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The One Big Beautiful Bill: Initial Analysis of Key Provisions for Private Equity Funds and Their Portfolio Companies

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On May 22, the House of Representatives passed H.R. 1, the budget reconciliation bill known as the One Big Beautiful Bill Act (the BBB). The BBB proposes amendments to the Internal Revenue Code (the Code) that could have significant consequences for private equity funds and their portfolio companies. This alert summarizes certain key tax provisions of the BBB that could impact private equity funds, their investors, and their portfolio companies.

The BBB has now moved to the Senate for consideration, where further modifications to the tax provisions discussed below may be made. We will continue to provide updates as the bill advances through the legislative process in Congress.

This summary begins with what the BBB does not do, which may in many regards be as important as what it does, and then provides a summary of the changes made by the BBB.

What the BBB Does Not Do:

- **No Carried Interest Provision**. Despite suggestions in the months prior to the passage of the BBB that the bill may treat carried interests as ordinary income subject to employment taxes, the BBB does not contain any provision implementing such treatment. This leaves the current treatment of carried interests in place, at least for now. This is good news for sponsors of U.S. private equity funds that benefit from the generally favorable tax treatment of income received pursuant to a carried interest. It remains to be seen, however, whether the Senate will introduce changes relating to the treatment of carried interests.

- **No Change to the Capital Gains Tax Rate**. Notwithstanding that the possibility of an increase to the federal long-term capital gains tax rate has been discussed for the past several tax seasons, the BBB leaves in place the current maximum tax rate for long-term capital gains. Additionally, the BBB does not include the addition of a “millionaire’s” tax, which had been a topic of conversation over the past few months. This will not only benefit investors in private equity funds upon a sale by the fund of its portfolio companies, but will also benefit sellers of portfolio companies to be acquired by the private equity funds, likely making portfolio company acquisitions simpler to facilitate and potentially less expensive.

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- **No Change to Section 1202 Capital Gain Exclusion Provisions**. The BBB leaves in place the current provisions of Section 1202 of the Code, which enable qualified taxpayers to exclude up to 100% of the gain on the sale of corporate stock from federal income taxation. Like the retention of the existing long-term capital gains tax rate, this will potentially benefit both investors in private equity funds and sellers of portfolio companies to be acquired by private equity funds.

What the BBB Does:

- **Section 199A Expanded**. Section 199A of the Code (originally enacted by the Tax Cuts and Jobs Act of 2017 (TCJA)) provides an effective tax rate reduction to noncorporate owners of pass-through entities (*e.g.*, partnerships and S corporations), serving as somewhat of a parallel to the corporate tax rate reduction enacted by the TCJA. The provision generally entitles qualified business owners to a deduction equal to 20% of the taxpayer's allocable share of the business's "qualified business income" (QBI), and is currently scheduled to sunset at the end of 2025. The BBB increases this deduction amount to 23% (further reducing the effective tax rate on QBI) and makes this provision permanent. In addition, the BBB adjusts the current mechanics providing for a phase-out or elimination of an otherwise permitted deduction for higher income taxpayers, a taxpayer-favorable change that increases the number of taxpayers potentially eligible for a deduction under the provision. Finally, the BBB expands the universe of business income potentially eligible for the deduction to include certain dividends from electing "business development companies" (essentially, certain regulated investment companies).

- **Section 163(j) Limitation on Interest Deductions Temporarily Relaxed**. Section 163(j) of the Code, originally enacted by the TCJA, generally limits the deduction for business interest expense to 30% of a taxpayer's "adjusted taxable income," currently calculated in a manner similar to earnings before interest and taxes (EBIT). The BBB adjusts the definition of "adjusted taxable income" for this purpose, returning to an earlier iteration which was based on a calculation of earnings before interest, taxes, depreciation, and amortization (EBITDA). This revision generally will increase the base amount to which the 30% limitation applies, thus increasing the amount available to be taken as an interest expense deduction. The provision is, however, temporary, and applies for taxable years beginning on or after January 1, 2025 and before January 1, 2030. Portfolio companies utilizing significant leveraging will likely benefit from this change.

- **Suspension of Requirement to Capitalize R&D Expenses**. The TCJA required certain qualifying research and experimental (R&D) expenses (immediately deductible under prior law) to be capitalized and taken into account over a period of years. The BBB temporarily reinstates the ability to currently deduct qualifying domestic R&D expenses (including certain software development costs) for tax years beginning on or after January 1, 2025 and before January 1, 2030. Foreign R&D expenditures would remain subject to the existing capitalization/amortization requirements. Portfolio companies with significant domestic R&D expenditures will likely benefit from this change.

- **Extension and Expansion of Bonus Depreciation/Immediate Expensing**. The BBB temporarily reinstates the ability for qualifying businesses to claim 100% bonus depreciation under Section 168(k) of the Code for qualified property acquired and placed in service after January 19, 2025 and before January 1, 2030. In addition, certain ceilings on the maximum amount available to be immediately expensed under Section 179 of

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the Code are increased. Further, the BBB introduces a new 100% bonus depreciation for the cost of certain "qualified production property" used in connection with the manufacturing, production, or refining of tangible personal property that is newly acquired or the construction of which begins after January 19, 2025, and before January 1, 2029, and that is placed in service after the date of enactment of the BBB and before January 1, 2033. Portfolio companies with significant capital expenditures will likely benefit from these changes.

- **Deductibility of Fund Management Fees**. The BBB permanently disallows miscellaneous itemized deductions for individuals. This change makes permanent the TCJA's suspension of such deductions, which was otherwise set to expire after 2025. Generally, an investor's allocable share of a general partner's management fee and similar investment expenses are considered miscellaneous itemized deductions. As a result, individual investors in private equity funds will generally no longer be able to deduct management fees or similar investment expenses allocated to them by the fund. This effectively increases the after-tax cost of investing in private equity for individuals.

- **Impact of Tax Rate Increases for Certain Foreign Investors.** As more fully discussed in our prior alerts, "The One Big Beautiful Bill: Initial Analysis of Key Provisions for Investment Funds and Sponsors" and "Insights – The Big Beautiful Bill and the Effects on Bank Lending Into the US," new Code Section 899 as added by the BBB can result in a retaliatory tax (from 5% to as high as 20%), which could include withholding, on certain types of income of certain non-U.S. persons that are residents of or otherwise have sufficient nexus with "discriminatory foreign countries" that have "unfair foreign taxes." Potentially included within income covered by this provision are dividends, interest, royalties, or other FDAP income; income that is effectively connected to a U.S. trade or business (ECI); FIRPTA withholding; branch profits; and investment income of non-U.S. private foundations. The "unfair foreign taxes" would include (i) taxes imposed under undertaxed profits rules of Pillar Two, (ii) digital services taxes, (iii) diverted profits taxes, and (iv) any tax, to the extent provided by the Secretary, that is an extraordinary tax, discriminatory tax, or any other taxes enacted by public or stated purpose that it will be economically borne disproportionately by U.S. persons. New Code Section 899 would provide that the exemption from tax under Section 892 that applies to certain income of foreign governments (including their sovereign wealth funds) would no longer apply to foreign governments of discriminatory foreign countries.

  - While the BBB does not directly restrict the investment activities of foreign investors, this increased tax exposure could reduce after-tax returns on private equity fund investments for the affected persons and institutions, potentially leading to significant adjustments in investment preferences for the affected persons and institutions.

  - As discussed in our earlier advisory, another area significantly impacted by Code Section 899 is loans from non-U.S. lenders. Portfolio companies with such loans from non-U.S. lenders should review their credit agreements to determine if this additional withholding applies and which party bears the economic burden of such amounts.

- **Impact on Portfolio Companies – BEAT.** In many PE structures, a U.S. portfolio company is owned by a non-U.S. holding company, directly or indirectly. Often the U.S. company is paying deductible amounts to a related foreign person, such as service fees or royalties. Under current law, the U.S. company may be subject to an incremental U.S. corporate tax under the Base Erosion and Anti-Avoidance Tax (BEAT) — but BEAT applies only to U.S. groups with revenues in excess of $500 million. Under proposed Section 899, if the U.S. company

is owned directly or indirectly by a company resident in a discriminatory foreign country, the threshold is eliminated. This could have the effect of significantly increasing the corporate income tax payable by the U.S. portfolio company.

- **Impact of Tax Rate Increases for Certain Private University Endowments and Private Foundations**. The BBB includes several provisions increasing the potential tax liability applicable to investments made by large private college and university endowments (increase to the excise tax on net investment income from 1.4% to as high as 21%), and private foundations (increase to excise tax on net investment income from 1.39% to as high as 10%). While the BBB does not directly restrict the investment activities of these institutions, as with the increased taxes on certain foreign investors, this increased tax exposure would almost certainly reduce after-tax returns on private equity fund investments for the affected institutions, potentially leading to adjustment in investment preferences for the institutions.

The tax provisions of the BBB will likely change, potentially significantly, as it moves through the current negotiation process. We are closely monitoring this process, and will provide updates as the bill advances. Please contact a member of the firm's Tax group if you have any questions.

For an initial analysis of the impact on bank lending, please see The Big Beautiful Bill and the Effects on Bank Lending Into the US | Troutman Pepper Locke.

For an initial analysis of key provision for the real industry, please see The One Big Beautiful Bill: Initial Analysis of Key Provisions for the Real Estate Industry | Troutman Pepper Locke.

For an initial analysis of the impact for the investment funds industry and sponsors, please see The One Big Beautiful Bill: Initial Analysis of Key Provisions for Investment Funds and Sponsors | Troutman Pepper Locke.

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