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Private Equity and Tax Policy

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What Lies Ahead

Key Findings

1. Trends in Washington could bring higher taxes for wealthy Americans, including those in private equity
2. New tax policies will likely target capital gains
3. IRS may treat monitoring fees as dividends instead of fees for service
4. Politicians are rethinking taxes on overseas earnings of international companies
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The Panelists

Adam Weinstein
Managing Director
New Mountain Capital

Rick Bailine
Principal, Washington National Tax Leader
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1. Trends in Washington could bring higher taxes for wealthy Americans, including those in private equity.

Income inequality is a hot political topic in the U.S. In December 2013, President Obama called the expanding gap between rich and poor Americans "the defining challenge of our times." And he followed that up in his January State of the Union address with a pledge to pursue proposals to address income inequality. For people in private equity, talk like that translates to: More taxes for us.

"In addressing income inequality, Congress is looking at whether upper-income folks—and that includes the vast majority in private equity—earn too much and need to pay more taxes," Bailine said. "A significant portion of any shift to address income inequality will affect the owners of private equity and their incomes."

Experts expect changes in tax policy to be aimed not at lifting rates but at shrinking deductions. That could mean higher taxes in a lot of different industries, including private equity.

"The focus is not on changing rates but changing policy surrounding different deductions," Weinstein said. "The argument has shifted to getting everyone to pay their 39.6 percent. So if you're in the energy busi-

Participating in the Privcap thought-leadership series "Taxes and Private Equity" are Adam Weinstein, Managing Director, New Mountain Capital; and Rick Bailine, Principal, Washington National Tax Leader, RSM

ness and you get all these deductions, those go away at a certain income level. If you're in the private equity or hedge fund business, carried interest will be paid at 39.6 percent."

Changes to deductions will also affect C corporations, which compose the majority of private equity portfolios.

"Typically, the private equity entity is a partnership," Bailine pointed out. "And because it's doing business as a partnership and not a corporation, it may not benefit from any rate reductions, but it very well may be subject to the loss of deductions."

2. New tax policies will likely target capital gains.

There are two ways for a government to boost revenue: raise tax rates or broaden the tax base. The latter is the preference of most politicians in Washington, and they're eyeing investment income as a way to get the broader tax base they want. This would have tax implications for people in private equity—and people in finance in general—because high-net-worth individuals derive a lot of their income from investment sources.

"There's a lot of capital gains in private equity and in virtually all high-net-worth individuals," Bailine said. "One of the things on new Senate Finance Committee chair Ron Wyden's list of changes is a limit on the application of capital gains."

Wyden has not given specifics on what he means by limiting capital gains, but it's likely Congress will approach the issue by implementing new rules dictating that if your adjusted gross income is over, say, $250,000, you won't benefit from the 20 percent capital gains rate. You might pay 25 percent. And very wealthy people might be subject to the full 39.6 percent rate.

Carried interest is usually in the crosshairs when the discussion turns to taxes and private equity. Weinstein noted that he's been in private equity for more than a decade and carried interest has been a hot topic of debate since he started in the industry. "Even under Republican administrations and Republican Congresses, you always have a voice talking about this," he pointed out.

But problems arise when Congress takes on carried interest, because it's difficult to craft a law that targets only private equity and very large, very profitable organization. Mom-and-pop companies almost inevitably take a hit as well.

"So that causes Congress to look at alternative

PE's Image Problem

Private equity suffers from a public-perception problem, as exemplified during the 2012 presidential campaign when Mitt Romney—and the industry where he made his fortune—were portrayed as greedy and heartless.

"The good that private equity does can be very difficult to measure, and therefore it's a tougher story to tell so that people have a more balanced view," Bailine said. "Unfortunately, every time private equity has tried to point out the good it does, the naysayers go, 'Well, what about this instance where this company filed for bankruptcy?'"

This negative image has made private equity an easy target for tax increases. After all, the average voter is unlikely to care if the industry gets walloped with higher taxes. Clearly, private equity would benefit from a little public support. But improving the industry's popular standing is easier said than done.

"The perception gap is part of this whole notion of income and equality," Bailine said. "It's difficult to make the political case—even though, without private equity, we're going to significantly stymie growth, that's for sure."

ways of addressing income inequality," Bailine said. "And pretty much it's a blank slate. They're looking at everything from fees to interest to deductibilities at the portfolio level."

3. IRS may treat monitoring fees as dividends instead of fees for service.

Many in the tax field predict changes in the treatment of the advisory fees, or monitoring fees, that GPs charge to their portfolios. These are paid to the firm to mitigate the cost of overseeing a portfolio company.

"From a GP's perspective, it's getting captured," Weinstein said. "It's coming in as ordinary income, as fee income, and then flows through to the partners. The GP is then reducing the LP's management fees in the next drawdown. So whatever the fee offset, it actually gets credited back to the LP."

These fees are now attracting scrutiny on Capitol Hill. "There has been a great deal of focus by the IRS and Congress on any flow of cash from a C corporation to a shareholder," Bailine said. "Is a corporation making a payment, which would be deductible to the corporation and income to the recipient? Or is it paying a dividend, which would be nondeductible to the corporation and taxable to the recipient?"

The way the tax code treats these fees today, the portfolio company pays a fee and gets a deduction. And the recipient has income. If the fees were to be reclassified as a dividend, the portfolio company would not have a deduction. But the recipient would have a 20 percent or a 23.8 percent tax rate, not the typical 39.6 percent.

"It's interesting that Congress is choosing to look at this, when changing the characteristic might actually benefit the shareholder—the management company—by giving it a lower tax rate," Bailine said. "But I don't think Capitol Hill is that foolish. It's not going to take them long to realize that they're benefiting the private equity group. And it would surprise no one if their solution is, well, it's nondeductible to the portfolio company, and we believe it should be taxed at 39.6 percent to the recipient."

4. Politicians are rethinking taxes on overseas earnings of international companies.

Companies of all types, including private equity, engage in offshoring. And the practice has provoked a great deal of debate in Washington.

What's the best way to address it? How can the U.S. disincentivize companies—be they private equity or other companies—from investing overseas and creating jobs overseas and instead encourage them to invest in the U.S., create jobs in the U.S., and pay taxes in the U.S?

"For years there has been a policy in place that money earned overseas by an overseas entity is not taxed in the United States directly unless the money is returned to the United States," Bailine said. "In the last five or six years, we've seen this referred to as a great incentive to cause American corporations to invest overseas rather than here in the United States and grow jobs in our country."

5. New taxes on overseas earnings is a solution in search of a problem.

It makes very little sense for any U.S. company to put major investment overseas simply to avoid U.S. taxes. In fact, it's a virtually nonexistent occurrence.

"The strategy a lot of people have tried is, if you're going to have a meaningful piece of your income in the future come from foreign earnings, you may be best advised to create a foreign holding company above the U.S. corporate business," Weinstein said. "But once that's already happening under the U.S. corporate business, it's near impossible to shift it overseas."

Companies set up in China, Germany, or India to access markets in those countries, not to evade U.S. taxes.

"The key question Congress is trying to address—and I think there isn't a lot of substance to it—is, how can we appropriately treat American businesses that want to access markets overseas?" Bailine said. "How do we tax them in an appropriate way, which discourages job growth outside the United States and maximizes job growth in the United States? That's not an easy puzzle to solve. If it were, it would have been solved a long time ago." ◆

Rick Bailine

Double Trouble

Nobody likes to pay taxes. So you can imagine how it feels to pay taxes twice. That's something U.S. private equity firms with foreign holdings are working hard to avoid.

One such firm is New Mountain Capital. Most companies in its portfolio have global operations, but they're all under a U.S. corporation, which means everything flows through the U.S. corporate-tax-paying entity.

"If you have a U.S. business where 90 percent of the income is coming from the U.S. and it has a holding company above it that is in a foreign-tax-beneficial jurisdiction, you're paying all of the U.S. corporate tax that you're supposed to on the 90 percent piece," Weinstein explained. "But what you want to avoid at the top level is paying U.S. tax on that 10 percent foreign."

There are many strategies PE firms can implement to escape paying double taxes, such as relocating the company overseas or creating offshore vehicles. But with offshoring comes controversy. "That's why we have never tried to employ a strategy like that," Weinstein said.

Expert Q&A

with Rick Bailine
Principal
Washington National Tax Leader
RSM

How does RSM work with private equity firms with regard to taxes?

First and foremost, RSM is a full-service public accounting firm. We offer audit services, tax services, and consulting services. Frankly, private equity needs all three of those services.

A simple example of what we do would be: if a private equity company is looking at making an acquisition, they have to do due diligence, meaning they have to have a team go look at the target corporation they're considering buying. That typically includes both audit and tax folks, because you need to look over their tax returns, make sure all their returns are filed, and the positions on their returns are correct.

Now that you decide to make the acquisition, you have ongoing needs for an audit of the company you just bought. We would offer those services and all the corollary services that go along with that audit. The company needs to have a tax return filed. We would be delighted to do the compliance work and file that portfolio company's tax return. By the same token, there are tax issues that company faces on a daily basis, just like any corporation, and we do tax consulting as well as tax compliance. We would be happy to help you in planning your business in a tax-efficient manner.

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