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Observations for Private Equity Funds Seeking to Address Tax Reform

When President Donald Trump addressed a joint session of Congress at the end of February, he provided few new details of his tax plans. He said his economic team "is developing historic tax reform" that will reduce business tax rates and provide "massive" tax relief for the middle class without specifying rates or terms. Notably, he did not indicate either support for or disapproval of the House Republican Blueprint and its border adjusted tax, nor did he say when his administration's tax plan might be released. Subsequently, directional guidance has still not been released.

KPMG LLP (KPMG) Observation: The timing of tax reform legislation remains uncertain. Differences between the Trump campaign tax plans and Republican congressional proposals such as the Blueprint are certainly an important reason for delay, as is the controversy over the border adjustable tax that is a critical element of the Blueprint. But the preceding consideration of the Affordable Care Act (ACA) is also an important factor. Repeal of the ACA taxes would eliminate the need to address the loss of revenue associated with those taxes in tax reform legislation, reducing the revenue cost of tax reform and potentially allowing lower rates. Further, disposition first of the ACA is important procedurally in order to allow tax reform legislation to proceed under congressional budget reconciliation, which eliminates the need for 60 votes in the Senate to prevent a filibuster.

The key issues for private equity funds in the existing tax reform proposals are described below.

- Carried interest and management fee taxation
  - While carried interest has been under scrutiny for several years and the subject of a number of proposals, the Blueprint does not mention changes to the carried interest regime.
  - The Trump campaign proposal called for taxing carried interest as ordinary income.
  - The Blueprint would provide a maximum individual tax rate of 25 percent for active business income from a sole proprietorship or pass-through entity, subject to the limitation that amounts representing "reasonable compensation" to owner-operators would be taxed as ordinary income.
  - The Trump campaign proposal would provide a 15 percent business rate for "all businesses, both small and large, that retain the profits within the business."

KPMG Observation: There is uncertainty regarding the types of income that would be treated as "active income" eligible for the maximum 25 percent pass-through rate provided by the Blueprint. Investment income is not expected to qualify as "active." In addition, what it means to "retain profits in the business" to qualify for the 15 percent rate under the Trump campaign proposal is uncertain. If capital gains treatment for carried interest is repealed, and depending on what tax rate changes are enacted, funds may consider whether carried interest arrangements should be restructured as incentive fees to qualify for lower pass-through or business tax rates.

KPMG Observation: In connection with his Senate confirmation hearing, Secretary Steve Mnuchin responded to a question by stating that the administration was in favor of repealing carried interest on *hedge funds*. This could possibly signal disparate treatment of carried interest between hedge, private equity, and real estate funds. A recent statement by Office of Management and Budget Director Mick Mulvaney indicated that the Trump administration remains interested in repealing the favorable treatment of carried interest, without distinguishing among different types of funds.

- Change in tax rates applicable to investment income
  - Both the Trump campaign proposal and the House Republican Blueprint would create a 33 percent maximum individual tax rate.
  - The House Republican Blueprint proposes a 50 percent deduction for capital gains, interest, and dividends, resulting in a 16.5 percent maximum rate for those items, while the Trump campaign proposal would retain a 20 percent maximum rate for capital gains and dividends (it makes no mention of extending this preferential rate to interest).

KPMG Observation: The Blueprint provision would seemingly create parity in the taxation of interest and dividends, potentially increasing the attractiveness of debt investments for individuals. There could also be an impact on the municipal bond market due to the declining value of the tax preference.

- Elimination of deduction for net interest expense

KPMG Observation: The proposal to limit the deductibility of net interest expense, such that it would be deductible only to the extent of interest income, can be expected to reduce the tax-efficiency of highly leveraged U.S. companies. Other tax reform proposals, including lower rates and full expensing of CapEx, may mitigate this effect in whole or in part.

KPMG Observation: The use and location of leverage in portfolio company acquisition structures, leveraged blockers, and the financing of general partner capital would be impacted.

- Repeal of net investment income tax

KPMG Observation: The net investment income tax was widely seen as an effective 3.8 percent increase in the capital gains rate, in addition to increasing the tax rate for other types of investment income. A repeal would likely have similar consequences to a capital gains rate cut.

- Allowance of an immediate deduction for investments in tangible property (other than land) and intangible assets

KPMG Observation: Immediate full expensing of CapEx would accelerate tax deductions and, other things being equal, increase after-tax cash flow. This change is particularly valuable for asset-intensive businesses. The Trump campaign plan would limit this benefit to U.S. manufacturers, with availability of full expensing for those taxpayers being conditioned on forgoing the deductibility of interest expense.

- Mandatory repatriation of untaxed accumulated foreign earnings at an 8.75 percent rate for cash and cash equivalents and a 3.5 percent rate for other assets under the Blueprint (or a flat 10 percent rate under the Trump campaign proposal)

KPMG Observation: Some form of repatriation relief appears likely even if broader tax reform is not enacted. This would result in offshore cash, including accumulated and likely future earnings, being available to be repatriated at a reduced tax cost without significant tax planning being required. This could, in turn, result in an increase in value for companies with a large amount of low-taxed foreign earnings and cash available to be repatriated.

It may be possible to reduce the potential tax on deemed repatriation through various measures, including:

- Foreign tax credits planning
- Earnings and Profits (E&P) reduction and E&P shifting
- Deployment of offshore cash
- Reduced corporate tax rate, resulting in corporate rates being lower than individual and pass-through rates.

KPMG Observation: Fund managers may consider converting from pass-through structures to corporations where lower rates may be beneficial if profits are not expected to be distributed. Few details exist regarding whether closely held companies or companies largely based on personal services will be subjected to an alternative regime. Conversion to corporate form may also have a significant state and local tax impact, which should not be ignored.

- Territorial tax system with potential for border adjustments

KPMG Observation: Perhaps the most controversial of the proposals, border adjustability is projected to raise significant revenue and accordingly is seen as a key to making possible other changes in the Blueprint plan, in particular the large proposed rate reductions. Whether the proposed border adjustment system would be permissible under the World Trade Organization General Agreement on Tariffs and Trade remains a highly debated issue. Additionally, there is considerable uncertainty as to how such a system would apply to services as well as financial products.

KPMG Observation: In its simplest form, border adjustability would seem to exempt from tax fees for investment management services provided to an offshore customer, such as a foreign fund or foreign partners. This could incentivize managers to use a fee structure, rather than an allocation structure. Should this prove to be the case, one might anticipate rules being enacted to prevent this income from escaping U.S. tax, especially where and to the extent that a foreign fund is actually comprised of U.S. investors.

Contact information

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