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Leon Black's Tax-Overhaul Dilemma Could Alter Wall Street Model
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By Simone Foxman and David Carey

(Bloomberg) -- Leon Black recently posed a question whose answer will determine how profitable the new U.S. tax regime could make Wall Street firms like his Apollo Global Management LLC.

Publicly traded partnerships, such as Apollo, are taxed differently than corporations. So should Apollo take advantage of the overhauled tax rules to pay less in taxes? Or should it use this chance to change to an Inc. from an LLC, which would increase its tax bill but allow it to attract investments from mutual funds that have previously been out of reach?

"We're still analyzing," Black told the Goldman Sachs U.S. Financial Services Conference Dec. 6. "It's an uncertain outcome."

Either way, it's most likely a money-making outcome. The tax changes are a boon for private equity firms such as Apollo, where Black is chief executive officer. The new lower corporate rate has made it possible for bigger publicly traded partnerships to consider the change. As it is, management fees, which typically account for 30 percent or more of their earnings, are already taxed at the corporate rate. That will drop. The legislation scarcely touched the 23.8 percent rate paid on incentive fees, also called carried interest, which incur no additional levy when paid out to shareholders.

Double Tax

If the partnerships converted to corporations, the incentive fees would be hit with a second layer of tax when they're paid out. That would push the combined tax rate on incentive income paid out as dividends to nearly 40 percent, according to Peter Furci, co-chair of Debevoise & Plimpton's global tax practice.

But it would also allow the newly minted corporations access to indexes, and therefore the mutual-fund and ETF markets. About \$2.2 trillion follows the S&P 500 Index,

according to its website. As of June, \$122.6 billion in assets tracked the Russell 2000 Index, the best-known small-cap U.S. stock index, and there was \$1.1 trillion bet on Russell U.S. indexes overall, according to the company.

The bigger universe of investors would likely boost the trading multiples of the firms' stocks. It's unclear how big the economic benefit of increased ownership would be, so the question is whether it would make up for the higher taxes.

"There's no way to say how much multiple expansion you could get by converting," said Gerald O'Hara, who follows private equity firms for Jefferies Group. "That's the question here that I think these firms are wrestling with."

Tax Complexity

One of the main reasons the funds have stayed away from private equity managers is tax complexity. Investors in typical stocks receive a Form 1099, a straightforward document that shows interest and dividends on investments at the end of each year. Owners of publicly traded private equity firms' stock get the Schedule K-1 instead. The K-1 shows their share of the partnership's interest, which determines how much the income is taxed. It's a headache, O'Hara said. Plus, firms can be inconsistent on the time of year they send out the forms, and the process of plugging in the numbers on a Schedule K-1 isn't as simple as it is for other kinds of income.

So asset managers, which offer options for many 401(k) investors, avoid buying shares of private equity firms.

On the campaign trail last year, President Donald Trump said he wasn't a fan of Wall Street "paper pushers" like hedge fund managers. He pledged to raise the tax rate on carried interest. The new tax law keeps it unchanged for investments held at least three years.

Hamilton Lane

Proponents of conversion to corporations point to Hamilton Lane Inc., an alternative-investment manager and pension-fund consultant that's a corporation and not a publicly traded partnership. The \$1.9 billion company, which went public earlier this year, is now included in dozens of S&P, Russell and WisdomTree Investments Inc. indexes. Hamilton Lane shares have about doubled since the initial public offering.

Ares Management LP, created by former Apollo executives, is the most likely of its peers to make the jump, according to analysts at Keefe Bruyette & Woods Inc. Much of its revenue comes from management fees, so becoming a corporation would hurt its after-tax earnings relatively little.

Bill Mendel of Mendel Communications, a spokesman for Ares, said the firm is studying the situation. Apollo spokesman Charles Zehren of Rubenstein Associates declined to comment. When Black spoke to the Goldman Sachs conference, he said he was certain of one thing: None of the big publicly traded partnerships wanted to be first to undergo conversion.

“If somebody does go first and their stock doesn’t move up, then you’ll know that was a pretty dumb decision,” he said. If, on the other hand, the “stock does great, then all of us may have converted” in two or three years.

--With assistance from Ben Steverman and Carolina Wilson.

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