AN ALERT FROM THE BDO PRIVATE EQUITY PRACTICE

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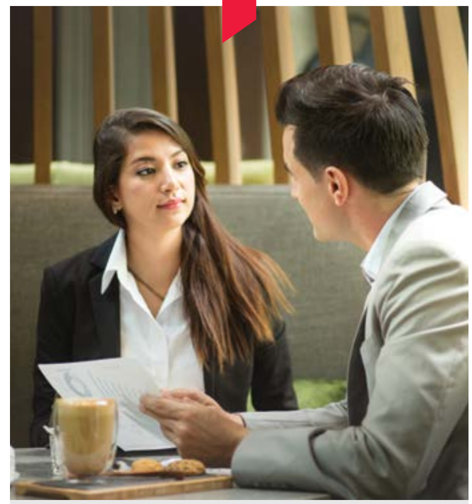
PRIVATE EQUITY



TAX REFORM'S POTENTIAL IMPACT TO PRIVATE EQUITY

The Tax Cuts and Jobs Act, passed by the House Committee on Ways and Means in early November, and the Senate Finance Committee's proposal differ on specific provisions, but both represent the first significant and detailed legislative steps toward tax reform under the Trump Administration.

While the road to passing comprehensive tax reform is sure to be a long one—and it looks increasingly unlikely that reform will be enacted before the end of the calendar year—private equity (PE) firms need to familiarize themselves with the proposals on the table and understand the potential impacts to their business and investment strategies.

WHAT'S AT STAKE FOR THE PRIVATE EQUITY WORLD?

The main provisions that could impact private equity firms include limits to interest rate deductibility, changes to the treatment of carried interest, a reduction of the corporate tax rate, alterations to the taxation of pass-through entities, and reforms to repatriation taxes.

INTEREST RATE DEDUCTIBILITY

The House bill proposes limiting the deductibility of interest from businesses' taxes to 30 percent of earnings before interest, taxes, depreciation, and amortization (EBITDA). Currently, PE firms, and others, can deduct 100 percent of their interest payments on corporate debt. Although the proposal wouldn't take effect until 2018, as written in the House bill, it will apply to existing debt facilities. It also includes a carryforward period of five years for unused business interest, which could reduce the value of the deduction.

For a highly-levered industry like private equity, limiting interest rate deductibility is the provision that could have the largest impact on firms' operations. The change could lead PE firms to reduce their issuance of debt and change the way they finance acquisitions. If enacted, firms could shift toward using more equity to finance deals, leading to lower returns on investment.

CARRIED INTEREST PROPOSAL

Throughout early tax reform discussions, possible changes to the treatment of capital gains was a hot-button issue. While a change is outlined in the House bill, private equity firms likely would not experience an impact. Under the current guidance, capital gains

HOW DO I GET MORE INFORMATION?

CONTACT:

SCOTT HENDON
National Leader of BDO's Private Equity practice
214-665-0750 / shendon@bdo.com

KEITH MANNOR
Tax Partner
312-233-1894 / kmannor@bdo.com

JOE CALIANNO
International Tax Technical Practice Leader
202-644-5415 / jcalianno@bdo.com

TODD SIMMENS
Controversy and Procedure Technical Practice Leader
732-491-4170 / tsimmens@bdo.com

JOHN NUCKOLLS
Private Client Services Technical Practice Leader
415-490-3393 / jnuckolls@bdo.com

BEN WILLIS
Corporate Tax Technical Practice Leader
bwillis@bdo.com

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on investments held more than a year are taxed at 20 percent. The House bill alters those requirements, proposing that only capital gains on investments held for a minimum of three years will qualify for that preferential rate. Any gains from investments held for under three years, the bill proposes, should be taxed as ordinary income.

As private equity firms' average holding periods already far exceed three years—and high valuations are likely to extend holding periods even longer—this provision is unlikely to impact the PE industry. The Senate bill does not currently address carried interest.

CORPORATE TAX RATE

Under the House's proposed plan, the corporate tax rate—currently set at 35 percent—would be reduced to 20 percent by 2018. This corporate tax rate is also included in the Senate tax reform bill, with one key difference: The bill proposes delaying reducing the rate to 20 percent until 2019.

A corporate tax rate cut might reduce some of the negative impacts to private equity firms brought by limiting interest rate deductibility, but it remains to be seen how much relief it will bring. Activities involving investing, trading or dealing in securities, partnership interests or commodities will generally not be eligible for the lower tax rate. The average effective corporate tax rate is also already below 35 percent after factoring in credits and incentives.

PASS-THROUGH TAXATION

Under the House version of these rules, "passive" investors will be subject to a 25 percent tax rate on 100 percent of their share of qualified business income. Additionally, "active" members of PE funds will be subject to the 25 percent tax rate on a minimum of 30 percent of qualified business income. However, an election is available that may result in an increased percentage of qualified business income subject to the 25 percent tax. The Senate bill also proposes creating a lower 25 percent rate by setting up a special "pass-through" deduction generally equal to 17.4 percent of qualified business income.

REPATRIATION OF FOREIGN PROFITS

The House tax reform bill proposes a one-time tax on repatriated foreign profits, with a 14 percent rate on cash and a seven percent rate on illiquid investments. The Senate bill proposes a 10 percent rate on cash and 5 percent rate on illiquid investments. If enacted, changes to the repatriation of foreign profits could make cross-border investments more lucrative for U.S. private equity firms. Alternatively, the boon corporations would experience from a lighter repatriation tax could spell trouble for PE firms in auctions. With a lighter tax burden, strategic investors might be willing to bid higher for deals, intensifying the already competitive deal environment and potentially further inflating valuations.

GRECIAN MAGNESITE DECISION: SALE OF PARTNERSHIP INTEREST BY FOREIGN PARTNER

Although not included in the House proposal, the Senate bill includes a provision that would effectively override the *Grecian Magnesite* decision and codify Rev. Rul. 91-32. Under this proposal, a sale of a partnership interest by a foreign partner will be treated as though the foreign partner sold a share of underlying assets, thereby creating effectively connected income. This would be an issue for certain foreign investors in the fund.

SELF-EMPLOYMENT TAXES

The House and Senate bills would both modify rules relevant to the imposition of self-employment taxes on distributive shares of income allocable to the fund managers.

NEXT STEPS

As we look ahead to 2018, private equity firms should review the provisions outlined in the House and Senate tax reform bills to familiarize themselves and their limited partners with the potential changes. General partners would also be wise to consider the impact of the outlined reforms to their portfolio companies and initiate business planning conversations.

While it's essential to stay apprised of the potential tax reforms and their business implications, it's also important to keep in mind that the bills are still in draft format. For now, proceed with business as usual, given the uncertain timeline for the passage of tax reform.

Read the **latest alert** from BDO's Tax practice to learn more about the tax reform provisions on the table.

For more information contact Keith Mannor, a tax partner at BDO USA. He can be reached at kmannor@bdo.com.