To: **Small Business/Pass-Through Tax Reform Working Group**
From: **Small Business Investor Alliance**
Date: **April 12, 2013**

On behalf of the Small Business Investor Alliance (SBIA), we appreciate the opportunity to provide comments on the *small business tax discussion draft* released by the Ways and Means Committee on March 14, 2013. SBIA is the premier association representing lower middle market private equity funds. Our members provide vital capital to small and medium sized businesses nationwide, resulting in economic growth and job creation.

The small business tax reform discussion draft makes significant changes to S corporation and partnership taxation. The comments by the SBIA focus on the partnership taxation changes because the most common tax structure for small private equity funds is a limited partnership. The ability to pool capital for investment via partnerships allows inactive capital to be actively invested in growing companies.

The partnership structure provides flexibility to private equity funds for allocating and distributing income and property to the partners. This flexibility is not intended to allow partners to avoid taxes. Rather, this flexibility is intended to promote healthy economic behavior within the partnership structure and it is essential to making capital available to small businesses in an efficient and cost effective way. Placing limits on how a partnership can function may distort markets and reduce the capital that is available for small businesses.

SBIA makes comments regarding four areas of the discussion draft: 1) mandatory entity-level withholding; 2) mandatory adjustment of partnership's basis in partnership property whenever there is an in-kind distribution or a partner transfers its interest; 3) partnership allocation rules; and 4) changes to the partnership tax filing date.

Mandatory entity-level withholding. The small business tax discussion draft proposes tax withholding on partnerships on their distributive share of pass-through income. This proposal would add a significant new administrative burden for private equity partnerships, which would be particularly onerous to small funds, the funds most likely to be investing in small businesses.

The proposal may be inoperable for certain private equity funds that have strict rules governing distributions in the partnership.

Under current law, partnerships are not required to withhold taxes because taxable income flows through to the partners of the partnership. Partnerships report their income to the IRS at the partnership level on Schedule K-1 (Form 1065). Schedule K-1 is used to report the allocations of income, loss, and gain that are passed through to each partner that has an interest in the partnership. This system allows for the partners, not the partnership, to be subject to taxable income.

The current information reporting system allows the IRS to make a determination of the payment standing of a taxpayer. The IRS can match the data provided on Schedule K-1s with the individual tax returns to make sure a taxpayer is not underreporting their taxes. This is a very effective way for the IRS to make sure taxpayers are not underreporting. As long as the IRS matches the Schedule K-1 data with the individual tax return data, the IRS has all it needs to ensure that partners are paying taxes on income from partnerships.

According to the Ways and Means Committee, the purpose of the entity level withholding is to close the federal tax gap, which is the difference between taxes owed but not paid to the IRS. Withholding procedures have proven in some cases to be an effective mechanism to bring in tax revenue because as long as an income transaction between two parties is periodic and estimable, it sets up a reliable collection process for the IRS. For example, employers are required to withhold taxes for their employees each pay period. This system works because the flow of income from the employer to the employee is generally straight forward and the tax liability of the employee is easier to estimate.

We do not believe the partnership withholding proposal is workable for private equity partnerships. The fluctuations of investment income, gain, and loss, as well as the complexities of the makeup of a limited partnership make this proposal highly complex. Unlike an income transaction between an employer and employee where estimated income is highly predictable, the income into a private equity fund changes based on the life of the fund and success of the investments. From an investor perspective, the investor may well have offsetting losses which would result in the taxpayer not owing any taxes. This would put the taxpayer in a position of having to file for a refund for taxes unnecessarily withheld.

The entity-level withholding proposal is most likely inoperable for a private equity fund organized as a Small Business Investment Company (SBIC). SBICs are highly regulated, specialized private equity companies that are licensed and regulated by the U.S. Small Business Administration (SBA). Requiring an SBIC to withhold at the partnership entity level would put SBICs in a position of potentially violating the rules promulgated by the SBA under which the SBIC must operate.

SBICs are subject to special rules with respect to distributions. Distributions of profits can only be made by SBICs drawing leverage (government funds) if the SBIC has Retained Earnings Available for Distribution ("READ"). READ is defined as net realized cumulative retained earnings, that is cumulative earnings after all expenses and realized and unrealized depreciation of investments have been deducted. An SBIC may have gains that are taxable but may not have READ, in which case the SBIC would be prohibited from making a distribution under the regulations under which the SBA operates. The SBA could not make a payment of the withheld amounts to the IRS without violating SBA regulations, as the payment by the SBIC would be treated as a distribution by the SBA.

This violation of SBA regulations could result in draconian penalties, including the acceleration of all outstanding Leverage, the loss of the SBIC's license to operate, the removal of its general partner or the SBIC being put into receivership. In addition, an SBIC is restricted in the amount of capital it may return to investors. This amount is 2% of Regulatory Capital (essentially private capital from investors) in any year. As a consequence, the SBIC may have insufficient funds to pay required tax withholding to the IRS without again violating the SBA regulations.

An additional serious concern for both SBICs and other lower middle market private equity funds is the treatment of tax exempt investors with respect to any withholding requirements. If no withholding is required for such investors, the issue of UBTI remains. It is untenable to require a private equity fund to deal with the tax obligations of its investors. By way of example, assume the investor is a state pension fund and the investment fund has UBTI generated by the private equity fund's investment in a limited liability company. State pension funds generally take the position that they are exempt from UBTI. We do not believe that the IRS has ever taken a position on this issue.

Entity level withholding is also a serious problem to a private equity fund if a portfolio company is formed as a pass-through such as an LLC. Accounting complications could arise when a portfolio company is required to withhold from a distribution it might otherwise make to the private equity fund. The problem is the investment funds are in turn pass-through entities. Consequently, how much should be withheld by the portfolio company? What if the investment funds have offsetting losses for the taxable gains of the portfolio company? These are real issues that would need to be addressed, and as a result would be costly to the entity withholding the taxes.

<u>Recommendation to the Ways and Means Committee:</u> We recommend removing the entity level withholding proposal from the small business tax return draft. We stand ready to work with the Ways and Means Committee and the IRS to review the current Schedule K-1 (Form 1065) to identify any adjustments to the form that will help to improve tax reporting by the partnership and the tax preparer.

In relation to the question on page 7 of the discussion draft fact sheet, “in light of the entity level withholding proposed in Option 2, should the IRS be permitted to audit and assess tax liability at the entity level”, we do not believe the IRS should be permitted to audit at the partnership level. The IRS already has the ability to audit individual partners of a partnership. During the potential audit of a partner, the IRS can view partnership information such as that detailed on Schedule K-1 (Form 1065).

Mandatory adjustment of basis in partnership property whenever there is an in-kind distribution or a partner transfers its interest. The proposal to require adjustment of basis for transfers of partnership interests and in-kind distributions would be burdensome and add material operational costs to private equity funds, again with proportionately greater burden on small funds.

As a consequence of the number of investors, the type of investors and the terms, it is common in private equity funds for investors to transfer their interests within the partnership. Under the discussion draft proposal, a private equity fund would be required to make a basis adjustment at the time of each transfer. This requires the partnership to maintain additional books and records, resulting in added costs and time demands on management. Private equity funds generally do not make these adjustments (referred to as the 754 election) because of the burdens involved.

The proposal would make it mandatory for the private equity fund to value their whole portfolio at the time of each transfer. Normally, valuations only occur during the buying and selling of portfolio companies. While the value changes during the fund’s ownership of a portfolio company, the private equity fund should not be required to value their portfolio company’s or assets unless it is buying or selling certain assets. The buying and selling of an asset is a taxable moment for the private equity company because the gain or loss on the asset is needed to figure out the taxable income of the partnership.

Tracking the basis of the assets of a private equity fund is expensive and often requires the professional services of a third party valuation company or tax attorney. Because owners can transfer their interests at different points of a life cycle of a partnership, it would become very expensive if a private equity fund had to value their entire portfolio every time an owner transfers interest in the fund. The process of valuing a company requires the portfolio company to produce financial documents and revenue predictions, and these are usually private companies – not publically traded companies with active stock prices on the open stock exchanges.

It is also worth noting that transfers of interests are private transactions, with the transferee receiving the capital account of the transferor. As a private transfer, the fund should not be asked to make a basis adjustment and be required to maintain these separate tax and bookkeeping accounts. While the number of in-kind distributions made by private equity funds varies depending on the fund and its partners, an adjustment in basis would be an added cost to the fund and could consequently discourage such distributions.

Some funds have more transfers than others. As 12-year plus partnerships, transfers arise by reason of death, change in investment policies, financial conditions of the holder (often adverse), changes in investment philosophy, changes in allocation of funds among competing types of investments, family transfers, transfers to affiliates, etc. During the life cycle of a fund, the transfers can add up and if the fund is required to adjust basis every time a transfer occurs, the costs will be prohibitive.

<u>Recommendation</u>: SBIA recommends keeping the 754 election for adjustment of basis optional. In order to track the transfers, in-kind contributions, and other transactions, partnerships should keep these records during the life of the fund. Should any transfers or new contributions occur, it is the responsibility of the partnership to keep these records and notify any other partners of these occurrences.

Partnership Allocation Rules. The small business discussion draft places a restriction on the ability to provide different distributive shares of pass-through items within a particular category to the same owner.

In some circumstances, investors in a private equity partnership may have different investment shares across the portfolio of investments or business divisions. This flexibility is one of the traditional benefits of a partnership. It is an economic arrangement that allows the partners of the partnership to make different levels of contributions to different portfolio companies and to take on different levels of risk within the portfolio companies.

Partnerships rely on the substantial economic effect test for guidance on allocation rules and the IRS relies on this test to prevent tax sheltering. The fundamental principal underlying the concept of economic effect in the regulations is as follows:

> "In order for an allocation to have economic effect, it must be consistent with the underlying economic arrangement of the partners. This means that in the event there is an economic benefit or economic burden that corresponds to an allocation, the partner to whom the allocation is made must receive such economic benefit or economic burden."[1]

A partnership must pass one of three tests to meet the economic effect for allocation of income, loss or deduction for tax purposes. For example, the basic test for economic effect outlines three requirements: 1) capital account requirement; 2) liquidation requirement; and 3) deficit makeup

[1] Section 1.704-1(b)(2)(ii)(a).

requirement. If all three requirements are met, the IRS can be assured the partnership's allocations are consistent with the economic benefits and burdens corresponding to these items. Private equity partnerships also rely on the *shifting tax consequences*[2] guidance that determines, more subjectively, if an allocation has substantiality. As a result of the substantiality test and the economic effect test, the IRS has the ability to determine if there is a tax scheme that should be reeled in.

In some circumstances, it may be necessary for the partnership to allocate income, loss, or deductions for certain purposes. The proposal to limit partnership allocations could be a problem if a limited partner invests in a private equity fund, but is prevented by law from making investments in certain industries. In this case, the private equity may still want to make an investment in those prohibited areas, but would need to allocate the income to other partners that are tied to that investment. Private equity partners come and go at different times, and some partners may want a reduced or expanded interest in any of the portfolio companies during the life of the fund.

<u>Recommendation:</u> We recommend keeping the substantial economic test in place to allow private equity funds to make allocations in most circumstances. These rules have been historically recognized by both the industry and the IRS and in most cases they have economic merit. With that said, there may be areas that the law should be tightened, such as deferrals, in order to crack down on the areas where most tax schemes take place. The IRS should focus on areas where tax dodging is most rampant and continue to enforce the law to make sure tax schemes do not take place in other uncommon areas.

Require the partnership tax return to be filed on or before the 15th day of the third month following the close of the taxpayers fiscal year. The small business tax return discussion draft proposes a new tax return due date for partnerships. The provision moves back the original filing date of federal income tax returns of partnerships. The filing date would be on or before the 15th day of the third month following the close of the taxpayer's taxable year, or March 15 in the case of a calendar year taxpayer.

Generally private equity partnerships invest in corporations which would under the proposal be required to file their returns a month later. This lag in time between a partnership filing date and the portfolio company (filing as a C Corp) filing date could lead to errors because a private equity fund would not have in hand the portfolio company information necessary for it to file a complete and accurate return.   Thus, it may be necessary to have to file for an extension or provide its investors corrected K-1s. Consequently, having a month separation in the filing dates of partnerships and corporations creates a hardship and additional costs.

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[2] Section 1.704-1(b)(2)(iii)(b).

Recommendation: We recommend keeping the filing date the same for partnerships and their portfolio companies to prevent errors in tax administration and unnecessary costs in paying for tax filing extensions.

We appreciate your commitment to tax reform during the 113th Congress, and look forward to working with you to draft smart tax policy that prioritizes job creation and small business investment. Please contact us at any time to discuss this comment letter in more detail. Thank you again for allowing an open process to hear from the public on tax reform.

Please contact Chris Walters at cwalters@sbia.org or (202) 628-5055 to set up a time to discuss any of the issues presented in this document.

Sincerely,

Brett Palmer
President
Small Business Investor Alliance