

Tax in asset management: Private equity

Transcript

SPEAKERS:

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ERIC COOMBS: Welcome to the Grant Thornton podcast, where we share information about the latest business trends and issues of the day.

My name is Eric Coombs and I'm the Tax Services Leader for Grant Thornton's national asset management practice.

As part of our series on key tax issues in the asset management industry, I'm speaking today with Melanie Krieger, corporate tax partner and tax leader of our private equity practice.

So Melanie, thank you for joining us today.

MELANIE KRYGIER: Thanks, Eric. Happy to be here.

ERIC COOMBS: Maybe before we get into some tax issues, let's just talk about the broader economic picture at the moment.

So how does the broader macroeconomic environment influencing liquidity tightness in the private equity space?

MELANIE KRYGIER: Yeah, absolutely.

So we've seen a pretty slow exit market in 2023 and the beginning of 2024 as well.

So we have many LPs out there looking for returns as well as many private equity funds are really actively in fundraising mode.

So demonstrating successful exits is a must. So I think there's a lot of pressure to increase exit activity to meet those liquidity demands.

We're now seeing that credit markets are starting to loosen up as well. So as opposed to using a sale or an IPO as an exit strategy, we are seeing leveraged recaps coming back. So that's a much more viable option with some of the interest rate reductions as well.

And then another way that we're seeing funds address the liquidity crunch is turning to continuation vehicles. So they've got valuable assets that are sitting in the portfolio that they want to see some additional value accretion and are looking to transfer those to either a separate continuation vehicle with some fresh capital or potentially transferring those investments to a subsequent fund.

And so it does allow an opportunity for some LPs to cash out in those situations.

ERIC COOMBS: So how do tax considerations at the portfolio level sort of intersect with liquidity challenge at the fund?

MELANIE KRYGIER: Yeah, that's a great question. So liquidity, I think, is linked in two ways. One, certainly from an excess cash flow perspective. So if funds were expecting interim returns through dividends, those recaps we were talking about, or even tax distributions in the flow-through context, to the extent that the portfolio company is cash strapped, there's less opportunity to distribute that excess cash flow.

Additionally, if there's liquidity constraints at the portfolio company, that may be limiting the company's growth, which then obviously limits the value accretion that the funds are seeing in those portfolio companies, which may have an impact on exit timing.

Certainly as we're in the sell side market right now, we are seeing instances where results from a financial perspective are not quite to where a lot of our funds would like them to be. So they might be delaying that ultimate exit by a quarter or two.

ERIC COOMBS: Understood. So which tax provisions are you seeing having a material impact down at the portco level?

MELANIE KRYGIER: I think there are two key ones that we tend to hear pretty consistently, Section 163(j) and Section 174.

So I'll go through and give a little bit of background for the non-tax folks on the line here. So Section 163(j) governs interest expense deductibility, and with the pervasive use of debt funding within private equity transactions and the high interest rate environment that we've been operating in, these interest expense limitations have been quite punitive for portfolio companies, providing less tax shield through interest expense deductions. So we are hoping for some relief in this area, but the rules have automatically tightened over the past couple of years, providing a little bit more punitive impact related to 163(j).

For 174, it requires capitalization of research and development costs, so for portcos that are investing in growth of products and processes, this provision has a pretty meaningful and detrimental impact to a company's tax position.

So we're seeing many of our portfolio company clients flip into cash taxpayers related to the capitalization of these costs much earlier than they expected to from a financial projection perspective.

So not only does this mean that investing in research and development is more expensive, it can also cause further cash strain on the company, further limiting liquidity available for growth or returns.

ERIC COOMBS: So Melanie, following up on those comments, have you noticed any consulting opportunities relative to either of those code sections that are causing so much constraint down at the portco level?

MELANIE KRYGIER: Definitely, and to some extent they can be linked. So with 163(j), so that results in this disallowance of interest expense. But there's also an opportunity to potentially capitalize that interest expense into other assets that may turn more quickly than actually freeing up interest expense limitation availability. So to the extent you have a capital intensive business or in some cases even a business that's in the technology or software space that's capitalizing under 174, it might actually provide an opportunity to attract some of those interest costs to those other assets, which could either be depreciable, amortizable or deductible in a current year.

ERIC COOMBS: Yep. So in essence, you're accelerating the rate at which those deductions would flip in an otherwise sort of indefinite carryforward that could persist for almost eternity, right, if it never materializes. Makes sense, OK, fantastic. So Melanie, we talked about some code sections that are causing some difficulties for various portcos.

Maybe you could expand upon some of the administrative challenges that some of our entities have faced over the last couple of years just in terms of general overhead and increased administrative burden.

MELANIE KRYGIER: Yeah, I think there's been a lot of additional regulatory requirements and also tax reporting requirements at the fund level that continue to be a further drain on resources there.

So we've seen a lot of PE groups that are faced with either increasing headcount, investing in costly technology solutions or increasing professional services spend in order to meet the ever-increasing complexity in reporting.

So things like Schedule K-3 and the complexity from a partnership tax return perspective, those rules just continue to require more information and disclosure than they have in the past, which is just a huge burden for our clients.

ERIC COOMBS: Yeah, certainly as a partnership tax professional by background, I can attest to the increased number of hours required to get a 1065 across the finish line these days. So certainly noticing some fee pressure from clients in that space.

MELANIE KRYGIER: Well, in addition to that, they still have the fun timing requirements too, so it's more volume of reporting and disclosure in the same compressed timeline, it's just really challenging to meet.

ERIC COOMBS: That's absolutely correct. OK. Well, thank you for joining us, Melanie. We appreciate the time today, and for more information on this topic and other issues related to tax and asset management, please visit our website at gt.com.