Top Three Tax Issues Impacting Private Equity Firms

It's hard to believe that over a year has gone by since the Tax Cuts and Jobs Act (TCJA) of 2017 was passed by Congress as one the most comprehensive changes to US taxation in over 30 years. The carried interest safe harbor, interest expense limitation and the corporate tax rate reduction are three of the most significant ways that the Tax Act has impacted private equity funds, their management companies and their portfolio companies.

Despite the controversial carried interest loophole, the TCJA only increased the holding period required for long-term tax treatment to greater than three years. If the holding period is less than three years, then the gain will be taxed as short-term capital gain (versus ordinary income), which tops out at ordinary rates of 37%. Additionally, the TCJA provides that if there is a transfer of a partner's carried interest to a related party, then the partner's entire interest will be characterized as short-term capital gain even if the holding period is greater than three years. Most private equity investments are held greater than 3 years, however, partners should be aware of add-ons that do not qualify for the three-year holding period or transfers to related parties.

At first glance, the interest expense limitation was not expected to significantly impact private equity, however the TCJA limits the amount of interest expense an entity can deduct to 30% of adjusted taxable income. Most private equity deals have historically employed a large amount of leverage in acquiring portfolio companies. Given the application of the interest expense limitation, private equity funds will need to review the amount of leverage used to acquire portfolio companies and consider potential alternatives in structuring debt as preferred equity versus typical debt structures, as well as where the debt is placed within the structure.

The corporate rate reduction to a flat rate of 21% has created potential for private equity funds to reevaluate the structuring alternatives as corporate versus pass-through entities. The corporate form provides some advantages including shorter hold periods for carried interest, however, there is a limit on the deductibility of interest as discussed above. Private equity firms will want to review the cash flow and valuation issues in considering alternative structures.

The carried interest safe harbor, interest expense limitation and the reduced corporate tax rate were all effective January 1, 2018. Considering the 2018 financial results and the effect of the application of these tax issues, private equity firms should consider the following actions in 2019:

- Review the structuring alternatives and options with respect to carried interest and management fee income.
- Review the impact of the application of the interest expense limitation and consider alternatives for structuring debt, along with the placement of debt in the structure, and
- Review the cash flow and valuation issues associated with the reduced corporate tax rate and consider alternative structures.

Contact Us

Should you have questions about these provisions of the TCJA, structuring opportunities or any other matter affecting businesses in the private equity segment, contact Raygan Evans or Laurie Bizzell by calling 770-396-2200.