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The M&A Tax Report

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Why Are (Some) Publicly Traded Partnerships Electing to Be Taxed as C Corporations?

By Donald P. Board • Wood LLP

"Choice of entity" is hot again. The Tax Cuts and Jobs Act of 2017 [P.L. 115-97] slashed the top corporate rate to 21 percent, drastically reducing the tax cost of operating a large firm as a C corporation. At the same time, the TCJA adopted Code Sec. 199A, which lets some owners of passthrough entities deduct 20 percent of their "qualified business income."

Legions of tax planners are still working out the implications of these and many other statutory innovations. If you ask them to identify the "best" entity for doing business, they can agree on only one thing: It's complicated.

But some daring taxpayers have already charged ahead. The boldest so far is Ares Management, L.P., a publicly traded private-equity firm that has more than $110 billion in assets under management. On March 1, 2018, Ares defied decades of conventional wisdom by electing to convert from a (tax) partnership to a C corporation.

The last time we met Ares, it had just persuaded the IRS to let it deduct the giant sum it had paid to induce some target shareholders to approve a merger. [*See* Donald P. Board, *IRS Lets Investment Advisor Deduct $275 Million "Support Payment" to Target Shareholders*, THE M&A TAX REPORT 1 (Feb. 2018).] Ares laid out this huge pile of cash before it even *applied* for the ruling. So, maybe we should not be surprised that it was the first big partnership to take the Subchapter C plunge.

Fortune favors the brave, and NASDAQ rewarded Ares with a 14-percent bump in the price of its common units. The market's encouraging feedback reportedly convinced an even larger private equity firm to follow Ares' lead. On July 1, KKR & Co. L.P., which has

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about $175 billion under management, checked its own box to be taxed as a corporation.

The business press has been speculating about who may be next. A natural focus of attention has been Blackstone Group L.P., which leads the industry with almost half a *trillion* dollars under management. According to a widely followed analyst at Credit Suisse, converting Blackstone to a C corporation could increase its market valuation by 50 percent.

What is going on here? True, the TCJA has cut the corporate rate by 40 percent. But can that really make up for subjecting business profits to a second layer of tax? And if electing Subchapter C is no tax bonanza, why would anyone imagine that converting a partnership to a C corporation would send its market valuation shooting through the roof?

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Tax Calculus Post-TCJA

Let's start by considering how the TCJA taxes *ordinary* business income. When earned by a partnership, ordinary income is taxed to high-income individual partners at 37 percent. General partners are subject to another 3.8 percent in self-employment tax. Limited partners, including public investors in private equity firms, are exempt from this additional levy pursuant to Code Sec. 1402(a)(13).

Ordinary income earned by a C corporation, in contrast, is now subject to tax at only 21 percent. Dividends are still taxed to individuals at 23.8 percent, counting Code Sec. 1411(a)'s tax on net investment income. So, the overall federal tax burden on distributed corporate earnings works out to 39.8 percent.

That is a lot better than the 50.5-percent rate that prevailed when corporate income was taxed at 35 percent. But 39.8 percent is still more than the 37 percent that limited partners pay on ordinary income earned by a partnership.

Corporations can reduce the overall tax burden by postponing the payment of dividends. If a corporation can reinvest its after-tax profits in successful projects, they can compound subject only to the 21-percent entity-level tax. If the corporation and its shareholders wait long enough, they can bring the overall tax on *distributed* profits down to much less than 37 percent.

When it comes to *capital gains*, on the other hand, converting from a partnership to a C corporation is a nonstarter. A corporation's distributed capital gains are taxed at an overall rate of 39.8 percent, just like its ordinary income. But even if we allow for substantial deferral, the overall corporate rate cannot compete with the 23.9-percent rate that applies to capital gains passed through to individual members of a partnership.

Ares and KKR are professional asset managers, so they hold carried interests in numerous investment partnerships. In good times, these carried interests generate large amounts of capital gain. Electing Subchapter C will *increase* the overall tax on those gains.

To understand why these firms still decided to flip—and why some others probably will *not*—we need to consider two more factors. The first is the particular composition of Ares' and KKR's income-streams, which will determine *how big* a tax increase they have signed up for. The second is the possibility that electing Subchapter C will provide *non-tax* benefits that outweigh the adverse tax consequences.

Publicly Traded Partnerships

Historically, most limited partnerships with publicly traded units have been concentrated in the natural-resources sector. However, over the last decade or so, a number of big private equity firms have gotten in on the act. Ares, KKR, Blackstone, The Carlyle Group, and Apollo Global Management have all found ways to operate as public companies while continuing to be taxed as partnerships.

This is not easy to do. Under Code Sec. 7704(b), any partnership whose interests are traded on an established securities market is a "publicly traded partnership." If a partnership is a PTP, Code Sec. 7704(a) treats it as a corporation for tax purposes. PTPs are therefore subject to the corporate income tax imposed by Code Sec. 11.

But there is an important exception. A PTP will *not* be treated as a corporation if at least 90 percent of its income is "qualifying income" described in Code Sec. 7704(c). Qualifying income includes most forms of passive income, including interest, dividends, and capital gains from sales of stocks and bonds. Income derived in the ordinary course of a trade or business does *not* qualify.

Like other PTPs, Ares and KKR relied on the qualifying income exception to avoid being taxed as corporations. Thanks to their carried interests, a major portion of their income consisted of dividends and capital gains. These "performance fees" counted as qualifying income under Code Sec. 7704(c).

These firms also earn substantial "management fees," which does *not* constitute qualifying income. To pass the 90-percent test, an asset-management PTP will want to get this "bad" income off its books. This is done by running the management fees through blocker corporations owned by the PTP. Fees that were earned as trade-or-business income emerge as qualifying dividends.

The blockers are C corporations engaged in a U.S. trade or business, so their management-fee income attracts corporate tax. This means that a significant portion of an asset-management PTP's income is *already* subject to double taxation. The tax cost of converting an asset-management PTP to a C corporation will therefore be *less* than the cost of converting a comparable private partnership. The private partnership will have had no reason to put taxable blockers in place.

Interfirm Comparisons

The tax cost of conversion will also vary *among* asset-management PTPs. The key variable is the proportion of their income that is already subject to corporate tax. The higher the ratio of a firm's management fees to its performance fees, the cheaper it will be to elect into Subchapter C. This helps to explain why Ares was the first firm to convert, and why Blackstone may never do so.

As Table 1 (2017 data) indicates, Ares' ratio of management fees to performance fees (1.14) was by far the highest in the group. Ares therefore faced the *smallest* tax cost of becoming a C corporation. Conversion subjected its performance fees to corporate tax, but these were a (relatively) modest 46.8 percent of the total.

Blackstone, on the other hand, has the *lowest* ratio (0.47), so it faces the *highest* cost of conversion. Electing into Subchapter C would subject an additional 68.2 percent of its fee income to corporate tax. Other things being equal, Blackstone should be the firm *least* willing to make the switch.

TABLE 1.

	Management Fees (taxed to blocker corporation)	Performance Fees (passed through to partners)	Ratio (mgt./perf.)
Ares	53.2%	46.8%	1.14
Apollo	46.3%	53.7%	0.86
KKR	44.5%	55.5%	0.80
Carlyle	32.9%	67.1%	0.49
Blackstone	31.8%	68.2%	0.47

KKR's decision to convert is interesting because its ratio of management fees to performance fees (0.80) is actually a bit less than Apollo's (0.86). If any firm is going to make the next move, it should be Apollo. Carlyle (0.49) is in the basement with Blackstone, so it seems relatively unlikely to convert.

Market Factors

But the basic question remains. Why would *any* of these firms—even Ares—want to convert if doing so is going to increase the overall tax burden on its earnings?

Managers of publicly traded private equity firms care about taxes, but they care even more about the market price of their companies' units or shares. Over the years, the performance of asset-management PTPs has lagged behind the market as a whole. The performance gap between asset-management PTPs and other publicly traded financial firms has been even worse.

The most popular explanation—certainly among managers of PTPs—is that the market systematically undervalues asset-management PTPs *because* they are taxed as partnerships. Yes, partnership status saves taxes. But there is also reason to suspect that it reduces investors' demand for the firm's units. Tax efficiency is nice, but the overall effect (they claim) is to *depress* the market value of the firm.

When Ares announced its conversion, it pointed to a variety of ways its new corporate status could make its shares more popular. To begin with, investors would no longer have to worry about getting stuck with unrelated business taxable income or income effectively connected with a U.S. trade or business. That would make Ares' shares a more tempting investment for tax-exempt and foreign investors, who are generally allergic to UBTI and ECI.

Ares and KKR both observed that partnership status imposes special reporting burdens on investors. Partners have to deal not only with the complexities of Schedule K-1, but also with the annoying task of filing multiple state tax returns. Converting to a C corporation eliminates these hassles. All things being equal, this should increase demand for the PTP's shares.

A third and more substantial consideration is the fact that institutional investors are frequently prohibited from investing in firms taxed as partnerships. Electing Subchapter C takes care of that. It also makes the PTP's shares eligible for inclusion in popular indices and retail investment products.

It makes sense that expanding a PTP's investor base would increase demand for its shares. The question is whether increased demand will push the stock price higher *despite* the tax inefficiency of operating as a C corporation. Ares and KKR both enjoyed at least temporary jumps in their market value after announcing their plans to convert.

Will conversion translate into long-term increases in these firms' stock prices? As usual, only time will tell. In the meantime, don't bet on Blackstone to beat Apollo in the C Corporation Sweepstakes.