CLIENT ALERT

The Tax Cuts and Jobs Act – Certain Provisions Affecting Private Equity Funds

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On November 2, 2017, Kevin Brady (R-TX), Chairman of the House Ways & Means Committee (the "Committee"), unveiled the long-awaited bill to implement tax reform proposals that had been under discussion among the so-called "Big 6" representatives of the House, the Senate and the Administration. The measure, H.R. 1, is titled the "Tax Cuts and Jobs Act" (the "Tax Bill"). At the commencement of the Committee markup of the bill on Monday, Chairman Brady introduced an amendment to the bill (the "Amendment"). The Tax Bill contains several provisions, discussed below, that could have significant implications for private equity funds and their investors. All of the provisions discussed below, if enacted, are scheduled to take effect beginning January 1, 2018. The full text of the Tax Bill released on November 2 can be viewed here and the Amendment here. Senate Republicans are expected to unveil their plan in the next few days and we will provide an additional update at that time.

Extended Carried Interest Holding Period

While the Tax Bill released on November 2 did not impact carried interest, the Amendment establishes a three-year holding period for an investment in a portfolio company before "carried interest" allocated in respect of such investment qualifies for the lower tax rate applicable to long-term capital gains, instead of the one-year holding period generally required. Carried interest in respect of an investment in a portfolio company that does not satisfy the three-year holding period will be treated as short-term capital gains taxed at the higher ordinary income rates. Carried interest resulting from "qualified dividend income" would remain eligible for the lower applicable tax rate.

"Carried interest" refers to an interest in partnership profits granted to a partner in exchange for services. As with prior legislative proposals to tax carried interest as services income, the Tax Bill applies to the provision of investment-related services in respect of securities, real estate, partnership interests, commodities or derivatives on the foregoing. Notably, as drafted, the Amendment would not apply to interests in portfolio companies granted to employees in connection with the performance of services to such companies. It also would not apply to interests in holding partnerships granted to employees of portfolio companies. Rather, the Amendment is drafted to apply to fund managers who receive carried interest.

25% Pass-Through Rate Applicable to Qualified Business Income

Under current law, business income allocated from a pass-through entity is taxed at regular rates, which, in the case of an individual taxpayer, is a maximum of 39.6%. The Tax Bill provides for a maximum 25% rate to be applied to "qualified business income." "Qualified business income" is defined differently depending on whether the income is derived from an active or passive business activity of the partner. Net income of a partner derived from a passive business activity would be fully eligible for the 25% rate. In comparison, only a portion (generally 30%) of the net income of a partner derived from an active business activity – *i.e.,* an activity in which the partner materially participates – would be eligible for the 25% rate. A facts-and-circumstances test would allow a portion larger than the 30% to qualify for the 25% rate, with the remaining business income taxed at regular rates. Capital gain and dividend income would continue to be taxed at the same rates as under current law.

In the case of a typical "line of equity" transaction where a private equity fund forms a portfolio company with a management team, the business income allocated to the private equity fund would generally be expected to be taxed at 25%, while only 30% of the business income allocated to management (who are actually working in the business of the portfolio company) generally would benefit from the 25% rate.

Corporate Tax Rate Reduced to 20%

The Tax Bill calls for reducing the corporate tax rate to 20% from a maximum of 35%. Although rumors before the bill was released suggested the rate reduction might sunset after some time period, as provided in the Tax Bill the reduction would be permanent. In addition, unlike an individual, a corporation would continue to benefit from the deductibility of state and local taxes under the Tax Bill.

The reduced corporate tax rate also impacts private equity fund structures. Private equity funds often utilize "blocker" structures for foreign investors that are sensitive to effectively connected income and tax-exempt investors that are sensitive to unrelated business taxable income ("UBTI") to prevent those investors from being allocated such income. Subject to the limitation on interest deductions discussed below, the 20% rate would reduce the current tax burden associated with the use of such structures.

Taxation of UBTI Received by Government-Sponsored Investors

Under current law, state and local government pension funds and state universities have generally taken the position that they are not subject to tax on their UBTI. However, under the Tax Bill, such entities would be subject to tax on UBTI. This could result in this group of investors electing to use investment structures such as "blockers" to avoid recognizing UBTI thereby reducing the after-tax return to such investors.

Limitation on Interest Deduction

Use of leverage is common in private equity transactions. Portfolio companies generally incur debt to fund a portion of the acquisition cost of an investment. In addition, as discussed above, private equity funds often include blockers in their structures to facilitate investment by certain types of investors. Such blocker entities are often capitalized in part with debt resulting in reduced taxes.

Unlike the current provision (Internal Revenue Code Section 163(j)) that limits the deduction for interest in the case of related-party debt and that contains a carveout for situations in which the taxpayer's debt-equity ratio is not over 1.5:1 or the taxpayer's net interest expense does not exceed 50% of its adjusted taxable income, the Tax Bill would impose a limit on the ability to deduct business interest each year to 30% of "adjusted taxable income" for all businesses with more than $25 million in average gross receipts. The Tax Bill defines "adjusted taxable income" generally as taxable income computed without regard to (1) any business interest expense or business interest income, (2) the amount of any net operating loss ("NOL") deduction or (3) any deduction allowable for depreciation, amortization, or depletion; thus, the Tax Bill would allow more than 30% of taxable income to be sheltered by interest expense. Also, interest in excess of the limit could be carried forward five years and be used to offset income in future years, including gains on a sale of the business. Lastly, the limit is applied at the partnership level, not at the partner level.

Immediate Expensing of Business Investments

Under the Tax Bill, taxpayers would be able to fully and immediately expense 100% (instead of the present law 50%) of the cost of "qualified property" placed in service during the next five years. The definition of "qualified property" would be modified to exclude any property used in any real property trade or business. In addition, under current law, bonus depreciation is available only for property, the original use of which begins with the taxpayer. The Tax Bill would expand the definition of "qualified property" to include used property.

This provision may increase the incentive for private equity funds to structure transactions as asset acquisitions (either actual or deemed through the election under Internal Revenue Code Section 338) so that they are able to immediately deduct a significant portion of the purchase price.

Elimination of Ability to Carry Back NOLs

The Tax Bill would eliminate the two-year carryback of NOLs that exists currently and would also limit the carryforward of the NOL to 90% of taxable income in a given year. This proposal may substantially limit the ability of private equity funds to monetize NOLs that may arise from the payment of transaction expenses, such as option cash outs, stay bonuses and change-of-control payments, in connection with the sale of a portfolio company treated as a corporation for tax purposes. Currently, sellers often negotiate to have the buyer carry back such NOLs to prior tax years of the target corporation in order to claim a refund of taxes for the benefit of the seller. NOL carrybacks are not subject to Internal Revenue Code Section 382, which limits the ability of a loss corporation to utilize NOLs following an ownership change of more than 50%. Under the Tax Bill, the NOLs generated from the payment of transaction expenses cannot be carried back and, accordingly, will be limited by Internal Revenue Code Section 382, thereby deferring and potentially reducing or even eliminating the ability of a seller to be compensated for the use of such losses.

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