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Client Alert
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Ares Checked the Box–Should I?
Entity Choice After Tax Reform

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Ares Management LP ("Ares") is a publicly traded investment firm that until now has been structured as a "publicly traded partnership" ("PTP"). Specifically, Ares is a Delaware limited partnership that has historically avoided being taxed as a corporation by meeting the 90% "qualifying income" exception for PTPs under Section 7704(c) of the Internal Revenue Code of 1986, as amended (the "Code"). Under the Code, a publicly traded entity is taxed as a corporation unless it meets one of a number of exceptions. In the case of Ares and other similarly situated money managers, the 90% qualifying income exception is probably the only relevant one. For these purposes, "qualifying income" includes dividends, interest, capital gains, certain income related to natural resources and other categories of investment income. Meeting the exception allows these firms to avoid being classified as a C corporation and the entity-level taxes that would result from that classification.

The recent U.S. tax reform legislation, commonly referred to as the Tax Cuts and Jobs Act (the "Act") reduced the corporate tax rate from 35% to 21% among a host of other changes. This change, when considered together with the fact that the preferential capital gains and qualified dividend rates were not modified, has caused U.S. business owners to re-evaluate whether the pass-through structure (to this point the most common among privately held entities and businesses) is truly the most advantageous tax structure for them. On February 15, 2018, Ares issued a press release announcing that, effective March 1, 2018, it has elected to be taxed as a corporation for U.S. federal income tax purposes.[i] Ares executives cited several factors supporting their decision to "incorporate."[ii] In particular, the CFO stated that the election "will simplify our structure, broaden our potential investor base, improve our liquidity and trading volume and provide a more attractive currency for strategic acquisitions."[iii] Eligibility for inclusion in the S&P 500 is itself an important factor, as is the elimination of the complexity of K-1 reporting (which will now be replaced with the more common 1099-DIV reporting to public shareholders). Certain categories of foreign investors who typically avoid investments in flow-through structures may also now consider an investment in Ares. Initial market reaction was overwhelmingly positive, with the trading price of Ares common units jumping over 14% following the announcement.

Not surprisingly, several of the other prominent fund managers have also stated that they are considering a similar move.[iv] The decision calculus facing these private equity sponsors involves numerous factors that are unique to the alternative fund manager business as well as the public equity capital markets. These factors include (1) the composition of the firm's income, and more specifically how much its revenue is in the form of management fees (which are taxed at ordinary income rates or are "blocked" by subsidiary C corporations owned by the PTP) versus more traditional carried interest (which is often long term capital gain or dividend income taxed at favorable rates); (2) the desirability of inclusion in stock indices; and (3) the extent to which management believes the equity of the PTP is undervalued. Ares could be somewhat *sui generis* in that a large percentage of its income consists of management fees that were already being subject to corporate tax. It remains to be seen whether Ares' peer firms will follow suit.

The underlying tax analysis, however, is not unique to businesses like Ares and its peers. Many privately held businesses, including the privately placed fund vehicles sponsored by these investment firms themselves, should at a minimum be reconsidering and reviewing the optimal entity choice in light of the tax reform changes. For private equity funds in the buyout or LBO space, even if the fund vehicles themselves continue to be organized legally as partnerships (or other entities taxed on a pass-through basis, such as LLCs) the choice of entity decision remains highly relevant when establishing the acquisition vehicles used to acquire particular portfolio companies. Closely held businesses currently operating in S corporation form will likely need to re-examine whether a C corporation structure is preferable to an S corporation with all its attendant restrictions and complexities.[v] This discussion will briefly describe some of the salient features of these analyses, and will necessarily make numerous assumptions that enable "apples to apples" comparisons.

As with many other business decisions, the determination of the optimal entity choice involves a balancing of numerous factors, many of which interact with each other in known and unknown ways. Accordingly, it presents an enormous challenge to comprehensively outline the list of relevant considerations, or to construct a foolproof "decision tree." Yet, there are a number of observations that are critical to any such determination.

Prior to the Act, business income earned through pass-through entities was subject to a maximum aggregate federal tax rate of 43.4% (39.6% top federal rate plus a 3.8% marginal Medicare tax rate imposed by the self-employment tax regime under Section 1402 or the "Net Investment Income" ("NII") tax under Section 1411[vi]). Business income earned through C corporations was subject to a maximum aggregate tax rate of 50.5% (35% corporate tax rate, plus a 20% income tax and 3.8% NII tax on dividends). This 7.1% differential ignores state taxes (which, under pre-Act law, were generally deductible for federal income tax purposes by both corporate and individual taxpayers).

In addition to the reduced 21% corporate tax rate, the Act has introduced a number of other changes that impact the above analysis.

- First, the top individual tax rate on ordinary income has been reduced from 39.6% to 37%.
- Second, under Section 199A, individuals can claim a new 20% deduction with respect to "qualified business income" earned directly or indirectly through pass-through entities (the "QBI deduction").[vii] The QBI deduction does not apply to compensation or compensation-like payments, and for higher income taxpayers is subject to complex limitations based on the business's Form W-2 wages paid and investment in depreciable property. As a result of these limitations, the ability to enjoy the full benefit of the 20% deduction under Section 199A remains uncertain. Therefore, any modeling of the benefit must reflect these limitations and related uncertainties.
- Third, individuals are now subject to a $10,000 cap on the deductibility of all state and local income taxes as well as property taxes that are not attributable to investment or business activity. Corporate taxpayers continue to be eligible to fully deduct state and local taxes.

Painting with an admittedly overbroad brush, the effective tax rate landscape now looks something like this. The maximum aggregate effective tax rate on distributed C corporation income is 39.8% (21% at the corporate level and 23.8% on the distributed after-tax earnings). For business income earned through pass-through entities, the result falls somewhere between 33.4% (where the QBI deduction is fully available, resulting in an effective income tax rate of 29.6%, and adding the 3.8% Medicare tax) and 40.8% (where the QBI deduction is inapplicable).

Aggregate U.S. Federal Income Tax Rate on Domestic Business Income (incl. 3.8% Medicare Tax)		
	Pre-Act	Post-Act
C corporation	50.5%	39.8%
Flow-Through Entity	43.4%	33.4% - 40.8%

The above very simplified numerical illustration demonstrates that taxpayers must carefully model and analyze their ability to claim the QBI deduction. The availability of the deduction would be a critical factor in the determination of whether a C corporation or pass-through structure is more tax-efficient for a given business.

The QBI deduction is capped based on two alternative tests. Specifically, it may not exceed (A) 50% of the W-2 wages paid to employees or (B) 25% of the W-2 wages plus 2.5% of the acquisition cost of depreciable tangible property used in the business (which does not include land or inventory property, for example).[viii] For purposes of these limitations, payments to independent contractors are not wage payments. Furthermore, the base on which the 2.5% limitation is computed is not reduced for depreciation deductions. Accordingly, businesses with small payrolls (i.e., those that contract out a lot of the services required to run the business or manage its properties) may still derive substantial benefit from the QBI deduction if they have significant capital investment. As an illustration, even assuming zero wages, a business that earns as much as a 12.5% return on its invested capital would be able to fully utilize the 20% QBI deduction.[ix]

Some businesses are considering engaging service providers as employees in order to increase the wage-based cap. However, this strategy is not without its costs, which primarily take the form of payroll taxes as well as costs associated with structuring around any “dual status” issues that may result from turning partners into employees. The asset-based limitation is certainly a boon to the real estate industry, where there are many businesses with small payrolls as a proportion of rental income. When it comes to real estate, it is important to note that ordinary dividends from a REIT are eligible for a 20% deduction under Section 199A without regard to the wage and asset limitation, so “REIT-able” real estate businesses can utilize a structure that avoids the QBI deduction limitations completely.

Not surprisingly, the analysis hardly ends with a determination of how the QBI deduction will apply. The numerical comparisons outlined above assume that the income earned by the C corporation is distributed to the business owners. For businesses that will reinvest earnings, the corporate structure may be of increased appeal in comparison to a pass-through structure because the earnings will only have been subject to a 21% federal tax rate.[x] In addition, the QBI deduction (as well as the reduced 37% top ordinary income tax rate) is scheduled to expire at the end of 2025. If the QBI deduction is left to expire, then the C corporation rate may end up lower than the pass-through rate in all events, even on distributed income. As highlighted by the Ares analysis, taxpayers may prefer the relative simplicity of corporate tax reporting as compared to dealing with Forms K-1 and potentially complex operating agreements, not to mention the preference of many foreign investors to acquire corporate shares and not interests in flow-through vehicles.

Finally, consideration must be given to other provisions (both under pre-Act law as well as those adopted under the Act) that apply differently (and in many cases less favorably) to individual taxpayers:

- As described above, corporate taxpayers continue to be able to deduct state and local taxes dollar-for-dollar, while individuals face a rigid $10,000 cap on such deductions. This will impact the numbers outlined above when the effect of state taxes is included in the computations.
- The passive loss rules (which were unaffected by the Act) continue to apply to individuals (as well as closely held C corporations) who are passive owners of businesses. After these rules are applied, the Act imposes an additional loss limitation on individual (but not C corporation) taxpayers, which serves to curtail the benefit of active business losses (treating any such unused losses as an NOL).
- While the Act imposes a new three-year holding period requirement with respect to carried interest, the rule does not apply to carried interest held through a corporation.
- The Act repeals the corporate alternative minimum tax but not the individual alternative minimum tax.

Other provisions of the Act will also impact corporate taxpayers, such as the new interest deduction limitation (which generally applies equally to corporate and non-corporate businesses but not to electing real estate businesses), and the new prohibition on NOL carrybacks and the annual utilization limitation on post-2017 NOL carryforwards to 80% of taxable income. Furthermore, as it relates to taxable business dispositions, C corporations remain at a disadvantage because a buyer cannot achieve a basis step-up without the seller's triggering both a corporate and a shareholder level tax liability.

When a U.S. business has a meaningful non-U.S. component, this will further complicate the choice of entity analysis. Very generally, the Act's international provisions apply more favorably to U.S. corporations with such operations, making it generally more advantageous for U.S. owners to hold foreign operations through a U.S. C corporation. This appears to generally be true whether the U.S. business operator is conducting the foreign business through a foreign subsidiary or through a foreign branch.

Because some provisions of the Act (in particular, provisions under Section 199A relating to the qualification for, and calculation of, the QBI deduction) are unclear and in need of guidance, many business owners currently operating in flow-through form are taking a prudent "wait and see" approach before adopting any structural changes. Some taxpayers remain concerned that implementing drastic changes based on the Act is shortsighted, since a future Congress could end up rolling back the changes. It is also worth noting that while converting from a pass-through entity to a corporation can generally be achieved on a tax-efficient basis, but the reverse is usually not true.

It is difficult to encapsulate the above with soundbites or tidy takeaways, but what is clear is that the Act has changed the landscape for business owners big and small making choice of entity decisions. The nature of a business's income, the applicability of the QBI deduction (and its limitations), the state tax profile, the business's cash reinvestment plan, level of debt financing and even prognostications about the fate of the Act sections that are scheduled to expire at the end of 2025 are all critical in charting a path forward. While Ares has made the leap, it is by no means an automatic blueprint for others.

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[i] See Exhibit 99.1 to Form 8-K filed by Ares with the SEC on February 15, 2018.
[ii] We use the term "incorporate" solely in a tax sense; Ares will remain a Delaware limited partnership for local law purposes.
[iii] See Exhibit 99.1 to Form 8-K filed by Ares with the SEC on February 15, 2018.
[iv] See, e.g., *Private equity chiefs face partnership dilemma,* The Financial Times, Feb. 20, 2018.
[v] Any tax advisor that has worked on a strategic acquisition of a family-owned S corporation can relate to the challenges these deals often present.
[vi] Both of these Medicare taxes have generally remained in place post-Act. While it is possible that certain taxpayers (such as active owners of a business operating as a state law limited partnership or employee-owners of an S corporation who can justify disproportionately small salaries) are able to avoid *both* of these 3.8% tax regimes, this discussion ignores that possibility.
[vii] Most service-oriented businesses are ineligible for this deduction, and suffice it to say that a *vast* amount of clarification is desperately needed to sort out the uncertainties and minefields in the new Section 199A.
[viii] For investors with income below certain thresholds, the wage and asset limitations do not apply, and are then phased in as income increases.
[ix] A $1,000 initial capital investment would give rise to a limitation equal to $25. In order for the QBI deduction to get as high as $25, the net income would have to be equal to $125, which amounts to a 12.5% return on invested capital.
[x] By comparison, a flow-through entity that makes customary tax distributions to its equity owners (ranging from 33.4% to 40.8% of its income to account for federal taxes based on the above table) would have significantly less money to reinvest in its business. An attempt to retain corporate earnings merely to avoid the shareholder-level tax, and not for purposes of reinvestment or other bona fide business needs, may run afoul of the accumulated earnings tax (the "AET") and the personal holding company tax (the "PHCT"). The AET imposes a 20% tax on certain undistributed income of a corporation that is "formed or availed of for the purpose of avoiding the income tax with respect to its shareholders…by permitting earnings and profits to accumulate instead of being divided or distributed." Section 532(a). The PHCT imposes a 20% tax on the undistributed income of certain closely-held corporations with income predominantly from specified "passive" sources, without regard to any tax-avoidance motive. Section 541.