INSIGHT: What Middle-Market Private Equity Funds Should Know About C-Corp Conversions

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Dec. 19, 2019, 9:00 AM

Since the enactment of the 2017 tax law, some large private equity funds have converted from publicly traded partnerships to C corporations. Jeremy Swan, Jonathan R. Collett, and Robert Richardt of CohnReznick LLP look that whether conversion makes sense for middle-market funds.

After the Tax Cuts and Jobs Act (TCJA) was enacted, two large private equity (PE) funds previously structured as publicly traded partnerships (PTPs) converted to C corporations—Ares Management Corp. and KKR & Co. Inc. Later, other PTPs joined these early converters, namely Apollo Global Management Inc., Blackstone Group Inc., and Carlyle Group. With these conversions, some middle-market PE funds have asked themselves if it would make sense for them to convert to C corporations. Of course, there isn't one right answer for a whole class of PE funds, yet there are benefits and drawbacks that middle-market PE funds should factor in if they contemplate the change.

Big Partnerships Add up Conversion Benefits

Before the TCJA, C-corps were not an attractive structure as an investment vehicle because of the prospect of double taxation—a 35% tax rate at the corporate level plus a potential 20% tax rate or long-term capital gains rate on dividends paid to investors. In addition to the federal rates, there are two layers of state taxation. But when the TCJA cut the 35% tax rate to 21%, the gap between tax on pass-throughs and C-corps narrowed, though a slight advantage still went to partnerships.

The lower corporate tax rate prompted PTPs to re-evaluate their structure. A corporate structure allows for a larger investor base, as many investors are averse to some tax issues associated with a partnership structure, such as effectively connected income (ECI), unrelated business taxable income (UBTI), and multiple state filings. In addition, the tax compliance and reporting for C corporations is much easier, because investors will simply get a Form 1099, as opposed to dealing with the often onerous and complicated process of Schedule K-1 reporting.

Finally, and most importantly, PTPs considered the types of investors—mutual funds, index funds, and institutional investors—that are unwilling to invest in partnerships. So, conversion would broaden their investor base, which may have a positive impact on stock prices.

Translating Benefits to Middle-Market Funds

The benefits to these large PTPs don't all translate to middle-market funds, which are private partnerships. For PTPs, conversion can attract big institutional investors and may boost their stock price, but for middle-market funds, conversion may not necessarily increase the value of the fund.

While most middle-market PE funds have not converted to a corporate structure, conversion can offer benefits to middle-market funds. C-corp conversions have been popular for real estate debt funds, which have converted from a partnership to a real estate investment trust (REIT) to take advantage of the special 20% pass-through deduction for noncorporate REIT shareholders. For these taxpayers, the maximum federal tax rate is reduced from 37% on interest income to 29.6% on REIT dividends. REITs are structured as C corporations but do not have double taxation on their earnings to the extent the earnings are distributed to their shareholders.

In addition, as discussed above, a corporate structure blocks ECI and UBTI, and provides for 1099 reporting to investors as opposed to Schedule K-1 reporting.

Nevertheless, the majority of middle-market PE funds have stayed with a partnership structure because of the flexibility. They generally have a lower tax rate than they would with a corporate structure because of the double taxation previously discussed (especially if the fund generates long-term capital gains). They don't have to worry about public markets. And in a partnership structure, general partners can benefit from capital gains rates on the carried interest if the required holding period is met.

In addition, the conversion process could be expensive because the funds would have to incorporate and revise all their documents, agreements, and incentive compensation. If the investors who control the corporation change after the conversion, a taxable transaction could result.

A corporate structure provides less flexibility than a partnership because the former cannot be liquidated or unwound without creating a taxable event. Let's say there were appreciated positions inside the C-corp at the point of liquidation. First, you would have to pay tax at the C-corp level; then you would potentially pay another level of tax on the liquidation distribution to investors. While the 21% federal corporate tax rate does not sunset, it is possible the rate could be increased through future legislation. Considering the uncertainty of the 2020 elections, this is a possibility that must be considered. If the federal corporate tax rate were to increase in the coming years, it would likely make the structure less appealing, and the options will be very limiting if the fund has appreciated positions and you cannot liquidate the corporation without creating a tax liability.

Analyze the Situation From All Angles

In thinking about the merits of conversion, middle-market partnerships should first map out the tax benefits and costs, as well as the consequences, such as the tax benefits they would lose.

Next, look at who your investors are. Analyzing the tax benefits for different types of investors will shine a light on which way your investors would want to go. We advise partnerships to look from the perspective of their investor groups. For example, is conversion good for tax-exempt investors? What would be the disadvantages if they invested in a C-corp? If there's tremendous tax detriment to investors, they may not invest.

Third, assess the types of investment the fund has been making. Maybe those types would lend themselves more to a partnership or a C-corp structure. If a fund invests in, say, securities and will generate long-term capital gain, it is likely advantageous for taxable investors to be in a partnership structure at a 20% rate. In a corporate structure, the rate would more than double, with the 21% corporate rate and the additional 20% tax at the individual level on either a dividend or exit from the corporation.

Fourth, explore how general partners will be compensated. Could becoming a C-corp shareholder present a significant tax detriment to the general partners? Could they lose capital gains rates by doing this?

Finally, the crux of this analysis is weighing the tax benefits against the nontax benefits. Although you may conclude that a conversion makes perfect tax sense, the change still may not work because of nontax issues. Those nontax benefits are in the domain of investment managers, who will look at the C-corp structure from an operational perspective and consider critical related questions. What effect would being a C-corp have on bottom-line returns? How would it affect fundraising? Would it help attract new investors?

After a handful of PTPs have converted to C-corps, the long-term results remain to be seen. Although because of the reasons stated, most middle-market funds are not converting, those that are still considering the change should conduct a thorough analysis. Examining all the benefits and drawbacks, as well as their investors and investments, is a good place to start.

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