



Frequently Asked Questions
The Enterprise Value Tax and New Jersey

What is an “Enterprise Value Tax”?

Any individual, partnership or corporation in the U.S. that creates a business and develops a sustainable customer list and an identifiable brand will have created goodwill or enterprise value. When that person sells the business, any gain attributable to the enterprise value of the business is taxable at capital gain rates. If the business is operated in a partnership or a corporation, gain from the sale of the partnership interest or the stock will also be taxed at capital gain rates to the extent attributable to goodwill value.

An “enterprise value tax” is a proposal to increase the federal tax on the sale of any business structured as a partnership. The tax would increase from the standard capital gains rate of 15% to the regular income tax rate, reaching as high as 35%.

What types of businesses and taxpayers would be affected?

Under the bill, there are two known triggers that we can identify now. It is written so broadly that other businesses and taxpayers could be ensnared in this. However, the impacted parties include anyone structured as conducting business with any of these facets (below). All forms of partnership business will be impacted: general partnership, limited partnership, or limited liability partnership (LLP).

- 1) Owners of an investment services partnership (“ISP”) which refers to partners doing any of the following:
 - a) Advising as to the advisability of investing in, purchasing, or selling any specified asset;
 - b) Managing, acquiring, or disposing of any specified asset;
 - c) Arranging financing with respect to acquired specified assets; or
 - d) Any activity in support of any service described in subparagraphs (A) through (C).

- 2) Partnerships with ownership of “specified assets” which are defined as:
 - a) Corporate stock;
 - b) Interests in partnerships;
 - c) Debt instruments;
 - d) Notional principal contracts;
 - e) Real estate held for rental or investment;
 - f) Commodities; or
 - g) Options or derivative contracts of assets in 1) through 6)

Who is proposing the Enterprise Value Tax and why?

There have been two failed EVT proposals to date:

1. H.R. 4213, the “American Jobs and Closing Tax Loopholes Act of 2010” passed the House but failed to move in the Senate. <http://thomas.loc.gov/cgi-bin/query/z?c111:H.R.4213>:
2. The President’s Economic Growth and Deficit Reduction proposal to the Joint Select Committee on Deficit Reduction p. 48
<http://www.whitehouse.gov/sites/default/files/omb/budget/fy2012/assets/jointcommitteereport.pdf>

Proposals to tax carried interest became popular a few years ago in response to growing resentment toward Wall Street and the need to reduce the burgeoning federal deficit. Proponents of the EVT claim that it closes a loophole in the tax code. In actuality, an EVT represents fundamental change in the tax laws that does not comport with long-established precedent.

There is absolutely no policy reason to distinguish between the enterprise value and goodwill created by investment managers from that created by businesses in other industries.

The valuation of goodwill for an ISP is no different than in the sale of any business which has multiple assets – one always needs to do a valuation of assets, such as inventory, property, plant and equipment, etc. Section 1060 of the Code provides the guidance to do so and, generally speaking, goodwill is simply the excess of the total purchase price over the value allocable to the identified assets. Also, the analogy to employee stock options is misguided. Entrepreneurs who build businesses from the ground up are not receiving the equivalent of employee stock options when the business is formed. In a sale, such entrepreneurs are selling the business that they have spent years building, taking risk to rent or build space, hire a work force, develop technologies, and incur other expenses. A stock option, by contrast, represents only upside and is granted by an employer, who receives a deduction when the option is exercised (which offsets the tax on the income the employee recognizes).

Fixing this will have far less revenue impact than suggested. Protections can be established to ensure that the partnership’s value attributable to carried interest is taxed at the new rate.

The argument that this problem cannot be fixed without “gutting” the new rules governing the taxation of carried profits interests is misleading. Goodwill can accurately be valued separately from carried interests and other assets. The relevant partnerships are typically subject to requirements that their assets are reported to investors at fair market value, and audited financial statements are produced in accordance with GAAP (which also requires FMV reporting)¹.

Also, persons who acquire an interest in an ISP have a compelling incentive to allocate more of their purchase price to carried interest than to goodwill value. An acquirer’s tax basis in an ISP attributable to underlying carried interest would typically be recovered within a much shorter

¹ For ISP’s that are registered with the SEC as investment advisers, the SEC rules require accurate valuations and investor reporting, and the SEC exercises oversight of the ISP’s valuation policies during routine audits.

period of 5 years or less (i.e., the acquirer's basis is recovered tax-free when the ISP's underlying portfolio investments are sold)². Acquirers of an interest in an ISP generally can only amortize and deduct goodwill value over 15 years.

How many businesses in New Jersey could be subject to the tax and how much will it cost them?

A large portion of New Jersey's small businesses are structured as partnerships, 172,000 in 2012. Partnerships are an important segment of America's economic and business landscape. According to business data from the United States Internal Revenue Service (IRS), in 2009 there were 3.169 million partnerships consisting of 21.1 million partners with \$18.8 trillion in assets and nearly \$9.7 trillion of equity.³ By 2012, the IRS estimates the number of partnerships will swell to 4 million, of which 171,900 will be owned by New Jersey residents.⁴

Are there certain industries that would be hit harder than others?

Professional services firms are most commonly structured as partnerships so accounting, legal, and financial services will be the hardest hit.

Could this affect New Jersey's tax collections or state tax policy?

The EVT is a new tax that will affect millions of businesses in the United States. To the extent that any new taxes, especially in this fragile economy, will create headwinds to new economic growth, New Jersey can expect related headwinds in tax collections.

Also, the EVT is a potential tax compliance headache depending on whether or not New Jersey policymakers decide to "import" the EVT down to the state-level by conforming to the federal tax law changes. In order to avoid an EVT-related tax hike at the state-level, policymakers may choose not to conform to the EVT. However, this means businesses will have to keep two sets of books—one for Uncle Sam and another for the state—which means higher tax compliance costs.

When might Congress vote on an EVT?

The EVT has come up two times in the last two years. The EVT was passed in the House of Representative as part of the "H.R. 4213: American Jobs and Closing Tax Loopholes Act of 2010", but the bill did not proceed to the Senate. The tax was again proposed by the Obama Administration in the 2012 America's Job Act in order for it to be considered by the now defunct Joint Select Committee on Deficit Reduction. Analysts anticipate the provision coming up again in this spring's Tax Reform debate. If it is included in Tax Reform bills proposed by the House, we can anticipate a vote by May 2012.

² *When a partnership interest is sold, an election is typically made to "step up" the acquirer's share of the basis of the partnership's assets to fair market value.*

³ U.S. Internal Revenue Service (IRS) business data and economic characteristics of partnerships can be found here: <http://www.irs.gov/taxstats/bustaxstats/article/0,,id=97127,00.html>

⁴ IRS projections for partnership filings can be found here: <http://www.irs.gov/pub/irs-soi/d6149.pdf>