash and without recovery of tax basis of the investment. The first issue (rate difference) has been eliminated for U.S. individual investors, but the second and third remain. For foreign investors, nothing has changed—looking solely at U.S. taxes, dividends are generally disadvantageous,[5] particularly in light of the total exemption from U.S. tax for most capital gains. Thus, phantom dividend income will still be undesirable for many investors (although less so) and the same structures that have been used in the past to avoid it will remain relevant.

Similarly, it has traditionally been complex to extract cash in a tax-efficient manner from an investment prior to exit. Now an interim dividend will be taxed to individual investors at the same rate as capital gains (15%); however, again, there will be no recovery of any portion of the taxpayer's basis until an actual sale of all or a portion of the investment, and foreign investors will still be disadvantaged by a dividend approach. In some situations (e.g. expected significant gain on the investment, few foreign investors), a simple dividend may now be a tax-efficient and straightforward solution, but in other situations, investors may still wish to resort to more complex structures to seek capital gains treatment.

Another structuring issue affected by the Act is the use of foreign corporations. A number of transactions, have, in the past, used foreign corporations as "blockers" for certain tax issues. Frequently, tax-haven "blocker" entities have been used. Under the new bill, however, it may make more sense to use foreign corporations eligible for the benefits of a tax treaty, because this will permit

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and extraordinary dividends, and dividends taken into account in computing the amount of deductible investment interest.

[3] It appears that at a minimum, the Barbados treaty will not provide this benefit.

[4] This relief applies only to dividends paid on stock of a class that is so publicly traded and does not apply if the Issuer is a passive foreign investment company, foreign personal holding company or foreign investment company, as defined in the Internal Revenue Code.

[5] In some cases, dividends may be acceptable to foreign investors despite U.S. withholding tax because of favorable country tax treatment.

repatriation from those corporations through tax-advantaged dividends. A number of European countries with tax treaties have very favorable holding company regimes that will make these structures relatively inexpensive. Note, however, that many U.S. tax treaties have strict eligibility requirements.

The lowering of individual rates has other effects. For example, now that individual and corporate rates are the same, operating LLC or partnership structures will no longer need to fund tax distributions at individual rates that are higher than the operating entity would have paid as a corporation. On the other hand, the relative advantage of these structures (avoiding double tax) has been reduced now that the rate of the second level of tax for some holders has been reduced.

The changes may also have some effect on fund terms and offering materials if the amount of dividend flows generally, and dividend flows in the private equity world in particular, increase. This increase may become a concern for foreign investors, to whom dividends will continue to be disadvantageous from at least a U.S. tax perspective, and such investors might possibly seek protection in fund agreements against excessive dividend income, much as they currently seek protection from "ECI." General partners can be expected to resist this request; the outcome in the market is hard to predict. At a minimum, funds should seek to avoid making what they, in the past, have considered to be throwaway statements to the effect that they do not expect significant dividend income.

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