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Impact of the Recent Tax Reform on the Private Equity Industry

The Tax Cuts and Jobs Act (the "Tax Act"), which was signed into law on December 22, enacted a broad range of changes with most provisions taking effect for tax years beginning after December 31, 2017. This alert summarizes some of the key (federal) tax provisions of the Tax Act affecting the private equity industry.

Corporate Tax Rate Reduction

The Tax Act reduced the highest corporate tax rate from 35% to 21% effective for tax years beginning after December 31, 2017, eliminated the special fixed rate of 35% for personal service corporations and repealed the corporate alternative minimum tax entirely. While the rate cut is obviously beneficial for corporate taxpayers, its impact on the private equity industry is less clear. The effect of the new lower rate for corporations and the new pass-through deduction for certain pass-through businesses (discussed below) will need to be carefully considered in deciding the best structure to hold portfolio company investments.

The balance sheet impact of the tax rate cut is also a material talking point. Companies with deferred tax assets are adding to their balance sheet the tax savings that will arise from future tax deductions whereas deferred tax liabilities reflect taxes that will be due on future taxable amounts. Both deferred tax assets and deferred tax liabilities are measured using the tax rates expected to be in effect when the deductions or liabilities are realized. With the corporate tax rate reduction, the value of the deferred tax asset will be cut and the exposure from a deferred tax liability will be reduced. Companies with large deferred tax asset balances must record a charge to earnings when they write down the value of these assets while companies with large deferred tax liabilities will report a big one-time earnings gain on the write-down of these liabilities. For private equity funds that have valued deferred tax assets in their earnings multiples for valuation or buyout purposes, this write-down will not be welcome news. However, the benefit of the lower corporate tax rate on future earnings softens the blow of the write-down.

The Tax Act also significantly affects the considerations that go into whether a particular acquisition should be structured as a stock or an asset acquisition. The lower corporate tax rate reduces the value to a corporate buyer of structuring the deal as an asset acquisition so that the tax basis of the acquired assets are "stepped-up" (if the purchase price exceeds the aggregate tax basis of the assets being acquired, the buyer receives a stepped-up basis in the assets equal to the purchase price). Because used depreciable tangible property is eligible for 100% immediate

expensing (discussed below in more detail), a purchaser of assets may be able to immediately expense a significant portion of the purchase price of the asset purchase. Whether this produces a net positive or net negative impact on the benefit of a step-up transaction to the buyer will depend on the particular facts and circumstances of the transaction.

Qualified small business stock is an often overlooked tax windfall. Under Section 1202 of the Internal Revenue Code, gain from the sale of qualified small business stock ("QSBS") held form more than five years in not includible in gross income; therefore, not taxable. To qualify as QSBS under Section 1202: (1) the stock must be in a domestic C corporation and it must be a C corporation for substantially all of the time you hold the stock; (2) the corporation may not have more than $50 million in assets as of the date the stock was issued and immediately thereafter; (3) Your stock must be acquired at its original issue (not from a secondary market); (4) during substantially all of the time that you hold the stock, at least 80% of the value of the corporation's assets must be used in the active conduct of one or more qualified businesses. While the Tax Act did not change Section 1202, the combination of the reduction in the corporate tax rate and the potential exclusion of gain on the sale of stock under Section 1202, may make Section 1202 more attractive to those that qualify under the requirements mentioned above.

New Pass-Through Income Deduction

Under prior law, net taxable income from pass-through business entities (such as sole proprietorships, partnerships, S corporations and LLCs) was simply passed through to their owners. It was then taxed at the owners' tax rates. In other words, no special treatment applied to pass-through income recognized by business owners.

For tax years beginning in 2018, the Tax Act establishes a new deduction based on a non-corporate owner's qualified business income (QBI). This new tax break is available to individuals, estates and trusts that own interests in partnerships, S corporations or sole proprietorships. The deduction generally equals 20% of QBI, with a cap equal to the greater of 50% of W-2 wages or 25% of W-2 wages plus 2.5% of the cost of qualified property. The deduction expires after the year 2025. Under an exception, the W-2 wage limitation does not apply until an individual owner's taxable income exceeds $157,500 ($315,000 for joint filers). Above those income levels, the W-2 wage limitation is phased in over a $50,000 range ($100,000 range for joint filers).

QBI is generally defined as the net amount of qualified items of income, gain, deduction and loss from any qualified business operating in the United States of the non-corporate owner. QBI does not include investment income, reasonable compensation income or guaranteed payments to the taxpayer from the business. The QBI deduction is not allowed in calculating the non-corporate owner's adjusted gross income (AGI), but it reduces taxable income. In effect, it's treated the same as an allowable itemized deduction.

The 20% deduction is not available for income realized from “specified service trades or businesses” such as health, law, accounting, consulting, financial services firms and other businesses where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners, unless realized by a taxpayer whose taxable income falls below the thresholds described above. The deduction is therefore not available with respect to management fees earned by the investment manager of a private equity fund. However, it is available with respect to income earned by non-corporate taxpayers through the private equity fund’s portfolio companies that are held as pass-through investments. Since the pass-through deduction will be limited based on W-2 wages paid at the portfolio company level, it will be relevant and important to structure compensation arrangements to qualify as W-2 wages as opposed to independent contractors (via Form 1099-MISC) or guaranteed payments (via Schedule k-1).

Anchin Observation: The Tax Act increases the compliance burden on pass-through entities and their owners while also lowering the corporate tax rate. However, these changes alone should not impact the decision to structure portfolio companies as corporations versus pass-through vehicles. Portfolio companies structured as pass-through entities may still be the way to go given the new pass-through deduction rules as well as some existing tried and true factors such as one layer of tax at the entity level and the ability to structure and exit with preferential buyer benefits. In addition, a future tax law change could increase the corporate tax rate, leaving many who converted to a C corporation with an inflexible tax vehicle with a potential high cost of converting to a pass-through.

Carried Interest

Under prior law, if a non-corporate taxpayer was allocated taxable income or gain in respect of a partnership interest (regardless of whether the interest was a capital or profits interest), the character of such income or gain was determined at the partnership level. If the partner was allocated capital gain income, whether that capital gain is long-term or short-term depended on whether the partnership’s holding period in the assets sold exceeded one year.

The Tax Act provides that for tax years beginning after December 31, 2017 and with respect to an “applicable partnership interest”, that capital gain recognized with respect to such partnership interest will be treated as long-term capital gain only to the extent that the partnership assets producing the gain were held for more than three years (as opposed to the generally applied one-year holding period threshold).

An “applicable partnership interest” is defined as a partnership interest received by the taxpayer in connection with the taxpayer’s performance of substantial services in the trade or business of raising or returning capital and either investing in, or disposing of, securities, commodities, real

estate held for rental or investment, cash or cash equivalents, options or derivatives and similar interest or developing such assets.

It is important to note that an applicable partnership interest does not include any interest held by a corporation or any capital interest allowing the partner to share in partnership capital corresponding with the amount of capital contributed. Amounts not meeting the three-year holding period test would be reclassified as short-term capital gain, rather than ordinary income (as some earlier carried interest proposals had called for). The three-year holding period rule would apply regardless of whether a §83(b) election is made and would also apply to gains generated from the sale of the applicable partnership interest itself. There is no grandfathering for partnership interests received prior to January 1, 2018.

Under this new legislation, it seems clear that the treatment of carried interest will not give rise to effectively connected income ("ECI") or unrelated business taxable income ("UBTI") issues; both were concerns under earlier versions of carried interest proposals. It also appears that qualified dividend income is not impacted under the new rules and will still be taxed at the lower preferential rates discussed above. Limited partners holding capital interests in private investment funds are also not affected and therefore retain the one-year holding period requirement for long-term capital gain treatment.

Anchin Observation: The carried interest change would apply to incentive allocations in private equity funds as well as fund interests acquired through management fee waivers. As mentioned earlier, it would not apply to a partner's earnings on capital contributions to the fund. However, it is still unclear how this new provision applies to mixed capital and profits interests, which is fairly common in private equity fund structures. Although not explicitly stated in this new provision, it would appear that the intent to allow such a bifurcation whereby part of any interest (capital interest) would qualify for the exception even if another part (profits interest) does not.

Also, even though we have had some recent press and an IRS notice highlighting the uncertainty, it still remains unclear if an applicable partnership interest held by an S corporation would be excluded under this new provision.

Excess Business Loss Limitation

A new limitation applies to deductions for "excess business losses" incurred by non-corporate taxpayers (individuals, trusts and estates). Generally, a taxpayer will have an excess business loss for a tax year if the taxpayer's deductible items from "trades or businesses" exceed the sum of (1) the taxpayer's aggregate business income and gains and (2) a threshold amount ($500,000 for taxpayers filing joint returns, $250,000 for other taxpayers). Losses that are disallowed under this rule are carried forward to later tax years and can then be deducted under the rules that apply

to NOLs (discussed below). This new provision applies after the application of the passive activity loss rules and, in the case of a partnership or S corporation, the excess business loss limitation applies at the taxpayer level and not the entity level.

Anchin Observation: This provision will limit the ability of owners of a private equity management company or a portfolio company structured as a pass-through from using those losses to offset other income of the owner (i.e., investment income such as dividends, interest and capital gains).

Net Operating Loss ("NOL") Deduction Changes

Under prior law, NOLs could be carried back two years and carried forward for twenty years. Under the Tax Act, NOLs arising in tax years ending after December 31, 2017 generally cannot be carried back, but can be carried forward indefinitely. In addition, the maximum amount of the deduction for a NOL carryforward will be limited to 80% of a taxpayer's taxable income (determined without regard to the NOL deduction), also effective with respect to tax years beginning after December 31, 2017. Relief is provided with respect to NOLs arising in taxable years beginning prior to December 31, 2017, which will continue to be available for the two-year carryback and the 20-year carryforward without regard to the new 80% taxable income limitation.

Anchin Observation: Since not all states have (or will) confirm to the federal law change, it is important to try to keep current of the states that the fund (and portfolio companies) operate in so as to manage the (increased) state tax liabilities as a result of this new provision.

New limits on business interest deductions

Under prior law, subject to some restrictions and exceptions, (business) interest paid or accrued by a business generally is fully deductible. The Tax Act significantly restricts the deductibility of interest paid or accrued by certain private investment funds that are engaged in a trade or business for tax years beginning after December 31, 2017, including interest paid on existing indebtedness. The term business interest would not, however, include investment interest (as described under §163(d)). The deduction for business interest expense is generally limited to the sum of business interest income plus 30% of adjusted taxable income. For this purpose, adjusted taxable income is determined at the entity level for partnerships and generally is earnings before interest, depreciation, amortization or depletion for tax years beginning before 2022 with no addbacks for depreciation, amortization or depletion for taxable years thereafter.

Certain taxpayers are exempted from the new interest deductibility limitation, including small businesses averaging annual gross receipts of $25 million or less for the three prior taxable years, as well as real property businesses that elect out of the limitation and certain public utilities.

For partnerships and LLCs that are treated as partnerships for tax purposes, this limit is applied at the entity level rather than at the owner level. Any business interest disallowed at the entity level in a taxable year is allocated to the partners and may only be deducted by them against excess adjusted taxable income allocated to them from such partnership in a future year. Amounts that cannot be deducted in the current year can generally be carried forward indefinitely. A partner's adjusted basis in its partnership interest is reduced (but not below zero) by the amount of excess business interest allocated to the partner. If a partner disposes of its partnership interest, including in a non-recognition transaction, the partner's basis in the interest is increased, immediately prior to the disposition, by the excess of: (i) the amount basis was reduced as described above over (ii) the amount of excess business interest allocated to the partner and treated as paid or accrued in a succeeding tax year.

The limitation also applies to tax shelters. A partnership or S corporation that allocates more than 35 percent of its losses for the year to limited partners or limited entrepreneurs is considered a tax shelter.

Anchin Observation: The interest expense ceiling could be problematic to highly leveraged private equity backed portfolio companies. There also is no rule on grandfathering existing debt. The extent to which the interest expense limitation will affect the private equity industry is not yet clear. Obviously, where income is high enough and interest is entirely deductible, borrowing to finance acquisitions or growth may be more attractive than dilution through the issuance of additional equity. On the other hand, if earnings are low enough to trigger the new interest deduction limitation, capitalization through additional equity issuances may become the preferred route. It should be noted, that most of the recent growth in private equity and their portfolio company investments has been financed with debt. Such funds must now consider carefully modelling their earnings expectations to determine potential interest deduction limitations, which could result in a shift to the use of more equity instead of debt.

Gain on the Sale of a Partnership Interest by a Foreign Person

This provision would impact foreign partners of partnerships engaged, directly or indirectly through one or more partnerships, in a U.S. trade or business. The Tax Act codifies Revenue Ruling 91-32, effectively reversing the Grecian Magnesite decision. Gain or loss on the disposition of a partnership by a foreign partner is treated as effectively connected income ("ECI") and subject to taxation in the U.S. if the gain or loss from the sale of the underlying assets held by the partnership is treated as ECI. To implement this new rule, the Tax Act requires transferees of partnership interests to withhold 10% of the amount realized on the sale or exchange of such an

interest unless the transferor certifies it is not a foreign person. This new rule has potential implications for sales of interests in private equity funds, portfolio companies in partnership form and in some sales of interests in fund management companies. The rules treating the gain or loss on a sale or exchange of a partnership interest as ECI are effective for dispositions on or after November 27, 2017 with the withholding provisions effective for dispositions after December 31, 2017. For our prior coverage on this, please click here.

Anchin Observation: This provision will also apply to partnership distributions in excess of tax basis that result in gain recognition to a foreign partner.

Immediate Expensing of (Certain) Capital Expenditures

The Tax Act permits most taxpayers to expense 100% of the cost of qualified property, including certain tangible personal property, placed in service after September 27, 2017 and before January 1, 2023. The Tax Act allows immediate expensing for used as well as new eligible property. However, consistent with prior law, intangible property and real property are not eligible for immediate expensing. Beginning in 2023, the immediate expensing will be reduced to 80%, followed by 60% in 2024, 40% in 2025, 20% in 2026 and reduced to 0% for years thereafter. A special rule allows taxpayers to elect to apply 50% bonus depreciation rather than 100% bonus depreciation for the first taxable year ending after September 27, 2017.

Anchin Observation: The availability of 100% bonus depreciation for even used assets that are acquired is expected to stimulate mergers and acquisitions activity for capital asset-intensive industries. This provision may in part or more than offset the effect of the limitations on interest deductibility discussed above. Full expensing may also provide significant benefit to private equity buyers in deals structured as asset acquisitions which provide basis step-ups (including to the tax basis of assets eligible for immediate expensing under this provision). Note that sellers may also benefit or ask for higher purchase prices knowing that assets acquired by the purchaser can be immediately expensed even if the buyer is not the first user of such property.

Also, since many states already decouple from or modify the current federal bonus depreciation provision, be wary of continued nonconformity which could lead to increased state taxable income.

Miscellaneous Itemized Deductions Subject to the 2% Floor Eliminated

The Tax Act repeals miscellaneous itemized deductions subject to the 2% of adjusted gross income ("AGI") floor limitation. Notable expenses include expenses incurred for the production or collection of income (such as investment management fees). The Tax Act also repeals the overall limitation on itemized deductions (commonly referred to as the "Pease" limitation), which reduced the total amount of itemized deductions for high-income taxpayers.

Anchin Observation: Some private equity funds are actively looking to modify fund terms with the intent to have less of a management fee (or in some cases, no management fee) with a corresponding increase in the incentive or carried interest allocation. This decision should not be taken lightly or should be carefully discussed and thought out with your various advisors. Choice of entity should also be a consideration and discussion point since these types of deductions continue to be fully deductible if you operate your business as a C corporation.

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Private equity, venture capital and mergers & acquisitions professionals have certain tax needs which makes compliance with tax reform slightly more complicated. The summary above highlights provisions that we believe will have the most significant impact to these professionals. We will continue to keep you updated going forward and stand ready as Your Expert Partner to help you plan effectively and to assist you in navigating through the various tax reform changes that may apply to you and your business.

Please contact E. George Teixeira or any member of Anchin's Private Equity Practice for more information on the provisions discussed above.

Anchin, Block & Anchin LLP
Accountants and Advisors
1375 Broadway, New York, NY 10018
212.840.3456 • www.anchin.com

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Ryan Donovan, Principal - Granger Management

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When you're ready to roll up your sleeves, please contact us by phone or email:

E. GEORGE TEIXEIRA, CPA
george.teixeira@anchin.com
Leader
Private Equity

STEPHEN PLATTMAN, CPA, CGMA
stephen.plattman@anchin.com
Leader
Private Equity

Anchin, Block & Anchin LLP
1375 Broadway, New York, NY 10018
212.863.1298 www.anchin.com

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Jeffrey I. Rosenthal
jeffrey.rosenthal@anchin.com
Partner-In-Charge

Peter L. Berlant
peter.berlant@anchin.com
Partner

Jeffrey J. Bowden
jeffrey.bowden@anchin.com
Principal

Marc G. Goldberg
marc.goldberg@anchin.com
Partner

David Horton
david.horton@anchin.com
Partner

Mitchell Rosenthal
mitchell.rosenthal@anchin.com
Partner

E. George Teixeira
george.teixeira@anchin.com
Partner

Edward F. Thorp
edward.thorp@anchin.com
Partner

Zurab Moshashvili
zurab.moshashvili@anchin.com
Director

Raymond Dragon
raymond.dragon@anchin.com
Senior Manager

Audelene Gutierrez
audelene.gutierrez@anchin.com
Senior Manager

Ronald Kalungi
ronald.kalungi@anchin.com
Senior Manager

Marina Shah
marina.shah@anchin.com
Senior Manager

Sheena Singh
sheena.singh@anchin.com
Senior Manager

Anna Wong
anna.wong@anchin.com
Senior Manager

Anchin, Block & Anchin LLP
Accountants and Advisors
1375 Broadway, New York, NY 10018
212.840.3456 • www.anchin.com

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