HISTORICAL RESTRUCTURING OR MARKET CORRECTION: CONSEQUENCES OF THE TAX CUTS AND JOBS ACT OF 2017 FOR THE PRIVATE EQUITY INDUSTRY

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I. INTRODUCTION 42
II. BACKGROUND 44
III. CORPORATE TAX RATE REDUCTION – I.R.C. § 11 47
IV. KKR CONVERSION AND IMPACT ON EFFECTIVE RATE 48
  A. *Blackstone and Carlyle Announce Conversions* 49
  B. *What to Look For* 50
V. THE LEVERAGED BUYOUT AND THE BUSINESS INTEREST EXPENSE DEDUCTION – I.R.C. § 163 51
  A. *The Leveraged Buyout (LBO)* 51
  B. *Business Interest Expense Deduction – I.R.C. § 163(j)* 52
  C. *What to Look For* 53
VI. CARRIED INTEREST – I.R.C. § 1061 53
  A. *Overview and Taxation* 53
  B. *Rationale and Debate Over Treatment* 55
  C. *Legislative Response – Tax Cuts and Jobs Act* 57
VII. CONCLUSION 58

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I. INTRODUCTION

The enactment of The Tax Cuts and Jobs Act of 2017 (the Act) sent shock waves through the American political and economic spheres. Many of the Act's reforms to the United States Internal Revenue Code (I.R.C.) fell under immediate scrutiny from various industries and individuals. One group that has taken a keen interest in the Act's potential impact on its future structures and operations is the private equity industry (the Industry). The Act's effect on the Industry's model has many of the major players converting their long-standing partnerships to corporations, hoping to open new avenues for investment.[1] The language of the act has left many outside parties concerned that the most notorious "loophole" continues to remain in effect.[2] Three areas predominately concern private equity firms: (1) the reduction in the federal corporate tax rate; (2) the limitations on the deduction of business interest; and (3) the lack of significant change in the treatment of carried interest.

Since the maturation of the modern private equity fund in the mid-twentieth century, the limited partnership (LP) structure has been the dominant choice when forming a fund.[3] In the LP structure, the private equity firm serves as the general partner (GP), managing the fund's capital investment. Traditionally, institutional investors and wealthy families serve as limited partners, providing the necessary capital.[4] In the months that followed the Act's enactment, three of the five largest private equity firms announced their intentions to transition away from the traditional LP structure.[5] The conversions of Kohlberg Kravis Roberts & Co. (KKR), the Blackstone Group Inc. (Blackstone), and the Carlyle Group (Carlyle) into full C-Corporations in 2018 and 2019 dominated the private equity news cycle.[6] One of the rationales cited for these conversions is the perceived reduction in the tax administrative

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1. *See* Josh White, *Blackstone Restructures as Corporation After TCJA*, INT'L TAX REV. (Apr. 18, 2019), https://www.internationaltaxreview.com/Article/3870036/Blackstone-restructures-as-corporation-after-TCJA.html?ArticleId=3870036; Rebecca Cooper, *Carlyle Group Changes Corporate Structure, Gives More Say to Investors*, WASH. BUS. J. (July 31, 2019, 10:03 AM), https://www.bizjournals.com/washington/news/2019/07/31/carlyle-group-changes-corporate-structure-gives.html; *see* Mark Vandevelde, *KKR Restructuring Shows Rivals How to Attract New Investors*, FIN. TIMES (Dec. 27, 2018), https://www.ft.com/content/2a3ef818-046f-11e9-99df-6183d3002ee1.

2. *See* Young Ran (Christine) Kim, *Carried Interest and Beyond: The Nature of Private Equity Investment and Its International Tax Implications*, 37 VA. TAX REV. 421, 423—24 (2018).

3. *See* David H. Hsu & Martin Kenney, *Organizing Venture Capital: The Rise and Demise of American Research & Development Corporation, 1946-1973*, 14 INDUS. & CORP. CHANGE 579, 605, 607 (2005); *see also* Steven N. Kaplan & Antoinette Schoar, *Private Equity Performance: Returns, Persistence, and Capital Flows*, 60 J. FIN. 1791, 1793 (2005).

4. *See* Kaplan & Schoar, *supra* note 3, at 1793.

5. *See* White, *supra* note 1; Cooper, *supra* note 1; Vandevedle, *supra* note 1.

6. *See* White, *supra* note 1; Cooper, *supra* note 1; Vandevedle, *supra* note 1.

and reporting burdens that comes along with a corporate structure, when compared to the time-consuming pass-through model applied to the traditional partnership. Such a transition is economically attainable through the entity level corporate rate cut.[7]

Since the introduction of the modern private equity fund, a driving force behind their success has been the use of leveraged buyouts.[8] The ability for firms to efficiently raise capital through high levels of debt borrowing has granted private equity funds the opportunity to take control of target companies without the requirement of ownership dilution.[9] One of the key drivers of this leveraged buyout strategy has been the firms' ability to deduct the interest expense that they owed to creditor(s) for the debt used to purchase the target entities.[10] The Act has placed a potential cap on the level of single tax-year deductions allowable for the business interest expense in an updated I.R.C. § 163(j).[11] If the firms cannot deduct the interest expense to the levels seen before, alongside the lower corporate tax rates reducing the value of those deductions per dollar, they may have to pull back on their current level of borrowing.

In the late 1980s and into the 1990s, the topic of carried interest came into the view of the academic world. The ability for fund managers to receive a profits interest for their services as a form of compensation, and yet be taxed on that income as if it is a return of capital (taxed at long-term capital gains rate of 20%), has been heavily debated.[12] The Act did not make a truly monumental shift in the treatment of this income item; however, it did extend the holding period requirement to three years to receive long-term capital gains treatment in the new I.R.C. § 1061.[13] Such a shift did not do much to appease the critics of the

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7. *See* White, *supra* note 1 (explaining how the lower tax rate provided by pass-through taxation of partnerships included the administrative burden of investors having to file "a 30-page form for the IRS each year"); Vandevedle, *supra* note 1 (discussing how the conversion will cause the entities themselves to have tax liability, but the 14% cut in the corporate allows for this transition to be feasible).

8. Steven N. Kaplan & Per Strömberg, *Leverage Buyouts and Private Equity*, 22 J. ECON. PERSP. 1, 4-5 (2008).

9. Stephen Fraidin & Meredith Foster, *The Evolution of Private Equity and the Change in the General Partner Compensation Terms in the 1980s*, 24 FORDHAM J. CORP. & FIN. L. 321, 327 (2019).

10. *See* William D. Cohan, *Why Private Equity Isn't Cheering the Tax Overhaul*, N.Y. TIMES (Jan. 19, 2018), https://www.nytimes.com/2018/01/19/business/dealbook/private-equity-tax-overhaul.html.

11. Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, § 13301, 131 Stat. 2054, 2117.

12. *Compare* Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. Rev. 1 (2008) (explaining how it is time for change in tax treatment of carried interest), *with* David A. Weisbach, *The Taxation of Carried Interests in Private Equity*, 94 Va. L. Rev. 715 (2008) (showing a belief that a change in the current tax law regarding carried interest would be faulty).

13. Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, § 13309, 131 Stat. 2054, 2130.

current treatment,[14] but it has made an impact on the consideration of fund managers across the Industry.[15] The Service's interpretation of when that holding period clock begins to toll will have a major impact on all fund structuring considerations.

This Article will discuss the impact of the three enacted reforms upon the Industry, with a focus on their significance to the publicly traded firms and funds in particular. First, this Article offers a brief background of the Industry as currently constructed and explores how the Industry expanded into the public markets. The sections following will navigate: (1) how the corporate rate cuts—and the conversions that followed—are a sign for what is to come in the public markets; (2) how the cap on business interest expense deductions could bring down the leveraged buyout market in a similar fashion to what was seen following the 1989 turn; and (3) how the extended holding period relating to carried interest will weigh heavily on the minds of fund managers in their structuring decisions.

II. BACKGROUND

Access to investment in what we now refer to as the Industry has always held an aura of exclusivity. Before the end of World War II, the barriers to entry were even greater than they are today. The most notable of the pre-modern exchanges is the quintessential example of an aristocratic transaction. In 1901, J. Pierpont Morgan's J.P. Morgan & Co. acquired the Carnegie Steel Corporation for four-hundred and eighty million dollars.[16] In this transaction, Morgan formed the largest company in history at that time: United States Steel.[17] These kinds of interactions, involving giants of American capitalism, dominated the Industry's landscape until the passage of the Glass-Steagall Act of 1933.[18]

It was not until 1946 that the first iterations of private equity firms, such as American Research and Development Corporation (ARDC), began to fill the void left by the Glass-Steagall's limitations on banks

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14. *See* Jessica Smith, *Democratic Lawmakers Move to Close Horrible Loophole in Tax Code*, YAHOO FIN. (Mar. 13, 2019), https://finance.yahoo.com/news/sen-tammy-baldwin-moves-to-close-horrible-loophole-in-tax-code-190339287.html.

15. *See* Barbara de Marigny et al., *Private Equity Funds Taxation Post-Tax Reform: What Really Changed?*, ORRICK HERRINGTON & SUTCLIFFE LLP (Jan. 31, 2018), https://www.orrick.com/Insights/2018/01/Private-Equity-Fund-Taxation-Post-Tax-Reform-What-Really-Changed#.

16. *See* John Steele Gordon, *A Short (Sometimes Profitable) History of Private Equity*, WALL ST. J. (Jan. 17, 2012, 5:51 PM), https://www.wsj.com/articles/SB10001424052970204468004577166850222785654.

17. *Id.*

18. *Id.* (finding that Glass-Steagall required merchant banks—like J.P. Morgan—to choose between being "a depository bank, and an investment bank, limiting the funds they had available" to complete the type of deals that created United State Steel).

participation in these transactions.[19] The significance of ARDC was in large part due to the fact it was the only "non-family firm[,]" and as such it had to raise capital from sources other than the wealthy families of the time.[20] Almost three decades later, a monumental shift occurred in what was to be included in these "other sources" of capital. The U.S. Labor Department's relaxation of restrictions in the Employee Retirement Income Security Act in 1979 allowed corporate pension funds to invest at higher rates in private equity.[21] This resulted in a major source of capital for private equity and other similarly situated investment models.[22]

In 1981, President Reagan signed the Economic Recovery Tax Act, lowering the capital gains rate from 28% to 20%.[23] This action helped advance what would be the first of the major booms in the Industry, pushed primarily by the highly leveraged buyout. For example, between "1979 and 1989 there were over 2,000 leveraged buyouts (LBOs) valued in excess of $250 billion."[24] From this boom in LBO transactions, a mass of major players in the Industry were formed and began to distinguish themselves. For example, it was during this time that both Blackstone and Carlyle came into existence.[25]

At the start of the 1990s, cracks in the buyout market began to appear. In 1991, "26 of the 83 largest [LBOs] completed between 1985 and 1989 had defaulted, and 18 had entered Chapter 11 bankruptcy."[26] These negative outcomes led to a reduction in the number of LBOs seen through the 1990s.[27]

Through the late 1990s and into the early 2000s there were cycles of booms and busts (e.g., the internet bubble), but by the mid-2000s the Industry was in an expansion.[28] Between 2000 and 2007, the Industry grew due to a combination of factors referred to by some as a "perfect

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19. *Id.*; *see also* Hsu & Kenney, *supra* note 3, at 6.

20. *See* Hsu & Kenney, *supra* note 3, at 4.

21. *See* Paul A. Gompers, *The Rise and Fall of Venture Capital*, 23 BUS. & ECON. HIST., Winter 1994, at 1, 2.

22. *Id.* at 12–13.

23. *See* Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 102, 95 Stat. 172, 186.

24. *See* Tim Opler & Sheridan Titman, *The Determinants of Leveraged Buyout Activity: Free Cash Flow vs. Financial Distress Costs*, 48 J. Fin. 1985, 1985 (1993).

25. *See* DAVID CAREY & JOHN E. MORRIS, KINGS OF CAPITAL: THE REMARKABLE RISE AND FALL AND RISE AGAINST OF STEVE SCHWARZMAN AND BLACKSTONE 44-56 (2010); David A. Vise, *Area Merchant Bank Firm Formed*, WASH. POST (Oct. 5, 1987), https://www.washingtonpost.com/archive/business/1987/10/05/area-merchant-banking-firm-formed/c567202c-e8ed-409a-8c08-d552e1857844/.

26. Viral V. Acharya et al., *Private Equity: Boom and Bust?*, 19 J. APPLIED CORP. FIN., Fall 2007, at 1, 4.

27. *Id.*

28. *Id.* at 1 (stating that in the U.S., "the number of transactions almost doubled between 2000 and 2005, while the value rose four times").

storm."[29] With the bursting of the internet bubble and the subsequent decline in the overall market, institutional investors turned to "'alternative' investments to make up for low yields in traditional assets classes."[30] The market trend and the low-cost of debt placed funds in an envious position, "they could borrow to finance acquisitions at relatively low cost, and expect to sell into a recovering stock market."[31] It was around this time that firms began to move into publicly traded markets. KKR entered the European markets in 2006.[32] In 2007 Blackstone following suit in the United States.[33] These moves have allowed the firms to open their funds to a broader investor base, and in the years since have produced well-rounded returns.

Outside of the firms discussed below, the modern private equity firm is organized as a partnership or a limited liability company under state law.[34] The firm will raise capital through a private equity fund most of which are "'closed-end' vehicles in which investors commit to provide certain amounts of money to pay for investments in the [target] companies."[35] The capital provided by investors will then be combined with debt financing with debt-to-equity ratios ranging from below 60%/40% to as high as 90%/10%.[36] The funds are organized as LPs, with the private equity firms serving as the fund's GP and receiving a management fee from the limited partners (i.e. the Investors).[37] The funds will usually have a fixed term of ten years.[38]

Regarding the previously mentioned public fund, there are three areas of focus concerning their tax positions as they currently stand: (1) applicable tax rates, (2) deductibility of business interest expense, and (3) tax treatment of carried interests. As mentioned above, the Act had varying levels of impact on each of these areas of concern, and the sections to follow will provide further detail on those impacts and how the Act's enactment started what could be a major restructuring of the public sector of the Industry. This comment will first look to the

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29. DONALD J. MARPLES, CONG. RES. SERV., RS22689, TAXATION OF HEDGE FUND AND PRIVATE EQUITY MANAGERS 2 (2014).

30. *Id.*

31. *Id.*

32. *See* Heather Timmons, *Opening Private Equity's Door, at Least a Crack, to Public Investors*, N.Y. TIMES (May 4, 2006), https://www.nytimes.com/2006/05/04/business/worldbusiness/04place.html.

33. *See* Jenny Anderson, *Blackstone Founders Prepare to Count Their Billions*, N.Y. TIMES (June 12, 2007), https://www.nytimes.com/2007/06/12/business/12blackstone.html.

34. *See* Kaplan & Strömberg, *supra* note 8, at 121, 123.; *see also* Fleischer, *supra* note 12, at 8-9.

35. Kaplan & Strömberg, *supra* note 8, at 123.

36. *Id.* at 124 (explaining further that if the private equity firm is buying a public company, the firm will pay a premium of 15% to 50% over the current stock price of the target company).

37. *Id.* at 123.

38. *Id.* (noting that the fund's life "can be extended for up to three additional years.").

corporate rate reduction and how KKR, Blackstone, and Carlyle's recent actions have impacted expectations for the market.

III. CORPORATE TAX RATE REDUCTION – I.R.C. § 11

Since the enactment and imposition of the federal corporate income tax in 1909, the rate and system of taxation have varied greatly.[39] The rate applied has ranged from as low as 1% on income over $5,000 in the initial year, to as high as 52.8% on earning over $25,000 in 1969 during the height of the Vietnam War.[40] When KKR was formed in 1978 the corporate rate applied to income earned above $50,000 was 48%.[41] The income would have been taxed twice, once at the corporate level and once at the shareholder level, had distributions been paid out by the firm from a corporate structure to an individual investor in the highest individual tax bracket; in effect, this would cause the taxpayer to see a tax liability on the distribution of over 70%.

To avoid such a harsh impact on the tax liability for their investors, firms would traditionally form their funds in a partnership or pass-through entity structure.[42] The partnership would pass-through the income and losses of the investment activity to the partners, and those items would keep the character of activity from which they arose.[43] As a fund "generally will derive most of its gains from securities held for more than one year," individual partners "will be subject to tax on their share of [the fund's] gains at favorable long-term capital gains rates."[44] The main rationales for why one would see a corporate entity within the fund structure would be for (1) a portfolio company in which the fund was investing, or (2) the blocker corporation in which tax-exempt entities, or non-U.S. based investors, would place their capital.[45]

One of the predominant areas of focus leading up to, and following the Act's enactment was the reduction in the tax rate applied to corporate entities operating within the United States.[46] The amended §

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39. IRS, CORPORATION INCOME TAX BRACKETS AND RATES 1909–2002 284-89 (2002), https://www.irs.gov/pub/irs-soi/02corate.pdf.

40. *Id.*

41. *See id.*

42. *See* Kaplan & Schoar, *supra* note 3, at 1793.

43. *See* MARPLES, *supra* note 29, at 2-3 (describing partnerships as "conduits of taxable income or loss and tax attributes to the individual partners").

44. PATRICK FENN & DAVID GOLDSTEIN, AKIN, GUMP, STRAUSS, HAUER & FELD, LLP, TAX CONSIDERATIONS IN STRUCTURING US-BASED PRIVATE EQUITY FUNDS 5 (2002), https://www.akingump.com/images/content/9/7/v4/974/376.pdf.

45. *See* MARPLES, *supra* note 29, at 3 (explaining that foreign and tax-exempt investors may prefer to invest in these non-US funds (through blocker corporations) to avoid creating a US tax presence or paying tax in the US on the fund's earnings).

46. *See* Willem Buiter & Anne Sibert, *The US Corporate Tax Cut Debate*, VOX (May 30, 2018), https://voxeu.org/article/us-corporate-tax-cut-debate; *see also* Danielle Kurtzleben, *FACT CHECK: Does the US Have the Highest Corporate Tax Rate In The World?*, NPR (Aug. 7, 2017, 10:09 AM),

11 of the I.R.C. implemented a flat 21% rate on taxable income of corporations.[47] This replaced a progressive rate system with a floor of 15% for taxable income below $50,000 to a maximum of 35% on every dollar of taxable income earned above $10 million.[48] It is uncertain how many of the currently open funds have engaged in due diligence related to the impact of the corporate rate reduction, but three of the biggest funds in the market have gone so far as to enact (or announce) corporate conversion.

IV. KKR Conversion and Impact on Effective Rate

On May 3, 2018, KKR announced that it was planning to convert to a corporation from its traditional partnership structure.[49] The firm believed that following the enactment of the Act, and the corporate rate reduction, that a corporate structure was an attractive opportunity.[50] The corporate rate reduction itself does not mean that the firm expected their tax liabilities to be lower through the conversion. On the contrary, KKR's CFO William Janetschek said during the July 9, 2018 "Investor Day" presentation that he expected the firm's tax rate to "go from 7% to roughly 20% over the next five years."[51]

With such a noticeable jump in the firm's tax liability, why make the change? The firm has proposed that the driving rationale behind the decision to convert was the push to make shares available to a broader spectrum of investors, especially institutional investors, who have thus far been prohibited from investing in the firm's publicly traded partnership.[52] Under the private model that many funds adhere to, the fund will avoid the registration and disclosure requirements that come with public offerings by relying on exemptions provided in U.S. securities law to make "private offerings."[53] For an investor to qualify they "must meet various income and asset thresholds" such as the accredited investor standard of "income of $200,000 or more in the past two years and at least $1 million in assets."[54] These requirements in the private market, and restrictions on having multiple classes of stock in

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https://www.npr.org/2017/08/07/541797699/fact-check-does-the-u-s-have-the-highest-corporate-tax-rate-in-the-world.

47. *See* I.R.C. § 11(b).

48. Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13221, 107 Stat. 312, 477.

49. Miriam Gottfried & Chris Cumming, *KKR to Ditch Partnership Structure and Become Corporation*, WALL ST. J., (May 3, 2018, 5:56 PM), https://www.wsj.com/articles/kkr-to-ditch-partnership-structure-and-become-corporation-1525344720.

50. *Id.*

51. Press Release, Craig Larson, Head of Inv'r Relations, KKR, KKR Investor Day 2018 (July 9, 2018), https://ir.kkr.com/app/uploads/2020/05/KKR-Investor-Day-2018-Transcript-vF.pdf.

52. *See* Gottfried & Cumming, *supra* note 49.

53. MARPLES, *supra* note 29, at 3.

54. *Id.*

the public markets, have placed barriers to entry for many investors (institutional and otherwise) to many funds such as KKR.

KKR will "trade a higher tax bill on profits for a public stock that should be easier for investors to own, and so it hopes, reach a higher valuation."[55] On July 2, 2018 KKR formally announced the successful conversion of its partnership into the newly formed KKR & Co. Inc. on the first of the month.[56] As of December 27, 2018, "more than [$1 billion] of KKR shares had been acquired by passively managed index funds."[57] As of the close of trading on October 25, 2019, the firm's share price was up more than 14%.[58] Additionally, in KKR's annual report (10-K) for the 2018 fiscal year, the company denoted a partial step-up in basis for certain assets due to the conversion, which resulted in an estimated net deferred tax asset of $257.1 million.[59] This conversion benefit, along with other traditional corporate deductions, allowed KKR to have an effective tax rate for operations in the 2018 fiscal year of -8.6%.[60] This is a strong result when compared to the company's effective tax rate of 8.06% in 2017.[61] However, this positive result may be short lived, as KKR believes that the effective tax rate is expected to rise significantly as the benefits of the partial step-up in basis are realized over the years.[62]

A. *Blackstone and Carlyle Announce Conversions*

At the time of KKR's announcement of anticipated conversion, both Blackstone and Carlyle expressed "caution," pointing to the anticipated loss in profits stemming from higher tax liability.[63] In a departure from their early cautionary stance, both Blackstone and Carlyle have since announced their own corporate conversion strategies.[64] Harkening to the same call that KKR championed, Blackstone founder Stephen Schwarzman said the decision to convert "will make it significantly

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55. Paul J. Davies, *KKR's New Pitch to Investors*, WALL ST. J., (May 3, 2018, 4:05PM), https://www.wsj.com/articles/kkrs-new-pitch-to-investors-1525377378.

56. Press Release, KKR, KKR Completes Conversion to a Corporation and Announces 2018 Investor Day (July 2, 2018) https://media.kkr.com/news-releases/news-release-details/kkr-completes-conversion-corporation-and-announces-2018-investor.

57. Mark Vandevelde, *KKR Restructuring Shows Rivals How to Attract New Investors*, FIN. TIMES (Dec. 27, 2018), https://www.ft.com/content/2a3ef818-046f-11e9-99df-6183d3002ee1.

58. *KKR & Co. Inc. (KKR) Stock Historical Data*, YAHOO! FINANCE, https://finance.yahoo.com/quote/KKR/history?period1=1530403200&period2=1572048000&interval=1d&filter=history&frequency=1d&includeAdjustedClose=true (last visited Feb. 19, 2021).

59. KKR & CO. INC., 2018 ANNUAL REPORT 99 (2019).

60. *Id.* at 209.

61. *Id.*

62. *Id.* at 121.

63. *See* Gottfried & Cumming, *supra* note 49.

64. *See* White, *supra* note 1; Cooper, *supra* note 1.

easier for both domestic and international investors to own our stock and should drive greater value for our shareholders over time."[65]

Another aspect of the conversion that Blackstone emphasized was the release from the administrative burdens placed on the limited partners for tracking and filing their own return in connection with the firm-provided K-1.[66] Because institutional investors are a driving force behind this change, and considering the lower corporate rates partnerships provide, it is noteworthy that many "institutional investors were loath to invest in MLPs because it would create more tax headaches."[67] Under the traditional partnership model, investors who did not invest in the foreign blocker corporation would receive K-1s with items such as effectively connected income and unrelated business taxable income.[68] Due to these items, direct investment was off limits to many institutional investors.[69]

Meanwhile, in an effort to take advantage of the lower rates and expand their investor base even further than their competitors, Carlyle announced in 2019 that they would be converting to a corporation with a single class of shares by January 1, 2020.[70] This action was "expected to pave the way for Carlyle's inclusion in indexes such as FTSE Russell's, which have minimum requirements for public-shareholder voting rights, and the S&P 500, which doesn't allow companies with more than one class of shares."[71]

B. *What to Look For*

The Act's corporate rate cut sent a signal to the Industry that an opportunity for expansion of the investor base was now in play. As it appears to be the large public funds that desire to achieve such an expansion, they have been the first movers into the realm of corporate structuring. However, outside of a few other well positioned public firms, the rise in the tax bill may be too large of a barrier to overcome. Even with the significant reduction in the marginal tax rate for revenue

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65. White, *supra* note 1.

66. *See id.*

67. *Id.*; SEC. EXCH. COMM'N., UPDATED INVESTOR BULLETIN: MASTER LIMITED PARTNERSHIPS – AN INTRODUCTION (2017), https://www.sec.gov/oiea/investor-alerts-bulletins/ib_mlpintro.html (explaining that an MLP is a Master Limited Partnership which is an "exchange-traded investments that are focused on exploration, development, mining, processing, or transportation of minerals or natural resources.").

68. *Reviewing Blackstone's Corporate Conversion and Dividend Policy*, SIMPLY SAFE DIVIDENDS (Apr. 18, 2019), https://www.simplysafedividends.com/intelligent-income/posts/2360-reviewing-blackstone-s-corporate-conversion-and-dividend-policy.

69. *Id.*

70. *See* Miriam Gottfried, *Carlyle to Abandon Partnership Structure and Dual-Class Shares*, WALL ST. J. (July 31, 2019, 6:30 AM), https://www.wsj.com/articles/carlyle-to-abandon-partnership-structure-and-dual-class-shares-11564569000.

71. *Id.*

earned in the corporate structure, the anticipated increase in the firm's effective rate over the next five to ten years would likely inflict too heavy of a burden on the firm for it to deliver expected returns to the investors. For those public firms that have the capital to spend, the enticement of a broadly expanded investor base may be enough to push them into the corporate form. But even those firms are likely to wade into the waters of corporate conversion only after a reasonable time has passed for proper evaluation of the first movers' expeditions.

V. THE LEVERAGED BUYOUT AND THE BUSINESS INTEREST EXPENSE DEDUCTION – I.R.C. § 163

A. *The Leveraged Buyout (LBO)*

One of the key engines driving the success of the Industry for the past forty plus years has been the LBO model. An LBO is "an acquisition of a company or division of another company financed with a substantial portion of borrowed funds."[72] Prior to the 1980s, the LBO was considered "little more than an obscure financing technique."[73] Around the turn of the decade, firms like KKR began to seize the opportunity to profit from undervalued corporate assets through a process known as a "bust-up."[74] Through this approach, firms would buy entire companies and then break up the assets and sell the pieces for more than the whole of the company was worth.[75] These actions helped perpetuate the public image of the Industry as being filled with "corporate raiders" and Gordon Gekko-type characters.[76] However, this public image did little to slow the exceedingly large rate of buyouts these firms completed over the decade.[77]

It was not until the crash of the junk bond market in 1989 that the public LBO market all but disappeared.[78] During the 1990s, the public-to-private transaction laid dormant, but there was still a market for private company LBOs from the 1990s and into the early 2000s.[79] In the years leading up to the recession, there was an influx of capital back into the LBO market.[80] This follows the noticeable pattern between buyout

72. Johnathan Olsen, Note on Leveraged Buyouts 1 (2002) (unpublished manuscript), http://pages.stern.nyu.edu/~igiddy/LBO_Note.pdf.
73. *Id.*
74. *Id.* at 2.
75. *Id.*
76. *Id.*
77. Kaplan & Strömberg, *supra* note 8, at 121–22.
78. *See generally id.* at 122 (discussing the history of LBOs from the 1980s through the early 2000s).
79. *Id.*
80. *Id.*

transaction activity and private equity fundraising. In general, "buyout transaction activity mirrors the patterns" seen in fundraising.[81]

B. *Business Interest Expense Deduction – I.R.C. § 163(j)*

As alluded to above, "the one common element of [an LBO] is the use of financial leverage (debt) to complete the acquisition of the target."[82] The Industry has thrived under this model as the "tax code allowed interest expense on the debt [raised for transactions] to be deducted from pretax income."[83] Said another way, "the amount of taxable income a business had in any given year could be reduced by the amount of interest expense the company paid to its creditors."[84] This financial leverage has had a profound impact on the Industry; for example, a reasonable estimate of the value of lower taxes due to the increased leverage for the 1980s would sit between 10% to 20% of firm values at the time.[85]

The enactment of the Act placed a limit on the total amount of business interest expense a corporation or partnership could deduct.[86] For a corporation, "the Act limits deductible interest to an amount equal to the corporation's interest income plus 30% of the corporation's earnings before reductions for interest, depreciation and amortization [(adjustable taxable income)] until 2022 and thereafter further restricts the deduction to 30% of earnings after depreciation and amortization."[87]

The disallowed interest expense from a current tax year will be subject to a carryforward and is potentially deductible in later years, subject to the same limitations.[88] Further, at the time of enactment, existing "debt obligations and related interest expense [were] not grandfathered in under the Act."[89] There are certain exceptions to the

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81. *Id.* at 7 (noting that the two items exhibit similar cyclicality as transaction value peaked in 1988 (before the junk bond crash), dropped in the early 1990s, and increased dramatically in the mid-2000s).

82. Olsen, *supra* note 72, at 2.

83. William D. Cohan, *Why Private Equity Isn't Cheering the Tax Overhaul*, N.Y. TIMES (Jan. 19, 2018), https://www.nytimes.com/2018/01/19/business/dealbook/private-equity-tax-overhaul.html; *see* Fraidin & Foster, *supra* note 9, at 335 (2019) (discussing how interest deductibility "benefits leveraged companies by allowing them to use pre-tax earnings to make interest payments, thereby reducing their total taxable income").

84. Cohan, *supra* note 83.

85. *See* Kaplan & Strömberg, *supra* note 8, at 134 (noting that these estimates would be lower for the 1990s and 2000s because both the corporate tax rate and the leverage used in LBOs declined).

86. Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, § 13301, 131 Stat. 2054, 2117-19.

87. Marigny et. al., *supra* note 15.

88. Sean Clancy et al., *Tax Reform's Impact on Private Equity*, NIXON PEABODY (Mar. 21, 2018), https://www.nixonpeabody.com/en/ideas/articles/2018/03/22/tax-reform-impact-on-private-equity.

89. *Id.*

limitation. For example, the limitation does not apply to a taxpayer whose average annual gross receipts for the three-year period ending with the prior tax year do not exceed $25 million.[90]

The limitation shall be applied to entities organized as partnerships at the partnership level.[91] Commentators have found that "to the extent that the cap limits an interest deduction [for a partnership], the excess interest expense is allocated to the partners and is not treated by the partnership as interest expense to be carried forward to the next year for the partnership."[92] Instead, the partner will treat this excess as additional deductible interest expense in the next taxable year where the partner is allocated excess "limitation from the partnership."[93] How this amendment impacts the partnership structure will be heavily scrutinized by the Industry in the years to come, particularly by the more prevalent non-public funds. However, for corporations, the reduced corporate tax rate will help alleviate some of these increased tax costs.[94]

C. *What to Look For*

A large portion of the recent expansion in funds has been through LBOs. Due to the amendments to I.R.C. § 163, these funds may want to consider alternative financing mechanisms such as preferred stock, or even a shift in debt from outside of the United States. The limit on deductibility of business interest expense could result in less debt being issued to finance LBO and other acquisitions within the Industry.[95] It will be of paramount importance to study debt issuance models in the years to come.

VI. CARRIED INTEREST – I.R.C. § 1061

A. *Overview and Taxation*

Traditionally, the fund managers (i.e. GPs) in the Industry have been compensated in two ways: (1) increased asset value in the investment and (2) fees paid by the investors (limited partners) in the fund.[96] The investors pay two fees, one based on the percentage of total

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90. Adam J. Tejeda & Frank W. Dworak, *Tax Issues for Private Equity: Private Equity Year-in-Review – A Lookback at 2017 and the Outlook for 2018*, NAT'L L. REV. (Mar. 12, 2018), https://www.natlawreview.com/article/tax-issues-private-equity-private-equity-funds-year-review-lookback-2017-and-outlook.

91. *See* Marigny et. al., *supra* note 15.

92. *Id.*

93. *Id.*

94. *See* Clancy et. al., *supra* note 88.

95. *Id.*

96. *See* MARPLES, supra note 29, at 4.

fund assets outstanding and another based on the fund's earnings percentage.[97] It is the latter fee that is referred to as the "promote," "carry," or "carried interest," and is the source of fervent debate between those inside and outside of the Industry.[98]

The standard formula for the two investor paid fees is "2 and 20."[99] This is because the "fund managers take 2% of the fund's assets each year as a management fee, and 20% of the total profits as a kind of performance bonus."[100] More specifically, the design of carried interest can vary throughout the Industry. In a 2008 piece for the National Tax Journal, Alan Viard stated that for firms performing LBOs, "a common arrangement requires that the rate of return on the fund's investment clear a hurdle rate of [18%] before the managers receive any carried interest."[101] The instant that the fund's rate of return clears the designated hurdle, the fund managers will have hit the "carry," and all returns from that point onward will be distributed 20% to the fund managers and 80% to the limited partners. The taxation of the fund manager's "carry" will vary greatly from that of the asset management fee.

The asset management fee is traditionally paid out in cash, and the fund manager will be taxed at their respective ordinary income rates.[102] On the other hand, carried interest is taxed at the capital gains rate when it is realized.[103] This tax treatment of carried interest "follows from the long-standing principle that the distributions of a partnership should be taxed the same as the underlying income—or that the income should retain its character."[104] "By taking . . . pay in the form of partnership profits, fund managers defer income derived from their labor efforts and convert it from ordinary income into long-term capital gain."[105]

When a GP receives a profits interest, such as a carried interest, in the partnership upon formation of the fund, the "difficulty of valuation and other considerations prevent the tax law from treating this receipt

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97. *Id.*

98. Fleischer, *supra* note 12, at 3.

99. MARPLES, *supra* note 29, at 4.

100. *Id.*; *see also* TAX POLICY CTR., TAX POLICY CENTER BRIEFING BOOK 197—98 (2016), https://www.taxpolicycenter.org/briefing-book/what-carried-interest-and-should-it-be-taxed-capital-gain (explaining that carried interest is compensation for the GP's investment management services)(last updated May 2020).

101. Alan D. Viard, *The Taxation of Carried Interest: Understanding the Issues*, 61 NAT'L TAX J. 445, 447 (2008).

102. MARPLES, *supra* note 29, at 4.

103. *Id.*; *see also* TAX POLICY CTR., *supra* note 100, at 197 (stating that the federal income tax rate for capital gains equals "23.8 percent (20 percent tax on net capital gains plus 3.8% on net investment income).").

104. MARPLES, *supra* note 29, at 5.

105. Fleischer, *supra* note 12, at 1; *see also* MARPLES, *supra* note 29, at 5 (explaining that tax payers "[prefer] to pay taxes in the future, rather than today because he or she can control the funds longer, use them in some other way, and benefit from the time value of money.").

as a taxable event."[106] Such an interest is one that gives the partner certain rights in the partnership (e.g., the right to receive profits generated by the partnership), but that has "no current liquidation value."[107] The IRS has provided a safe harbor qualifications for such partnership profit interests in Revenue Procedure 93-27.[108] If a fund were to liquidate immediately upon formation, the holder of the carried interest would receive no funds for their interest.[109] Any value the carried interest would have had at the time of formation is not related to a "substantially certain and predictable stream of income from partnership assets."[110]

For partnerships, payments to GPs are not characterized as "compensation," as the GPs are not just employees of the firm, but partners in the partnership (or members in the LLC).[111] Under I.R.C. § 707, "[s]o long as the payments are made to the partner in its capacity as a partner (and not as an employee) and is determined by reference to the income of the partnership . . . then the payment will be respected as a payout of a distributable share of partnership income rather than salary."[112] Therefore, the payment to the GPs as part of their holding carried interest will be treated as a return on investment capital, which in traditional funds normally gives rise to long-term capital gains.[113]

B. *Rationale and Debate Over Treatment*

The general rationale for paying carried interest is that it helps align the incentives of the GPs with the goals of the limited partners.[114] The term "carry" harkens back to the time when ship captains would share in the gains from selling cargo that they "carried" for merchants.[115] Carried interest "encouraged those captains to deliver profits for the merchants backing their voyages."[116] Similarly, as GPs can earn

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106. Fleischer, *supra* note 12, at 10 (citing to I.R.S. Notice 2005-43, 2005-1 C.B. 1221 (providing a liquidation value safe harbor for purposes of I.R.C. § 83 and, thus, helping to ensure that a profits interest is not taxed at the time of issuance)).

107. *Id.* at 11.

108. *Id.* (citing Rev. Proc. 93-27, 1993-2 C.B. 343) (finding that to qualify, the profits interest must not relate "to a substantially certain and predictable stream of income from partnership assets" and must be disposed of within two years of receipt)).

109. *See id.* at 12 (explaining how carried interest has no current liquidation value, as all the capital would be returned to the limited partners).

110. *Id.* (finding that the amount of carry is rather uncertain and unpredictable).

111. *Id.* at 14.

112. Fleischer, *supra* note 12, at 14-15 (referencing I.R.C. § 707(a), (c)).

113. *Id.* at 15.

114. *Id.* at 8.

115. DONALD MARRON, TAX POLICY CTR., GOLDILOCKS MEETS PRIVATE EQUITY: TAXING CARRIED INTEREST JUST RIGHT 1 (2016), https://www.taxpolicycenter.org/sites/default/files/alfresco/publication-pdfs/2000956-Goldilocks-Meets-Private-Equity-Taxing-Carried-Interest-Just-Right.pdf.

116. *Id*. at 1.

significant compensation for high fund performance, "fund managers are driven to work harder and earn profits for the partnership as a whole."[117] Further, GPs may have a few people working within the partnership; as a result, "a carried interest worth millions of dollars may be split among just a handful of individuals."[118]

However, there are those who disagree with the current treatment of carried interest. For example, some believe that it violates the economic principle of horizontal equity; thus, managers should be taxed in a similar manner to the traditional worker.[119] Others within the Industry believe that "[GPs] are more like entrepreneurs who start a new business;" thus, the GP should be able to treat their return as capital, not as wages and salary.[120] This return of capital concept is based on the belief that the GPs should be granted such a benefit for their contribution of "sweat equity."[121]

One of the most notable pieces against the treatment of carried interest is Victor Fleischer's *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*. Fleischer claims that "the status quo treatment of profits interest in a partnership is no longer a tenable position to take as a matter of sound tax policy."[122] Further, Fleischer explains that this "conversion of labor income into capital gain is contrary to the general approach" of the I.R.C.[123] Fleischer notes that if the GPs and the limited partners are taxed at the same rates, "the tax benefit" to the GP of a nontaxable event at receipt "is offset perfectly by the tax detriment to the [limited partners]."[124] This is seen as "substitute taxation" and would have little impact on the Service's revenue collection.[125] If the limited partners are tax-exempt, as is becoming more common in the Industry, then substitute taxation would no longer be applicable.[126] This leads to a frustration of the Service's revenue collection, and provides ample opportunity for creative tax planning.

117. Fleischer, *supra* note 12, at 8.

118. *Id.* at 9.

119. *See* MARPLES, *supra* note 29, at 5 (explaining that the fund managers provide labor to the fund the same as other workers provide to their employers, and as such should be taxed similarly as those who receive income/salary for performance of labor).

120. TAX POLICY CTR., *supra* note 100, at 197—98; *see also* MARRON, *supra* note 115, at 1 (explaining how carried interest is seen "as the reward managers get for developing new ventures, improving existing business, and creating business value").

121. TAX POLICY CTR., *supra* note 100, at 197-98.

122. Fleischer, *supra* note 12, at 59.

123. *Id.* at 4.

124. *Id.* at 13 (referencing the inability for the partnership, and thus the limited partners, to deduct for the value of what would be compensation awarded to the GP at the time of grant).

125. *Id.*

126. *Id.* (noting that many limited partners in private equity funds are tax exempt, "such as pension funds and university endowments").

C. *Legislative Response – Tax Cuts and Jobs Act*

The growing lack of applicability of substitute taxation between the fund's limited partners and GPs, and alleged horizontal inequities, have littered academic and editorial papers since the carry first made waves in the mid-2000s.[127] However, it appears this outside criticism has done little to sway the legislatures tasked with regulating the Industry and affiliated taxes.

Legislation has been proposed by members of Congress and the Treasury Department surrounding this matter,[128] but these proposals have not had the impact those calling for change desired. Following Donald Trump's election, debates formed around whether the legislation would "recharacterize all of the return paid to [GPs] in [funds] . . . as ordinary income" rather than capital gains.[129] Trump—candidate at the time—grew the Industry's concern when he claimed he intended to alter the taxation of carried interests.[130] However, the final language of the Act dispelled these concerns.

Under the new I.R.C. § 1061, "gains derived from an applicable partnership interest" will be treated as short-term capital gains, those relate to property that has a hold period of less than three years.[131] An applicable partnership interest, for the purposes of I.R.C. § 1061, is defined as "any interest in a partnership, which directly or indirectly, is transferred to (or is held by) the taxpayer in connection with the performance of substantial services by the taxpayer, or any other related person, in any applicable trade or business."[132] Further, § 1061(c)(2) explains that an applicable trade or business includes:

> [A]ny activity conducted on a regular, continuous, and substantial basis which, regardless of whether the activity is conduction in one or more entities, consists, in whole or in part, of –
>
> (A) raising or returning capital, and
>
> (B) either –
>
> (i) investing in (or disposing of) specified assets (or identifying specified assets for such investor or disposition), or

127. *See id.* at 13; MARRON, *supra* note 115, at 16; Viard, *supra* note 101, at 445.

128. *See* Fleischer, *supra* note 12, at 12; Viard, *supra* note 101, at 447; MARPLES, *supra* note 29, at 7–8.

129. Marigny et al., *supra* note 15.

130. *See* Smith, *supra* note 14.

131. Marigny et al., *supra* note 15 (denoting that such short-term capital gains will be taxed at ordinary income rates).

132. I.R.C. § 1061(c)(1); Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, § 13309, 131 Stat. 2054, 2130.

(ii) developing specified assets.[133]

These rules will generally be applicable to the profits interests provided to the fund's GPs.[134] Not only will they apply to profit interests issued post enactment, but those issued prior to January 1, 2018 will also be subject to these new constraints.[135] However, the overall impact of this change will not likely weigh heavily on the Industry, as the traditional investment horizon extends beyond the three-year holding period requirement.[136] As such, some commentators surrounding the Industry believe this action will actually continue to help support the goal of long-term investment within the Industry.[137]

The Act did provide exceptions to the above definition of applicable partnership interest. Of note, I.R.C. § 1061(c)(4)(A) states that any interest in a partnership directly or indirectly held by a corporation does not meet the Code's definition.[138] This could potentially provide another opportunity for firms to restructure their funds into the optimal corporate structure to take advantage of the holding period exception. Yet, "the IRS has signaled that it will issue guidance to clarify that the provision covers corporations as well."[139] This notice of pending guidance is likely to slow any movement on anticipated formation changes for those only changing for the holding period exception.

The predominant advantage provided by the tax treatment of carried interest for fund GPs, long-term capital gains treatment, weathered the legislative changes of the Act. As such, I am in agreement with Marigny et al. when they say the Act's carried interest changes will "not work a significant change on the tax profile of the recipients of carried interest in [funds]."[140]

VII. CONCLUSION

The Act had a resounding impact upon the financial lives of countless American businesses across a multitude of industries. The Industry was not left untouched by the broad sweeping changes. For the

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133. I.R.C. § 1061(c)(2); Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, § 13309, 131 Stat. 2054, 2130 (explaining further that specified assets are securities, commodities, real estate held for rental or investment, cash, options or derivative contracts, and an interest in a partnership to the extent of the partnership's interest in the foregoing).

134. Tejeda & Dworak, *supra* note 90.

135. *Id.* (explaining how the Act does not provide for any grandfather protections for those profits interests issues before enactment, but still held by the GPs post January 1, 2018).

136. *See* Kim, *supra* note 2, at 424 (citing JASON FACTOR & MEYER FEDIDA, CLEARY GOTTLIEB, TAX CUTS & JOBS ACT: CONSIDERATION FOR FUNDS (2018), https://www.clearygottlieb.com/~/media/organize-archive/cgsh/files/2017/publications/tax-cuts-and-jobs-act-2017/updates-1-2-18/tcja-summary—private-equity-jan-2.pdf.)

137. Cohan, *supra* note 83.

138. Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, § 13309, 131 Stat. 2054, 2130-31.

139. *See* Clancy et al., *supra* note 88.

140. Marigny et al., *supra* note 15.

public firms within the Industry, the reduction to a flat 21% federal corporate tax rate has provided a window into the possibilities of greater access to the public markets at large. Firms such as KKR, Blackstone, and Carlyle continue to lead the Industry with their early movement on corporation conversion. The benefits provided by access to a larger population of institutional investors, coupled with the reasonable reduction in the corporate rate have provided these firms the justification for such an audacious action. Look for additional public firms to track and emulate the early success of these and similar movers.

Another key area of focus for the Industry as a whole was the Act's limitation on the deductibility of business interest expense. The ability to deduct the interest incurred in connection with the significant amount of debt needed to complete a leverage buyout was a key to the logarithmic expansion of the Industry over the latter half of the 20th Century. The Act's cap upon the deduction of such interest will likely lead to a short coming in the buyout market over the foreseeable future. The 30% cap put in place by I.R.C. § 163(j), which will only become more restrictive in 2022, will likely lead firms to be more vigilant with the levels of leverage they extend in the buyout process.

Finally, since drafts of Victor Fleischer's *Two and Twenty* entered circulation in the early 2000s, carried interest has been a topic of great debate amongst academic and Industry participants alike. The tax benefits it provides to fund managers, such as long-term capital gains treatment, and the deferral of gains have helped lead the "carry" to be one of the most important drivers of firm success within the Industry. The commonalities between the payments made to these managers and traditional salary and wage payments have led many like Fleischer to call for changes to the model of taxation applied. However, the legislative changes that have been introduced since the publication of *Two and Twenty* have done little to change the treatment of this financial tool. The Act's extension of holding period requirements for carried (and other profits) interests to a full three years before beneficial tax treatment can be applied may have an impact upon hedge funds but will likely make little difference to the status quo of the Industry.

In the coming years we will be curious to see how these and similar changes impact the structure of the Industry, from fund formation to levels of leverage applied. These fascinating movements of a few public firms could be potential indicators of the future actions by the purely private players in the Industry.