Blackstone and Apollo Take the Sub C Plunge

By Donald P. Board • Wood LLP

Two more giant asset-management firms are switching their tax classification from publicly traded partnerships to corporations subject to Subchapter C. On April 18, 2019, Blackstone Group LP said it would check the box and start paying entity-level taxes in July. Apollo Global Management LLC followed suit on May 2.

Blackstone and Apollo are going down the path that KKR and Ares Management blazed about a year ago. [*See generally* Donald P. Board, *Why Are (Some) Publicly Traded Partnerships Electing to Be Taxed as C Corporation?* The M&A Tax Report 1 (Aug. 2018).] This leaves The Carlyle Group as the last of the big asset managers holding onto its status as a PTP.

The TCJA's 40-percent reduction in the corporate tax rate can take most of the credit. Of course, the new corporate rate (21 percent) is still no match for the zero-percent tax imposed on partnerships. So, why do these big PTPs believe that converting to Subchapter C will yield net economic benefits for their shareholders?

Sticking It to Demand

The shares of publicly traded asset-management firms taxed as partnerships are priced as much as 30 percent *below* what they would be going for if they had kept up with the market as a whole. Executives at the underperforming PTPs attribute this to the fact that partnership interests: (1) are ineligible for inclusion in the big stock indices; (2) cannot generally be held by mutual funds; and (3) scare off investors who do not want to deal with the reporting complexities that come with a Schedule K-1. This reduces investor demand for PTP shares, which supposedly depresses their market price.

Blackstone's announcement lifted its share price by about 10 percent. Apollo's price also spiked, but a month later it was trading for about 10 percent *less* than before the switch. This is similar to what happened to KKR and Ares, whose share prices initially increased, but have been way up and down over the past year. The executives say not to worry, the Subchapter C bonanza will be realized over the *long* term.

Marginal Tax Cost

Apollo estimates that operating as a C corporation will reduce its after-tax earnings by about nine percent. Why isn't the figure closer to 21 percent? That's the tax rate, after all.

The answer is that a good portion of the profits earned by the big PTPs were *already* being taxed under Subchapter C. To avoid having *all* its income taxed at corporate rates, a PTP must ensure that at least 90 percent of its income is "qualifying income" within the meaning of Code Sec. 7704(c). Passive income (*e.g.*, income from investing in stock and bonds) is fine, but income derived in the ordinary course of a trade or business does not qualify.

An asset manager's compensation consists of: (1) management fees, which are trade-or-business income; and (2) performance fees, which consist of dividends and capital gains from the manager's carried interests in the funds it manages. Performance fees are qualifying income, but management fees are not.

Hence, an asset-management PTP will arrange for the management fees to be run through a corporate subsidiary. This "blocker" sub has to pay tax on the fees, but this gets the non-qualifying income off the PTP's books. When the blocker distributes its after-tax income, it will be a harmless dividend to the PTP.

Because asset-management firms are *already* paying corporate tax on their management fees, electing into Subchapter C will affect only the treatment of their performance fees. If 80 percent of a PTP's income consists of management fees earned by taxable subsidiaries, converting to a C corporation will subject only the remaining 20 percent (the performance fees) to corporate tax. A 21-percent tax on 20 percent of the firm's income will reduce its after-tax income by only 4.2 percent.

Who's Going First?

The marginal cost of electing into Subchapter C depends on the composition of a PTP's two principal income streams. If a firm earns mostly management fees, the additional tax cost may be modest, as in the example above. But if most of the firm's income consists of performance fees, electing to be taxed as a corporation will be expensive.

Historically, Ares had the highest ratio of management fees to performance fees among the biggest firms. This meant that Ares faced the smallest tax impediment to conversion to a C corporation. Not surprisingly, this PTP was the first to check the box in 2018.

KKR was second out of the gate. That was slightly anomalous, because KKR's ratio of management fees to performance fees was a bit *less* than Apollo's. Perhaps the fact that Apollo took an extra year before converting can be chalked up to a deficiency of animal spirits.

Blackstone's conversion is more puzzling. It had by far the *lowest* ratio of management fees to performance fees, so it should have been the *last* firm to volunteer to pay corporate tax. But it edged out Apollo by two weeks and charged past The Carlyle Group, which is still languishing in tax-free Subchapter K.

Concluding Thought

It would be interesting to know what Apollo *et al.* have assumed about *future* corporate tax rates. If a new Congress hikes the corporate rate to, say, 28 percent, will any of these conversions still make sense? The four mega-firms that have opted into Subchapter C are pretty good with spreadsheets, so you can bet they've calculated the tax consequences to a fare-thee-well.

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