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The Impact Of Tax Reform On Private Equity

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Law360, New York (April 26, 2017, 4:47 PM EDT) -- If the past 12 months have taught us anything, it's that the future is hard to predict. One need only look at the ascendancy of Brexit, President Donald Trump, or even the New England Patriots in the second half of the Super Bowl to realize the importance of remaining prepared for the unexpected. In the midst of what has proven to be an era of surprises, private equity sponsors would be well-advised to apply this lesson in considering their current tax posture in the United States.

Uncertainty notwithstanding, there are a few things we do know. For one, there is currently a Republican president and a Republican majority in both houses of Congress. Second, both the Republicans and the president have been outspoken about implementing sweeping tax reform. This tells us that tax reform is likely, although there are many details that are still unknown.

The blueprint unveiled Wednesday by President Trump does not conform perfectly to that of the Republican Congress, although there is significant overlap between the two. Nonetheless, most tax practitioners believe the most likely starting point for tax reform will be the congressional proposal, also known as the House GOP blueprint. While predicting exactly where President Trump and Congress will land when it comes to tax reform is at best an inexact science, there have been some consistent themes that have emerged:

- Widespread elimination of corporate and individual deductions, including the deduction for interest expense
- Full capital expensing, allowing for asset purchases to be written off in "year one"
- Potential for a border adjustment tax
- Mandatory deemed repatriation of all global earnings of U.S. corporations

The impact of the elimination of corporate-level deductions for private equity funds cannot be understated, both with respect to domestic companies and cross-border tax planning. Much of the current tax planning related to private equity structures is designed to (1) leverage U.S.

companies to the extent possible, so that maximum benefit of the interest expense can be realized, and (2) remove valuable operating subsidiaries "out from under" U.S. parents in order to maximize tax-efficient repatriation of offshore earnings.

The loss of the tax shield generated by the interest expense deduction could create significant cash flow constraints at portfolio companies, as not only does interest expense need to be paid as existing debt is serviced, but additional cash would need to be used to satisfy taxes that otherwise would have been reduced from the deduction of such interest expense. Some are speculating that any elimination of the interest expense deduction would phase in gradually over time, so as not to create a dramatic upheaval in existing businesses. If so, sponsors should consider implementing refinancing or levering up. In the past, gradual phase-ins have sometimes grandfathered pre-existing debt and sponsors could benefit from putting debt in positions to be grandfathered.

Under the blueprint, in lieu of depreciation and amortization deductions, businesses would be permitted full, one-time expensing of both tangible property (such as buildings) and intangible property (such as intellectual property and goodwill). It is not clear whether the effect of this proposal would be to allow "instant" depreciation on all otherwise depreciable assets or whether certain assets would be excepted from this provision. Sponsors will want to monitor the specifics of this provision to see which business sectors may receive a disproportionate benefit.

In the interim, consideration should be given to delaying any remaining 2017 capital projects until further clarity is available as to these new expensing rules. Additional thought should also be given to models valuing targets where substantial capital investment is anticipated, and what impact changes to the current rules may have. Further, as any implementation of full or accelerated expensing will likely occur in connection with the elimination of interest expense deductions, sponsors should consider whether any capital investments can be timed in a manner as to reduce the potentially negative impact the loss of interest expenses deductions may have.

With the intent of eliminating existing incentives to move operations and businesses outside of the U.S., as well as to strengthen the U.S. dollar, the Trump administration is considering a "border adjustment" provision. Less a "tax" than a doctrinal shift in the corporate tax system toward a consumption-based model, this new provision would deny expenses attributable to imports, thereby effectively taxing such imports at the corporate rate (i.e., 20 percent, under the blueprint). Income attributable to exports, on the other hand, would escape tax completely. Whether or not the border adjustment will have its desired effect on the economy, or on the value of the dollar, there is no denying that such a provision will produce some clear winners (e.g., certain oil and gas exporters) and clear losers (e.g., retailers like Wal-Mart) that will be affected "bigly."

Sponsors need to be considering and planning for the impact a "border adjustment" tax could have on cash flows. When considering potential acquisition targets, projections of cash flows should incorporate scenarios with a "border adjustment" tax, particularly when determining debt loads that can be comfortably supported by targets that rely (1) heavily on imports or (2) on suppliers that themselves rely heavily on imports (as such suppliers may seek to pass some of the costs down the supply chain). Sellers of portfolio companies that rely heavily on exports will note the desirable impact on these industries and should adjust their investment plan accordingly.

U.S. multinational corporations currently have an aggregate of approximately $2.5 trillion in cash and other assets that are "trapped offshore," so to speak. Under the current system, a repatriation of such earnings would give rise to prohibitively high tax in the U.S. Recognizing the influx of revenue that could

be generated by taxing this income in the U.S., the blueprint would deem the full amount of these offshore holdings to be repatriated (i.e., as a deemed dividend) at a modest rate of 8.5 percent in the case of cash and cash equivalents, and at a friendlier rate of 3.5 percent with respect to nonliquid holdings. After imposition, it would be possible to repatriate all such funds without further tax.

With potentially hundreds of billions, if not trillions, of liquid dollars coming back onshore, executives and boards of U.S. multinationals are going to have three primary options with respect to their newly accessible cash hoards: (1) return the money to shareholders in the form of dividends or stock buyback programs; (2) invest internally in R&D (research and development) and PP&E (plant, property and equipment); or (3) seek earnings growth through acquisitions.

Activist investors are likely to bring extreme pressure to use the cash for one of their purposes. With potentially hundreds of billions in extra capital chasing the same number of deals here in the U.S., one would expect to see increased competition for a finite number of targets creating upward pressure on valuations. While the excess dry powder is potentially a boon for sponsors with a ripe portfolio of investments ready for exit in industries with acquisition-hungry strategics, sponsors will need to impose even greater price discipline in the acquisition evaluation process. Sponsors should be setting the stage now to increase their pipelines for proprietary sourced deals to avoid some of the increased pressure that may be faced in public auctions from strategics.

While it is next to impossible to predict the exact details of tax reform that may ultimately be adopted, the themes above should give private equity sponsors and their advisers some insight into the likely direction of tax reform and some strategic thought as to how their investments may be impacted. Indeed, a bit of strategic planning heading into the half may give sponsors the game plan needed to avoid finding themselves on the wrong end of a 31 point second-half rally.

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