Impact of U.S. Tax Reform on PE

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- An insider look at the new tax reform bill and its impact on alternative investments
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Two seasoned tax experts from RSM decode the new tax reform bill and what it means for private equity firms, funds, partners and portfolio companies

Privcap: Why do you think it’s important for people to understand carried interest in the context of PE?

Nick Gruidl, RSM US LLP: Well, because there’s good and bad news. The good is that we now have a statutory definition of carried interest. The bad is that there’s now a three-year holding period to get that carried interest considered as a long-term capital gain. This applies at both the partner level, but also with respect to allocation of gains to the carry based on sales of investments. In other words, if a fund holds an interest for less than three years and recognizes a gain, that will be treated now as short-term gain or at the same rate as ordinary income. If someone had a capital loss in the same year, which generally is tougher to utilize, you could utilize it against that carry.

How are GPs going to appropriately allocate income, i.e., clawbacks or waterfalls? And how fixed is that carry once it’s earned on an investment?

Tommy Wright, RSM US LLP: If you continue to hold investments through flow-through entities and you’re granting management in the company, a CFO, a COO, a profits interest in a flow-through portfolio company, that will continue to be treated under the old rules as a profits interest—as opposed to, under these new rules, as a carry. The carry relates to people who are involved in the raising and returning of capital and investing and disposing of portfolio companies, exactly what private equity does. That’s a carry, as opposed to your traditional profits interest.

It may seem onerous to go from a one-year hold to a three-year hold, but when you compare it with what could’ve happened with a total repeal of carried interest, it’s actually not that bad of a provision.

What are the most important things that we need to know about pass-through deduction and corporate provisions?

Gruidl: You can only utilize net operating losses (NOLs) going forward, not in the past, and only up to 80 percent for any post-’17 NOLs, only 80 percent of taxable income.

The other significant corporate provision is a move to a territorial-type system. If you’re a portfolio company and there are controlled foreign corporations within your portfolio, those will be subject to a one-time repatriation fee. That repatriation fee will be taxed at either a 15.5 percent or 8 percent tax, depending on what you’ve done with those earnings. Do you sit on them in cash, or are they invested overseas in property? That repatriation doesn’t matter, whether you take the cash back or not. That’s a significant tax.

The positive news going forward is that any earnings of a C-corp that owns foreign operations through foreign corporations, those earnings will be free of corporate tax.
going. You can make the money overseas, repatriate it to the U.S., and generally have no tax.

**How does the three-year holding period apply to add-on investments?**

**Gruidl:** It depends on how you define an add-on investment. I think general tax law would tell you that your interest could be split into multiple holding periods. In the past, that’s been used to apply to a one-year holding period. Now it would be a three-year holding period. If you had a portfolio company that used its own proceeds to go and make an add-on, I don’t think that’s going to change anything. If there are additional funds that are brought in from the investors into a portfolio and you get a new carry on that, there’s no specific guidance on that in the statutes. These are general corporate principles. If I have stock or a partnership interest and there is new investment that comes in, and I don’t get any additional units but I have this new investment dollar come in, I actually end up with what’s called a split holding period in a unit. Whereas I could have a share of stock that has a holding period of three years for part of it and brand-new for another part because of the way the investment came in.

**Can you explain the impact of interest deduction limitations in the tax reform? How do you think that’ll change the approach to doing deals and even the underwriting assumptions?**

**Gruidl:** If you are a fund that does a lot of leveraged buyouts with significant amounts of debt using mezzanine investors, this could have a major impact. You go back to the old idea, “Hey, 21 percent tax on something is a lot more than a 35 percent tax on zero.” Companies that were highly leveraged had, in many situations, a five-year hold period of zero taxable income because of these significant tax deductions. Again, that could be a significant flip.

For those that take on a modest amount of debt, this may not be an issue. At the 30 percent limitation, based on what’s called adjusted taxable income, adjusted taxable income from 2018 to 2021 is essentially EBITDA. After 2021 it’s EBIT, so it’s worse post-2021. Important note, though: EBITDA and EBIT, you can’t use GAAP and book income. EBITDA and EBIT is based on taxable numbers. You take taxable income under the old rules, and then you add back interest, taxes, depreciation, amortization. It’s based solely on tax, not on financials.

**What about any favorable exclusions?**

**Gruidl:** There is a favorable exclusion if you have less than $25 million in gross receipts; 163(j), the interest-deferral rule, just does not apply. There are related party issues you have to look at in this case, and how this $25 million gross might work or apply as a leverage blocker. That is an area that is unclear. We would expect significant regulatory and similar guidance to address some of the issues we have with the flow-through of this deferral, and blockers that may just hold a partnership interest, and then debt. There are not, at this point, completely clear black and white rules. The Internal Revenue Code is long, but we have to remember the Treasury regulations have to be three times, four times as long as the Internal Revenue Code.

**How would this affect the real estate businesses who have a separate rule in terms of 163(j) and its applicability?**

**Wright:** Those in the real estate business or real estate funds that would otherwise be subject to this 30 percent limit on the deductibility of business interest can elect out of the interest limitation and instead apply some longer appreciable lives to their fixed assets.

**What does this all mean for immediate expensing and how that relates to M&A valuations?**

**Gruidl:** From an M&A perspective, if you go out and buy a company and they have significant machinery and equipment, if you do an asset deal, you no longer have to amortize that over five or seven years. You get to write off the full amount of that in year one. If you don’t have a lot of income, then maybe that’s not all that much of a benefit, because it creates a net operating loss. If you’re a flow-through and you generate all of those deductions and then they flow through to your investors as ordinary deductions, that could be a significant benefit at your investor level. If you’re at a corporate, you have a significant NOL now, and that’s going to offset income during your holding period.

From a deal perspective, it makes asset deals even more attractive than they were before. From a purchase-price-allocation perspective, this will put more strain on parties trying to agree. If I’m buying, I want as much five- and seven-year property as I can. If I’m selling, I generally want to avoid a lot of allocation to that property, because I may have to recapture it at an ordinary income rate. Purchase-price allocation and a further benefit now to doing an asset deal versus a stock deal is going to be two pretty important factors with expensing.

**Does the 20 percent flow-through deduction apply to the sale of a portfolio company, or only to current income?**

**Gruidl:** If you had ordinary income recapture on, say, your machinery and equipment and that’s recaptured at ordinary income rates, that portion would be eligible. On capital gains rates, you’re already at a 15 percent or 20 percent rate.

**Could we define carry to be paid only out of qualified dividends and long-term gains?**

**Wright:** I think under the general partnership rules, typically you can’t allocate to one taxpayer some preferred class of income that results in a lower tax rate for them and allocate, say, ordinary income to another investor who’s maybe tax-neutral or has a loss. In other words, you can’t manipulate the allocation of different types of income to different investors. As a general rule, it’s got to be pro rata. I couldn’t allocate all the dividends, for example, to the general partner and allocate the portfolio operating income to the limiters.

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RSM Insights: Arguably the most talked about tax provision for high income individuals is the personal income tax rate reduction. The rates at most income levels have dropped by about two percent, not to mention the expansion of the income brackets allowing for a further reduction in ordinary income taxes. Despite the overall decrease in ordinary income tax rates, the tax rule change on the cap for deductibility of state and local income taxes and real estate property taxes, along with the elimination of miscellaneous itemized deductions subject to the two percent of adjusted gross income (AGI) floor will possibly wash out some of the savings from the lower individual tax rates for fund executives, especially those living in high taxed states such as California, New Jersey and New York.

Carried Interest: As mentioned in RSM’s recent article Private Equity fund and portfolio companies: The impact of tax reform, carried interest rules were altered by adding a holding period minimum requirement of at least three years of an applicable partnership interest in order to qualify for the favorable long-term capital gain tax treatment for tax years effective Jan. 1, 2018. The portion of the carried interest that relates to gain on property held less than three years would now be considered short term capital gain.

RSM Insights: Overall, some general partners of alternative investment funds may continue to enjoy carried interest tax benefits that existed under prior law as long as the underlying investments that gave rise to the gain are held for more than three years as required under the new law. This may have more of a negative impact on hedge funds, since most private equity funds have longer term holding periods of applicable partnership interests. For funds that do not meet the three-year holding period it will be important to determine if a capital loss position can be recognized to mitigate the negative tax impact. A strategy that may work is to accelerate or realize short or long term capital losses within a fund or personally offset any carried interest short term capital gain with personal capital losses.

Individual Tax Rate Decreases: The TCJA reduces the top individual tax rate from 39.6 percent down to 37 percent.

Pass-through Income Tax Deduction: Section 199A of the TCJA provides owners of qualified pass-through businesses the ability to claim a 20 percent deduction from taxable income of qualified business income potentially creating a net effective federal tax rate of 29.6 percent compared to the new top ordinary income tax rate of 37 percent. A qualifying trade or business under this code section is defined as any trade or business other than a specified trade or business. Unfortunately, a trade or business of performing services (such as a management company) is included in this carve out.

In addition, an additional deduction limit was included under the rule if a partner’s taxable income exceeds $157,500 for single tax filers ($315,000 for joint filers) and will fully apply once taxable income is greater than $207,500 for single tax filers ($415,000 for joint filers). If subject to the limit, the deduction will be limited to the lesser of:

1. 20 percent of the qualified business income or
2. The greater of
   a. 50 percent of W-2 wages from the qualified trade or business or
   b. 25 percent of W-2 wages from the qualified trade business plus 2.5 percent of the unadjusted basis immediately after the acquisition of all qualified property.

As briefly alluded to above, it is important to note a carve out for specified service trade or business, which will not allow for the 20 percent deduction to be used. These businesses include but are not limited to professional services such as law, accounting, management, health, consulting, actuarial or investment brokerage. Also excluded are businesses whose principal asset is the reputation or skill of one or more of its employees and/or owners or which involves the performance of services consisting of investing, investment management, trading in securities or similar services.

Qualified business income for the pass through deduction does not include investment-type income (e.g., capital gains, dividends and non-business interest). The TCJA did try to appease specified service businesses right before final signing by President Trump, by allowing specified service business owners the 20 percent deduction as long as the taxpayers’ taxable income doesn’t exceed $207,500 for single filers ($415,000 for joint filers), subject to a phase-in of the wage limitation discussed above beginning at $157,500 for single filers ($315,000 for joint filers). In contrast with qualifying businesses mentioned previously, if the taxpayers’ taxable income exceeds $207,500 ($415,000 for joint filers) no deduction is be allowed for the specified service business such as in the fund management space. This may be helpful for some taxpayers at lower levels of taxable income but overall does not help many alternative investment fund management company members due to the lower income limitation.

Please note that we can expect significant regulations and explanations from the Department of Treasury and Internal Revenue Service in the coming months to clear up many areas of ambiguity. The following tax reform provisions may have a deep impact to these taxpayers.
RSM Insights: Many alternative investment funds generate income (dividends, long-term capital gains, etc.) that will likely not qualify as qualifying business income for this provision. However, if a U.S. partnership such as a private equity fund has portfolio investments such as flow through portfolio companies that are engaged in a U.S. trade or business which generate qualifying business income and have W-2 wages, it is possible that the individual limited partners and the general partners of the private equity fund could benefit. Similarly, in a co-investment scenario, where fund investors, fund sponsors’ operating partners and/or fund principals invest directly in a pass-through portfolio company, the deduction may be possible.

Itemized Deduction Changes: The TCJA has made several changes to itemized deductions:

1. Placed a limit of $10,000 on an individual taxpayer’s combined itemized deduction for state and local income taxes and real estate taxes.
2. Eliminated the miscellaneous itemized deductions subject to the two percent of AGI floor, including but not limited to investment fund management fees.
3. Limit on home mortgage interest deduction to the first $750,000 of acquisition indebtedness on newly purchased principal and secondary residences after Dec. 15, 2017.
4. Elimination of the home equity interest deduction if not qualified.

RSM Insights: This will undoubtedly affect a significant number of individuals in the hedge fund and private equity world who happen to live in high taxed states like California, Connecticut, New Jersey and New York to name a few. The limited cap on the state and local income tax/real estate tax itemized deductions will offset the majority of the benefits previously mentioned. Choosing or moving state residency of fund executives may become a hot topic given these tax reform changes.

Alternative Minimum Tax (AMT): The TCJA has left the AMT in place for individual taxpayers but has increased the exemption amounts to $70,300 for single filers ($109,400 for married taxpayers filing jointly) compared to $54,300 and $84,500 respectively, in 2017.

RSM Insights: In addition to the increase in the exemption amounts mentioned above, the phase-out thresholds have also increased from $120,700 to $500,000 for single filers and from $160,900 to $1 million (married filing jointly). Due to the increase in the AMT exemptions, the increase in the phase-out thresholds and the reduced alternative minimum taxable income add-backs of state and local income taxes/property taxes and miscellaneous itemized deductions subject to the two percent of AGI floor, we anticipate a significant decrease in the number of individual taxpayers who are subject to the AMT beginning in 2018.

Estate and Gift Tax Exemption Increase: With the passing of the TCJA, the estate and gift tax lifetime exemptions have increased to about $22.4 million for a married couple beginning on Jan. 1, 2018.

RSM Insights: The near doubling of the estate and gift tax lifetime exemptions to about $22.4 million (inflation adjusted) will provide an excellent opportunity for wealthy Americans to maximize their estate and gift tax planning. Most, if not all, estate plans should be reviewed at this point in time to take advantage of this opportunity. One thing to consider is the fact that this provision is temporary and is set to sunset at the end of 2025. Therefore, fund executives who have accumulated substantial wealth either in their fund interests or through personal investments, should consider the ability to make transfers before 2025. This combined with the exemption increase, along with the fact that proposed regulations under IRC section 2704 which relate to limiting valuation discounts of interests in family-controlled entities for gift, estate and generation-skipping transfer tax purposes have been repealed will make for a great tax environment for hedge fund and private equity owners to consider additional gifting transactions starting in 2018.

Limitation on Excess Business Losses of Non-corporate Taxpayers: For taxable years beginning after Dec. 31, 2017 and before Jan. 1, 2026, the TCJA disallows a deduction for business losses (excess deductions which are attributable to trades or businesses) in excess of business income plus $250,000 for individual filers ($500,000 for joint filers) for the current taxable year. These losses will be carried forward and treated as a net operating loss carryforward into future years. The limitation will apply after the application of the passive loss rules under section 469. In the case of partnership and S corporation losses, the limitation will apply at the partner or shareholder level.

RSM Insights: Owners of a management company or pass-through portfolio company will be limited from using losses from the management company or pass-through portfolio company to offset other income of that individual partner or shareholder if the losses exceed the threshold amount provided under the new provision.

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