AN ALERT FROM THE BDO PRIVATE EQUITY PRACTICE

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PE ON THE LOOKOUT FOR MORE TAX REFORM CHANGES

Private equity firms have been keeping a close eye on the Tax Cuts and Jobs Act and the changes it brings to the asset class. At first glance, it seemed that the impact would be mostly neutral, but as the government tinkers with tax reform and begins offering more clarity as to what each provision entails, private equity managers are staying alert.

TAXATION OF CARRIED INTEREST

While the media largely portrayed private equity as having come out unscathed by the new carried interest rules, that is not entirely accurate. Under the new law, long-term capital gain recognized from investments held for less than three years may be recharacterized as short-term capital gain and taxed at the ordinary rates. This may result in tax at a 37 percent rate (for ordinary income) as compared to the lower 23.8 percent rate imposed on long term capital gain. While private equity tends to hold investments for an average of four to six years, periodic "add-on" investments create a "trap for the unwary." Each time an add-on equity investment is made, a new holding period is created with respect to that new investment.

If a private equity firm sells a portfolio company where it has made add-on investments less than three years before the exit, part of the total gain from that investment may be subject to these carried interest recharacterization provisions. To avoid this potential recharacterization concern, private equity funds may consider structuring these add-on investments as debt-financing.

There's more. In the enacted statute, there's an exception for carried interest held by "corporations." However, it has been unclear whether this exception was applicable to C corporations only, or if it also applied to S corporations. The Internal Revenue Service recently announced its intent to publish regulations that will close a perceived "loophole" whereby these recharacterization rules would not apply to partnership interests held by S corporations.

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CHOICE OF ENTITY DEBATE

As a result of tax reform, the effective tax rate difference between corporate and pass-through entities has been significantly reduced. This has created an environment where, even with two levels of taxation, a C corporation structure may generate greater after-tax cash value to its owners as compared to a pass-through entity. Two key factors have a significant impact on the overall Choice of Entity analysis: Availability of the Section 199A Deduction and Reinvestment of Undistributed Earnings.

This change in tax rate structure will certainly play a role in the decision-making process of private equity firms that are considering their "choice of entity" options. Some well-known players in the private equity space already have made their choice. In mid-February, Ares Management announced its conversion from a publicly-traded partnership to a C corporation, and KKR is said to be considering the pros and cons of doing so as well.

In considering choice of entity, taxpayers will need to take a few key steps, including:

- Determine the extent to which the Section 199A deduction can be utilized.
- Evaluate the businesses, planned use for after-tax cash earnings, i.e., to fund distributions or internal reinvestment.
- Model projected after-tax cash benefits to the business owners.
- Evaluate tax and non-tax considerations, including limitations of the state tax deduction for individual taxpayers and the ability to get a step-up in basis on the sale of a partnership interest.

LIMITATION OF INTEREST RATE DEDUCTIBILITY

For a highly-leveraged industry like private equity, limiting interest rate deductibility is the provision that could have the largest impact on firms' operations. The change could lead private equity firms to reduce their issuance of debt and change the way they finance acquisitions. Anecdotally, many firms are already relying more on preferred equity and mezzanine financing to fund deals.

The new tax regime caps interest deduction to the sum of business interest income plus 30 percent of the adjusted taxable income of the taxpayer for the taxable year. Adjusted taxable income is defined similar to EBITDA for taxable years beginning after Dec. 31, 2017 and before Jan. 1, 2022, and is defined similar to EBIT for taxable years beginning after Dec. 31, 2021. Limitation applies to both related party and unrelated party debt. Disallowed interest is carried forward indefinitely.

STATE-LEVEL CHANGES AHEAD?

In addition to the new federal tax law, also looming large are potential state tax implications. While it's difficult to know what, if any, changes states will make to local tax laws, the possibility isn't far-fetched and firms should follow any such news closely.

For more insight into the impact of tax reform on private equity, please listen to the latest episode of *BDO's Private Equity PErspectives Podcast* **here**.

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