Tax Reform Considerations for Private Equity

Janice Kong, Director | DHG Private Equity

The sweeping tax reform legislation, commonly referred to as the Tax Cuts and Jobs Act (the Act), P.L. 115-97 was signed into law on December 22, 2017. At DHG, we recognize that the new tax landscape may present more questions than answers and a feeling of uncertainty. That is why we have prepared this article which provides a high-level summary of the Act's key provisions affecting the private equity community.

Three-Year Holding Period for Carried Interest

With respect to dispositions of carried interest or "applicable partnership interest," the Act imposes a three-year holding period to be eligible for long-term capital gain tax rates. Prior to provision implementation, the holding period was one year for long-term capital gain treatment. Dispositions of applicable partnership interest which fail the three-year holding period, will be taxed at the short-term capital gains rate.

An applicable partnership interest is a partnership interest held by a U.S. taxpayer in connection with the performance of substantial services in a trade or business. In general, an applicable trade or business is the activity of raising or returning capital, and either investing in or developing securities, commodities, real estate held for rental or investment, cash, options, or derivative contracts.

Application to Private Equity

The new three-year holding period, related to carried interest provision, will broadly apply to most private equity groups. However, because private equity funds generally hold investments for longer than three-years, it is expected the new provision will result in a minimal impact.

An exception in the Act provides that an applicable partnership interest does not include an interest in a partnership held directly or indirectly by a corporation. Accordingly, carried interest held by corporations are not subject to the three-year holding period to be eligible for the long-term capital gains treatment. On March 1, 2018, the Internal Revenue Service (IRS) announced, in Notice 2018-18, that it will issue regulations stating that carried interests held by S corporations will not qualify for the exception from the Act's carried interest provision for interests held by corporations. Accordingly, S corporations are subject to the new extended three-year holding period applicable to carried interests.

Interest Expense Deduction

Under the new Internal Revenue Code (IRC) section 163(j), the deduction of net business interest expense is limited to 30 percent of a business' adjusted taxable income (ATI). The limitation applies to interest expense properly allocable to a trade or business. For tax years 2018 through 2021, ATI is generally calculated using tax earnings before interest, taxes, depreciation and amortization (an EBITDA based calculation).

For tax years beginning after 2021, depreciation and amortization are not added back to determine ATI (an EBIT based calculation).

For partnerships and S corporations, the limitation applies at the entity level and there is no provision for grandfathering the deductibility of existing debt. In addition, rules limit the netting of income and expense between related partnerships and S corporations.

Disallowed interest may be carried forward indefinitely. Taxpayers with average gross receipts for the previous three taxable years of less than $25 million are exempt from the limitation. Real estate trades or businesses can elect to not apply the interest expense limitation, which requires the use of slower depreciation of property.

Application to Private Equity

According to the Congressional Joint Committee on Taxation's Estimated Budget Effects of the Conference Agreement for H.R 1 (dated December 18, 2017), the limitation of the net interest deduction is expected to raise $253 billion of taxes over the next 10 years.

Private equity funds utilizing debt to leverage their acquisitions may experience a significant increase in the cost of financing. Accordingly, it is recommended that alternative transaction structures, such as leasing, convertible debt instruments and preferred debt financing be considered.

Deduction for Qualified Business Income of Pass-Through Entities

For taxable years beginning after December 31, 2017, the Act provides an individual taxpayer with a 20 percent deduction for Qualified Business Income (QBI).

The deduction is calculated as the lesser of

(1) 20 percent of the taxpayer's taxable income less net capital gains, or the sum of:

(2) The lesser of:

a) 20 percent of such QBI, **or**

b) The greater of:

i) 50 percent of the W-2 wages with respect to the qualified business, **or**

ii) 25 percent of the W-2 wages with respect to the qualified business, plus 2.5 percent of the unadjusted basis immediately after the acquisition of qualified property

Plus:

c) 20 percent of qualified real estate investment trust (REIT) dividends, **and**

d) Qualified publicly traded partnership income

Plus:

e) the lesser of:

i) 20 percent of qualified cooperative dividends, **or**

ii) Taxable income reduced by net capital gain

QBI is defined as income or loss from any qualified trade of the taxpayer during the year. QBI must be effectively connected with the conduct of a trade or business within the United States. Foreign-source income, generally, will not qualify for the deduction. In general, QBI does not include nonbusiness interest, dividends, capital gains or losses.

The term “qualified trade or business” does not include specified trade or business activities which entails the performance of (i) certain professional services (i.e., health, legal, consulting, or any trade or business where the principal asset is the reputation or skill of one or more of its owners), (ii) investing and investment management, or (iii) trading or dealing in securities, partnership interests or commodities.

The 50 percent of W-2 wages limitation does not apply in the case of a taxpayer with income of less than $157,500 for individuals, or less than $315,000 for married individuals filing jointly.

This deduction is temporary and is subject to sunset on December 31, 2025.

Application to Private Equity

In general, the 20 percent deduction for QBI from pass-through entities, combined with the top ordinary income tax rate of 37 percent, will result in a net effective tax rate of a 29.6 percent. Accordingly, it is expected that taxpayers will reconsider the choice of entity (C corporation versus pass-through) for their businesses. When determining the choice of entity, private equity should consider various factors, such as the need for a blocker corporation, W-2 wage limitation, Medicare, self-employment taxes, and the business exit plan.

Expensing for Certain Qualified Property

The Act expands the first-year bonus deduction and temporarily provides for a 100 percent expensing for certain qualified property placed in service between September 27, 2017 and December 31, 2022. After December 31, 2022, the allowable deductions are as follows:

- 80 percent for property placed in service during 2023.
- 60 percent for property placed in service during 2024.
- 40 percent for property placed in service during 2025.
- 20 percent for property placed in service during 2026.

Furthermore, the Act modifies the definition of property eligible for bonus depreciation (qualified property). Pre-owned property is now eligible for bonus depreciation under the Act, as long as the taxpayer has not previously used the property, and did not acquire it from a related party. In addition, the Act eliminates the qualified leasehold improvement, qualified restaurant, and qualified retail improvement property asset types, and the associated 15-year depreciation period. Instead, the Act introduces a broad-encompassing asset type called “qualified improvement property,” which generally includes certain improvements made to the interior of a nonresidential building after the year in which the building was originally placed in service. Starting in 2017, qualified improvement property assets are not eligible for bonus depreciation, and are depreciable over 39 years.

Application to Private Equity

The immediate expensing provisions, under the new law, will have a significant impact on mergers and acquisitions. Buyers will be highly motivated to pursue asset sales and IRC section 338/336(e) transactions. This may provide sellers more leverage in negotiating a lower sales price for taxable asset transactions.

Taxpayers who take advantage of the accelerated bonus deduction under the Act, should note that in certain transactions, sellers may experience higher taxes resulting from ordinary gain related to “hot assets” and recapture of depreciation deductions.

Corporations

Reduction in Corporate Tax Rate: Under prior law, corporations paid tax at graduated rates, with taxable income over $335,000 taxed at 34 to 35 percent. The Act removes the graduated tax rate in favor of a flat 21 percent, effective after December 31, 2017.

Alternative Minimum Tax (AMT): Additionally, the corporate AMT is repealed. For tax years beginning after 2017 and before 2022, a prior AMT credit is refundable in an amount equal to 50 percent, and AMT credit carryforward becomes a refundable credit. Refundable AMT credits may be subject to sequester spending reductions.

Net Operating Loss (NOL): A corporation's NOL deduction, created in 2018 and in subsequent years, is limited to 80 percent of taxable income. Corporations will not be able to carryback NOLs and will be able to indefinitely carryforward unutilized NOLs. NOLs generated in tax years prior to 2018 are not subject to the new legislation.

Application to Private Equity

The decrease in the corporate income tax rate will result in permanent cash tax savings to the extent taxable income may be deferred to years after 2017. Private equity should consider implementing tax accounting method changes for the last available tax year, to which the pre-Act corporate tax rates apply. Automatic method changes may be filed until the due date of the 2017 tax return (including extensions).

Disposition of Partnership Interest by Foreign Partner

Gains realized by a foreign partner, from the sale or exchange of a partnership interest that is engaged in a trade or business within the U.S., is deemed to be treated as effectively connected income (ECI) and subject to U.S. income tax. The purchaser or transferee must withhold 10 percent of the amount realized on the disposition of the partnership interest, unless the foreign partner can certify that it is exempt from withholding.

The tax applies to dispositions occurring on or after November 27, 2017. The withholding requirement applies to sales or exchanges occurring after December 31, 2017.

Application to Private Equity

The additional taxes imposed on foreign partners may potentially decrease foreign investments. Furthermore, there will be an increased compliance burden to private equity, with respect to withholding and reporting of foreign investors.

It is recommended that private equity managers consider the impact of the Act on their foreign investors and reevaluate fund structures such as blocker corporations and off-shoring.

Janice Kong
Director, DHG Private Equity
703.970.0418
janice.kong@dhgllp.com