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Legislative Update

One Big Beautiful Bill Act — A Private Equity Perspective

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On July 4, President Donald Trump signed into law the One Big Beautiful Bill Act (OBBBA). This alert summarizes the key changes under the OBBBA relevant to private equity sponsors and their investors, as well as some of the notable proposals that did not make it into the final version of the bill signed into law.[1]

Business Tax Provisions

Business Interest Deductions Under Section 163(j)

Section 163(j) of the U.S. Internal Revenue Code of 1986, as amended (Code), which was introduced under the 2017 Tax Cuts and Jobs Act (TCJA), generally limits the allowable deduction for business interest expense to 30% of a taxpayer's "adjusted taxable income" (ATI). Under the TCJA, ATI was calculated to approximate earnings *before* interest, taxes, depreciation and amortization as determined for income tax purposes (EBITDA). However, for taxable years beginning after December 31, 2021, ATI was determined *after* taking depreciation and amortization deductions as determined for income tax purposes into account (approximating EBIT), which changed ATI and, therefore, further limited interest deductibility. The negative impact of the limitation was especially pronounced for portfolio companies that benefited from stepped-up basis resulting from an acquisition and other portfolio companies with significant depreciation and amortization deductions, although some strategies were developed to limit the impact.

The OBBBA reinstates, for taxable years beginning after December 31, 2025, the previous method under the TCJA approximating EBITDA, which should result in a greater allowance for current business interest deductions.

The bill, however, largely closes the door on a popular workaround to Section 163(j) whereby taxpayers could capitalize business interest into other assets under different Code sections (e.g., Section 263(a), 263A or 266) and recover the resulting increase in tax basis as depreciation, amortization or cost of goods sold, as applicable, without being subject to the limitations under Section 163(j). Under the OBBBA, for taxable years beginning after December 31, 2025, capitalized business interest is generally treated as business interest subject to Section 163(j).[2] Sponsors who have historically relied on this workaround to Section 163(j) may need to reevaluate how interest deductions are taken into account for the 2024 and 2025 taxable years and whether different planning strategies should be implemented for structuring future investments.

The return to an interest expense limitation for taxable years beginning after December 31, 2025, based on tax equivalent of EBITDA also eliminates the benefit of structuring transactions as acquisitions of partnership interests as a tool to increase the limitation.

100% Bonus Depreciation Made Permanent and New Expensing for ‘Qualified Production Property’

Section 168(k), as enacted under the TCJA, permitted an up to 100% deduction for the cost of certain depreciable property, including property that had a recovery period of 20 years or less and was placed in service prior to January 1, 2027. Before the enactment of the OBBBA, the TCJA bonus depreciation was 40% of the cost of the property for the current year and was scheduled to be 20% of the cost of the property for 2026 and to be 0% thereafter. The OBBBA makes the 100% expensing allowed under Section 168(k) permanent for qualifying property acquired after January 19, 2025.

The OBBBA also enacts new Section 168(n), which temporarily expands the 100% expensing allowed under Section 168(k) to “qualified production property,” a new category of property that includes nonresidential real property placed in service in the U.S. used in a “qualified production activity.” A “qualified production activity” under the bill includes manufacturing, production (limited to agricultural and chemical production) or refining of “qualified personal property” (generally, tangible personal property, excluding food or beverage prepared in the same building as a retail establishment in which such property is sold).

The new expensing for qualified production property is a significant expansion of the bonus depreciation rules, which under the TCJA did not apply to real property. Capital intensive businesses, such as chemical plants, large-scale agricultural processors (e.g., grain-milling and meatpacking), auto, food and beverage, high-tech (e.g., semiconductors[3]) and other manufacturers, are expected to benefit from the new category of production property, which is a positive development for private equity funds with existing portfolio companies in these categories or strategies targeting these industries. It is important to note, however, that in order to qualify as qualified production property, the property must both (1) begin construction after January 19, 2025, and before January 1, 2029, and (2) be placed in service before January 1, 2031.

Permanent Deduction for R&E Expenses

The TCJA significantly altered the rules for deducting research and experimental (R&E) expenses under Section 174 by requiring taxpayers to capitalize and amortize such expenses over five years, or 15 years for foreign expenses. The OBBBA partially reverts to pre-TCJA law and allows taxpayers to deduct, for taxable years beginning after December 31, 2024, domestic R&E expenses in the year incurred or to make an election to capitalize and amortize such expenses over a five-year period. However, foreign R&E expenses, which were deductible in the year incurred under pre-TCJA law, must still be capitalized and amortized over 15 years under the OBBBA consistent with the TCJA.

In addition to reviving the current expensing of domestic R&E expenses for taxable years beginning after December 31, 2024, the OBBBA allows certain eligible small businesses (generally, any business with $31 million or less average annual gross receipts during the preceding three taxable years) to expense, on amended returns, R&E expenses for taxable years beginning after December 31, 2021. All other taxpayers that are amortizing R&E expenses incurred in a taxable year beginning after December 31, 2021, and before January 1, 2025, may elect to accelerate the remaining unamortized amounts over a one- or two-year period.

The revival of the expensing rules under the TCJA for domestic R&E expenses, including retroactive expensing for qualifying small businesses and accelerated expensing for all other taxpayers, are welcome developments and may help existing life sciences and other portfolio companies that spend significant amounts on R&E to defray high upfront costs often associated with multiyear research programs and make such companies more attractive for potential buyers. Qualifying small businesses seeking to amend past-year returns may also qualify for refunds of taxes paid in those years, creating additional liquidity for these companies.

Increased Qualified Small Business Stock Flexibility

Under Section 1202, noncorporate taxpayers holding qualified small business stock (QSBS) in a domestic corporation are eligible for exemption from capital gains upon a disposition of such stock. Generally, prior to the OBBBA, in order to qualify as QSBS, the corporation issuing the stock could not have gross assets exceeding $50 million at the time the stock is issued, and the taxpayer was required to hold the stock for more than five years before being eligible for the exemption, which depending on the issuance date of the stock, was equal to 50%, 75% or 100% of the capital gain realized from the disposition of the stock, subject to a cap.

The OBBBA eliminates the flat more than five-year holding period, and instead, *for stock acquired after July 4, 2025*, allows a 50% deduction for a sale of QSBS held for at least three years, 75% for a sale of QSBS held for at least four years and 100% for a sale of QSBS held for five years or more, with an increased cap on the exemption amount (generally, increased from the greater of $10 million or 10 times the taxpayer's tax basis in the QSBS, to the greater of $15 million or 10 times the taxpayer's tax basis in the QSBS), adjusted for inflation on an annual basis beginning in 2027. In addition, the gross assets limit for the corporate issuer of QSBS is raised from $50 million to $75 million.

These changes, together, increase the number of companies that are able to issue QSBS, and are expected to drive additional investment in these businesses by providing an increasingly valuable tax benefit (and planning tool) for private funds investing in early-stage and smaller companies, although such changes will also necessitate careful tracking of when shares of QSBS were issued for follow-on investments in existing qualified small businesses after the effective date to plan for the applicable limitations. The differentiation among QSBS of the same issuer may also result in planning opportunities at disposition time, including in cases of partial rollovers.

For further discussion, please see our July 16 client alert.

Permanent Section 199A Deduction

Under Section 199A, first introduced as part of the TCJA, certain noncorporate taxpayers enjoy a deduction for up to 20% of "qualified business income" derived from certain "qualified trades and businesses." The deduction generally applies to individuals and certain trusts and estates that, subject to applicable thresholds, earn income from sole proprietorships carried on by an individual taxpayer or, relevant for private equity investors, pass-through operating businesses (i.e., businesses conducted by partnerships and disregarded entities for U.S. federal income tax purposes).

For funds that invest in pass-through operating businesses, the Section 199A deduction is a valuable tax benefit for qualifying individuals (as well as certain trusts and estates) that participate in such investments unblocked (i.e., without the use of a corporate blocker between the investor and operating business) — namely, such investors may be entitled to deduct up to 20% of qualified business income generated by the operating business and flowing up to the investor.

Pre-OBBBA, Section 199A was set to expire at the end of the year, and the OBBBA expands and makes permanent this valuable tax benefit (although it does not increase the deduction to 23% as was contemplated in earlier versions of the bill).

Clean and Renewable Energy Incentives

The OBBBA has received considerable attention for its impact on the Biden-era clean and renewable energy tax credit framework established under the 2022 Inflation Reduction Act (IRA). While the OBBBA preserves the availability of certain clean energy incentives, it also accelerates the phaseout of others. In particular, the OBBBA shortens the window for new wind and solar projects to qualify for the federal tax incentives. The bill also introduces new Foreign Entity of Concern (FEOC) restrictions on project ownership, supply chains and tax credit buyers, and codifies long-term policy shifts that will impact renewable energy developers, tax equity investors, tax credit purchasers, lenders and manufacturers.

The OBBBA preserves a significant portion of the IRA's clean energy tax architecture, but imposes key limitations and new diligence obligations for developers, investors, lenders and credit buyers.

For discussion of the key renewable energy tax changes under the OBBBA and its impact on renewable energy developers, tax equity investors, tax credit purchasers, lenders and manufacturers, please see our July 11 client alert.

International Tax Provisions

Although outside the scope of this summary, the OBBBA made a number of changes or clarifications to the international tax regime, including: (1) making permanent current deduction rates for foreign-derived intangible income (FDDI, renamed "foreign-derived deduction eligible income") and global intangible low-taxed income (GILTI, renamed "net CFC tested income") that were scheduled to decrease[4]; (2) repealing a scheduled increase in rates that apply under the base erosion and anti-abuse tax (BEAT); (3) clarifying certain provisions under the GILTI regime to ensure the rules better incentivize onshore manufacturing as originally intended by the TCJA; and (4) enhancing benefits of inventory sourcing in the U.S., among other clarifications and refinements. In another welcome change, the OBBBA modifies certain attribution rules that had been in effect under the TCJA and that had previously greatly expanded the reach of the U.S. "controlled foreign corporation" regime.

All in all, the overall goal of the changes appears to be prioritizing U.S. investment and manufacturing. U.S. private equity funds making foreign investments and U.S. portfolio companies with foreign subsidiaries and sales outside the U.S. should carefully evaluate the impact of the revised rules when evaluating new investments.

Notable Proposals Not Included in the Final OBBBA

Carried Interest

The favorable capital gains treatment for "carried interest" (i.e., the share of profits of a partnership received by private equity fund sponsors) remains intact. Nevertheless, Section 1061, enacted as part of the TCJA and which generally requires a three-year holding period for carried interests issued to fund managers in order to receive the favorable capital gains treatment, still applies and will continue to be relevant for private equity fund sponsors.

'Revenge Tax'

The so-called "revenge tax" under proposed Section 899, which we previously covered in two separate alerts on June 16 (covering the version of the bill passed in the House, with a focus on relevant considerations for private funds) and June 18 (covering the version of the bill passed in the Senate), notably was left out of the final version of the bill signed into law by President Trump. Proposed Section 899, generally, would have imposed an additional tax, increasing 5% each year up to a cap of 20%, on certain U.S. source income earned by non-U.S. persons resident in "discriminatory" non-U.S. countries that impose an "unfair foreign tax." It was expected that most European Union member states, Australia, Canada, Japan and the United Kingdom, among others, would be considered to be discriminatory foreign jurisdictions.

However, proposed Section 899 was not included in the final version of the OBBBA, which is an overwhelmingly positive result for private equity funds with non-U.S. investors.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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1 Previous client alerts as part of our broader coverage of the OBBBA covered: on June 16 and June 18, proposed Section 899, left out of the final version of the bill and which would have, as proposed, imposed an additional 5-20% tax on certain types of income earned by non-U.S. individuals and entities in countries imposing an "unfair foreign tax" under the proposed legislation; on July 11, key energy provisions under the OBBBA, including the impact on developers, tax equity investors, tax credit purchasers, lenders and manufacturers in the broader tax credit market; on July 16, changes applicable to the rules for qualified small business stock, designed to further encourage investment in U.S.-based earlier-stage companies; and most recently, on July 18, the application of the OBBBA to REITs.

2 In addition, under the OBBBA, a taxpayer's allowable business interest deduction applies first to reduce the taxpayer's aggregate capitalized business interest, and any remainder reduces any noncapitalized business interest. This is a departure from pre-OBBBA law under the TCJA, which applied Section 163(j) after application of provisions that subject interest expense to disallowance, deferral, capitalization or other limitations under other Code sections.

3 The OBBBA also increases the current advanced manufacturing investment tax credit (also known as the "semiconductor credit" or the "CHIPS credit"), enacted under Section 48D as part of the 2022 CHIPS and Science Act, available to eligible taxpayers (generally, any taxpayer other than a foreign entity of concern, i.e., any foreign entity that is owned, controlled or subject to the jurisdiction of a government from a designated "covered nation", such as China, Russia, Iran or North Korea) for qualified investments in new buildings, facilities and other depreciable tangible property integral to the operation of a facility to manufacture semiconductors or semiconductor manufacturing equipment from 25% to 35% for property placed in service after December 31, 2025.

4 Although the legislation does eliminate the so-called QBAI deduction that had previously served to reduce the impact of the GILTI rules.