Private Equity Firms Are Converting to Corps, Sort Of

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By Eric Yauch

More private equity firms are converting to corporations, but that doesn't mean the partnership structure isn't alive and well in those businesses.

In fact, recent moves by major private equity partnerships KKR & Co. LLP, Ares Management LLP, and the Blackstone Group in converting to corporations suggest that marrying the two structures creates more flexibility for both fund managers and their investors.

The Carlyle Group LP has publicly stated that it's considering joining the above major private equity firms in converting from a partnership to a corporation, a move not entirely based on the tax benefits but nudged forward by the Tax Cuts and Jobs Act's lower corporate tax rate of 21 percent.

"Tax reform made these conversions more palatable, but it's not necessarily something that's happening solely because of tax reform," Adam Kool of Kirkland & Ellis LLP told *Tax Notes*. "The real drivers of these decisions tend to be much more specific to publicly traded asset management companies."

Kool said one major benefit for an asset management company making the conversion is being included in major stock indices, which are typically limited to corporations. Some institutional investors couldn't invest in asset management companies organized as partnerships, Kool said, but in many cases they could if those companies were corporations.

By investing in a partnership, institutional investors that are treated as tax exempt could be stuck with prohibited income that they aren't typically allowed to receive because it flows through the partnership directly to the partners. And if the partnership operates in several states, the partners could be forced to file dozens of state returns.

Private equity asset management companies can avoid those headaches by converting to a corporation, but that's only one small piece of the overall business structure for a business, and the compensation of asset managers will largely remain intact.

"In the fund context, a conversion of the parent management company doesn't change the underlying fund structure, which utilizes partnerships," said Steven R. Schneider of Baker McKenzie LLP.

Schneider said partnerships are key in incentivizing managers. He added that items like carried interest using partnership interests will continue to play a role in compensation for funds.

An organizational chart of KKR after it incorporated shows that passthroughs still dominate the company structure.

Private equity managers are typically paid a fee amounting to 2 percent of the assets under management, which is treated as ordinary income, and a 20 percent carried interest that's typically taxed at lower capital gain rates.

The asset management companies that operated as partnerships received the 2 percent fee, and it flowed up to the individual partners, who could pay a top rate of 37 percent. By organizing as a corporation, that fee may be subject to two levels of taxation, but with the corporate rate at 21 percent, the difference is minuscule.

Second Bite at the Apple

Although the managers may change the tax classification of an entity that receives the management fee, they're still getting a carried interest. The carried interest could come from a fund organized as a partnership and would be received by the general partner of that partnership, which is likely also a partnership.

Investors in the fund partnership may come in through a separate partnership, sometimes referred to as a feeder or alternative investment vehicle, and the operating partnership may invest in portfolio companies that are also partnerships.

In short, partnerships still play a huge role in private equity firms even after the asset management company converts to a corporation.

And while the conversion may not be driven entirely by the corporate tax rate, there are partnership tax advantages at play.

In March the IRS issued a private letter ruling (LTR 201906002) on the tax benefits of a corporate conversion, based on a request sent in October 2018. The letter ruling shows a web of partnerships typical in a private equity structure, and the IRS blessed a basis increase under section 743(b) that's amortizable under section 197(a).

A section 743(b) adjustment allows a purchaser of a partnership interest to adjust the inside basis of partnership items to cure disparities in the partner's outside basis and the partnership's inside basis of items, as long as the partnership has made a section 754 election.

Seeking Input

The company wanted the IRS's assurance that the historical owners could cash out of the old partnership and that the newly-formed corporation could receive tax benefits for purchasing the interests by deducting a portion of the price over several years, according to Glenn Dance of Holthouse Carlin & Van Trigt LLP. The amortizable step-up would also occur if there were public purchases of the units.

Dance said an amortizable basis step-up was already occurring when existing corporate subsidiaries of the publicly traded partnership acquired interests from the historical owners, but some of the publicly traded partnership subsidiaries weren't corporations, so they didn't seek to obtain a basis adjustment to their assets when they acquired the old partnership interests from historical owners.

But when those subsidiaries converted to corporate status, another sale or exchange of the interests in the operating partnerships was considered to have occurred.

Dance said the takeaway is that when an owner wants to monetize their investment in the historical business, their partnership distributes interests in each historical operating partnership, and that person then sells the interest in the operating partnership to the subsidiary of the public corporation that was just created.

Each sale would generate a section 743(b) adjustment opportunity.

"However, not all of the operating partnerships have historically made [section] 754 elections — generally just the ones owned by corporate subsidiaries of the public company," Dance said. "As part of the incorporation transaction, however, those partnerships have a second bite at the apple, and will generally be motivated to make the election to allow newly formed corporate entities to harvest the latent basis adjustments."