



HOW TAX REFORM WILL IMPACT PRIVATE EQUITY

On December 22, just a few weeks following the passage of the Senate's Tax Cuts and Jobs Act, the conference version of the bill was signed into law, marking the largest change to U.S. tax policy in decades.

With most of the provisions set to go into effect in the new year, it's important that private equity firms review the changes that occurred during the conference process to understand the impact to their funds and portfolio companies.

PROVISION	SUMMARY OF CHANGES	IMPLICATIONS FOR PRIVATE EQUITY
CORPORATE TAX CUT	<p>Corporate tax is reduced from 35% to 21%</p> <p>Effective date: Taxable years after Dec. 31, 2017</p>	<p>Industry View: Positive/Neutral</p> <p>What's at stake: The cut in the corporate tax rate may alleviate some of the added expense from the limitation of interest rate deductibility. It could also spur portfolio companies to have more capital to enhance operations or expand.</p> <p>On the other hand, the cut gives strategics even more bargaining power in competitive auctions, potentially making them an even fiercer competitor for deals vs. private equity firms.</p>
CARRIED INTEREST CHANGES	<p>Carry from investments held for under three years will be taxed at the higher ordinary income rate rather than the lower capital gains rate. Previously, the threshold was one year. The capital gains tax rate was kept as is, at a maximum of 20%.</p> <p>Effective date: Taxable years after Dec. 31, 2017</p>	<p>Industry View: Negative/Neutral</p> <p>What's at stake: The change in the provision is not expected to have much of an impact on private equity firms as they already tend to hold investments for more than three years.</p>

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PASS-THROUGH INCOME RULE APPLYING TO PE FUNDS	<p>Raises the deduction available to pass-through filers to 20%.</p> <p>Effective date: Taxable years after Dec. 31, 2017</p>	<p>Industry View: Positive</p> <p>What's at stake: Eligible partners would benefit from this new deduction as it could reduce the amount of income taxed at ordinary rates.</p>
LOOK-THROUGH RULE WHEN APPLIED TO GAIN ON SALE OF A PARTNERSHIP INTEREST	<p>A gain from the sale of a stake in a partnership in a U.S. trade or business by a non-U.S. person will be treated as effectively connected income subject to U.S. tax if a sale by the partnership of all of its assets would give rise to effectively connected income. The transferee of the partnership would be required to withhold 10% of the amount realized.</p> <p>Effective date: The tax would apply to sales on or after Nov. 27, 2017 but the withholding will only apply to sales taking place after Dec. 31, 2017.</p>	<p>Industry View: Negative</p> <p>What's at stake: This provision would impact foreign partners of partnerships engaged, directly or indirectly through one or more partnerships, in a U.S. trade or business, including partners in various fund structures. Partnerships, whether U.S. or foreign, that transfer such interests would be required to treat the appropriate amount of gain or loss as effectively connected to a U.S. trade or business and withhold on this amount. This would reverse the favorable decision in <i>Grecian Magnesite Mining</i> that was decided earlier this year.</p>
LIMITED DEDUCTIBILITY OF INTEREST FOR FINANCING OF PORTFOLIO COMPANIES	<p>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.</p> <p>Effective date: Taxable years after Dec. 31, 2017.</p>	<p>Industry View: Negative</p> <p>What's at stake: Interest expense ceiling could be problematic to highly levered, private equity-backed companies. It will likely also make financial sponsors less willing to take on debt.</p>

PROVISION	SUMMARY OF CHANGES	IMPLICATIONS FOR PRIVATE EQUITY
LIMITATIONS ON EXCESS BUSINESS LOSS	<p>For 2018 through 2025, an excess business loss of a non-corporate taxpayer is disallowed and is permitted to be carried over as a net operating loss.</p> <p>Effective date: Taxable years after Dec. 31, 2017.</p>	<p>Industry View: Negative</p> <p>What's at stake: The tax bill would deny business deductions for taxpayers (other than C corporations) for any net business losses in excess of \$250,000 (or \$500,000 in the case of a joint return).</p>
IMMEDIATE EXPENSING OF CERTAIN CAPITAL EXPENDITURES	<p>Companies would be able to fully expense capital expenditures in 2018.</p> <p>Effective date: Applies until 2022 for purchases made after Sept. 27, 2017. The percentage of allowable expensing will be phased out at a rate of 20% per year from 2023 (80 percent) to 2026 (20 percent).</p>	<p>Industry View: Positive</p> <p>What's at stake: This could encourage more capital spending, especially by private equity-backed companies in capital-intensive industries like manufacturing.</p>
DEDUCTION FOR DIVIDENDS FROM FOREIGN CORPORATIONS	<p>Certain U.S. corporate shareholders would be entitled to a 100% dividends-received deduction for dividends from certain foreign corporations.</p>	<p>Industry View: Positive</p> <p>What's at stake: The bill includes a dividend exemption system in which certain U.S. corporate shareholders would be entitled to a 100% dividends-received deduction for dividends received from certain foreign corporations, essentially exempting such dividend from U.S. tax. Non-corporate taxpayers however would not be entitled to such an exemption.</p>
IMPOSE TRANSITION TAX FOR EXISTING OVERSEAS PROFITS	<p>U.S. shareholders of certain foreign corporations are required to include the foreign corporations deferred foreign earnings into taxable income. Earnings held in cash and cash equivalents subject to a 15.5% rate and an 8% rate applies to all other earnings.</p> <p>Effective date: Effective for the last taxable year of a foreign corporation that begins before Jan. 1, 2018, and with respect to U.S. shareholders, for the taxable years in which or with which such taxable years of the foreign corporation's end.</p>	<p>Industry View: Neutral</p> <p>What's at stake: The one-time repatriation tax rate is relatively low, but may still come as an unexpected expenditure for companies with significant cash overseas.</p>

TAX REFORM: 5 STEPS PRIVATE EQUITY FIRMS CAN TAKE NOW

1. Assess impact. Tax professionals will likely need to review the bill manually, measuring their firm's specific circumstances against it to assess the impact of each provision, as well as the holistic effect on their firm and portfolio company's bottom line.
2. Assemble a team. While the heaviest burden may fall on accountants, firms and their finance teams will have an important role to play to create a tax strategy moving forward.
3. Dig into the data. Assessing the impact of tax reform requires a substantial amount of data to be readily available. Firms need to move from modeling the impact of tax reform to focus on data collection and computations as soon as possible.
4. Establish priorities. Focus on the areas that could have the greatest impact on your firm and portfolio companies. For private equity firms, landmark provisions include: changes to deductions for pass through income, limited deductibility of interest for financing, and the elimination of net operating loss (NOL) carrybacks.
5. Initiate tax reform conversations with your tax advisor. Tax reform of this magnitude is the biggest change we've seen in a generation, and will require intense focus to understand not only how the changes apply at a federal level, but also the ripple effect this is likely to have on state taxation and the impact to financial statements.

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