Private Equity – Tax Reform Highlights

January 2018

President Trump signed into law the *Tax Cuts and Jobs Act* on Dec. 22, 2017. Provisions of the new law are likely to have a significant impact on many private equity groups (PEGs) and their portfolio companies. Assessing the specific impact of the provisions on matters ranging from tax efficient acquisition and sale structures, leverage, and tax planning over the course of the investment period will be critical. Below are several of the more significant measures of the new law with a brief summary of how they may impact the way PEG's may structure and plan. Members of the Crowe Private Equity practice are readily available to help you assess and plan appropriately.

FUND OR PARTNERSHIP-LEVEL ITEMS			
TOPIC	**PREVIOUS LAW**	**NEW LAW**	**IMPACT**
Pass-Through Income Deduction	Income included at ordinary rates.	Deduction for 20 percent of pass-through income not to exceed the greater of the following: • 50 percent of wages paid by business. • 25 percent of the wages paid by the business plus 2.5 percent of the original tax basis of certain tangible property. Service businesses (other than engineers and architects) generally are ineligible for the deduction.	This deduction results in an effective federal tax rate of 29.6 percent when considering the top individual rate of 37 percent. Private equity group (PEG) management companies may be considered service businesses and be ineligible for the pass-through deduction. The new law does not provide guidance regarding the character of qualifying income as it flows through a fund structure, but subject to future guidance, presumably qualifying income should retain its character.
State and Local Tax Deduction	Deductible.	Deductible.	Unlike individuals, pass-through entities continue to be able to deduct entity-level state and local taxes.
Carried Interest	Treated as a capital gain.	Three-year holding period on assets to qualify for capital gains on profits.	This may affect some PEGs who sell companies within three years, but for the most part, carried interest holding period changes may not be impactful presuming a typical holding period of longer than three years.

CORPORATE-LEVEL ITEMS			
TOPIC	**PREVIOUS LAW**	**NEW LAW**	**IMPACT**
Corporate Tax Rate	Top rate of 35 percent.	21 percent flat rate for tax years beginning on or after Jan. 1, 2018.	The reduction in the corporate rate could increase the attractiveness of holding portfolio and management companies in corporate form, especially when considering certain deductions corporations are entitled to take that may not be available to individuals filing as pass-through entities under the new rules (e.g., state taxes, miscellaneous itemized deductions). The reduction in the corporate rate will likely have an immediate impact on deferred tax assets and liabilities, as well as a corresponding tax expense. The tax provision impact will need to be analyzed in short order. Companies should also consider the impact on existing and future bank covenants.
Corporate Alternative Minimum Tax (AMT)	20 percent rate.	Repealed.	Many corporations previously subject to AMT will see immediate savings from this repeal as well as a reduction in administrative burden. Any previous AMT credits can still be carried forward to offset regular income tax.
Net Operating Loss (NOL)	Can offset 100 percent of income. Can offset 90 percent of alternative minimum taxable income. Two-year carryback and 20-year carryforward of NOLs.	NOLs generated in 2017 and earlier can offset 100 percent of income. NOLs generated in 2018 and later can offset 80 percent of income. Generally no carryback and unlimited carryforward of NOLs.	The value of NOLs needs to be reconsidered. For example, consider the sale of a corporation in 2018 results in change-of-control payments and transaction fees incurred that generate a significant NOL in the year of sale, but the corporation had taxable income in the previous two years. Under prior law, if the corporation generated income in the 2 years before the sale, the NOL would have been carried back for a refund of tax paid at 35 percent. Under new law (2018 and thereafter), the loss cannot be carried back and monetized. Instead the NOL carries forward, subject to Section 382 limitations, and can be used by the buyer to offset tax at a 21 percent rate.
Interest Expense	Generally deductible when incurred without limitation.	Deduction limited to 30 percent of adjusted taxable income. Adjusted taxable income is earnings before interest, taxes, depreciation, and amortization (EBITDA) through 2021 and earnings before interest and taxes (EBIT) in subsequent taxable years. Unlimited carryforward of disallowed amounts.	Interest limitation provisions will likely have an immediate impact on the taxable income of portfolio companies with significant debt and interest expense. It could also make projecting the value of interest carryforwards very challenging. Strategies around using leveraged recapitalizations may change under the new laws. Interest limited under the new law carries forward and may have value to a buyer.

CORPORATE-LEVEL ITEMS (CONTINUED)			
TOPIC	**PREVIOUS LAW**	**NEW LAW**	**IMPACT**
Bonus Depreciation	50 percent bonus depreciation on new assets.	100 percent bonus depreciation for new and previously used assets purchased on or after Sept. 28, 2017, through Dec. 31, 2022. Bonus depreciation phases down to zero from 2023 through 2027, with no bonus depreciation available in 2028.	A significant benefit may exist for portfolio companies with large fixed asset purchases. Depreciation recapture considerations: For example, consider Seller that is a pass-through entity with Section 1245 recapture property and Buyer that is a corporation with a 21 percent tax rate. Seller wants Buyer to pay for the additional tax cost of doing an asset deal instead of a stock deal. Buyer needs to consider the new benefit of immediately expensing fixed asset acquisitions with the lower benefit of amortizable goodwill to determine if the additional cost is worthwhile.
Domestic Production Activities Deducation	Deduction of up to 9 percent of taxable income for manufacturers.	Repealed.	Domestic manufacturing companies will lose a major deduction.
Deemed Repatriation Income Inclusion	No provision.	Requires deemed repatriation income inclusion of post-1986 foreign subsidiary earnings and profits as of Nov. 2 or Dec. 31, 2017, by U.S. shareholders owning at least 10 percent. 15.5 percent tax rate on foreign earnings and profits held in liquid assets and 8 percent for the remainder.	This income may represent a significant payment made by a foreign subsidiary affecting the value of the subsidiary, but also may generate a tax basis step-up in the foreign subsidiary for dividend paid. This provision likely will require additional compliance burden in foreign earnings and profits (E&P) tracking.
Dividends Received by Domestic Corporations From Foreign Subsidiaries	Included in income with a credit for foreign taxes paid.	Adopts a modified territorial system with 100 percent dividends received deduction (DRD) if the domestic corporation owns at least 10 percent of the foreign subsidiary paying the dividend. No foreign tax credit or deduction allowed with respect to the foreign dividend.	The new law provides flexibility for PEGs to invest via U.S. platform companies in foreign subsidiaries with increased ease of capital movement. However, deemed repatriation provisions under Subpart F and Section 956 may still subject foreign subsidiary earnings to US tax and be ineligible for the DRD.

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