

WHY CAN'T MLPs JUST BECOME C-CORPORATIONS?

1. Incorporating a business instantly reduces its value. The business is worth what a buyer will pay for it. A buyer of a pass-through business gets an asset basis step up while a buyer of stock does not. So, a buyer will pay less for stock.

Example: Let us assume there is a zero-basis asset for which a buyer is willing to pay \$100. This is in part because of the value of future depreciation deductions of \$100 on the asset. If the same asset is in a corporation, the buyer will be willing to pay less than \$100, because the buyer's purchase price for the stock will produce no depreciation deductions to the corporation nor reductions in corporate earnings and profits. There also is a similar issue for the basis step-up at death, as a step-up in asset basis is more valuable than a step-up in stock basis.

2. Incorporation may trigger an immediate tax liability. A transferor of an asset into a corporation has immediate gain to the extent liabilities associated with the asset exceed the transferor's basis in the asset. Debt of a partnership is allocated up to its partners for this calculation. Many long-held interests in pass-through entities have a low or zero basis, so they will generally recognize taxable gain upon the incorporation, without receiving any cash proceeds. In addition, some incorporation structures (like sponsor roll-ups of MLPs) are fully taxable transactions.

3. Incorporation is permanent, but the 20 percent corporate rate may not be. Once an asset is incorporated, there is a significant tax cost to getting it back out of the corporation – tax to the distributing corporation and the distributee shareholder. So, if in the future, corporate tax rates rise relative to individual tax rates, the immediate tax cost of reversing the incorporation will generally be prohibitive.

4. MLPs are attractive to yield oriented investors. MLPs traditionally distribute to owners a higher percentage of their cash from operations than C-corps, and existing MLP unit holders have purchased units based on this expectation. MLPs are typically valued by the market based on yield on equity; therefore, MLPs are motivated to distribute a large percentage of cash flow. On the other hand, most C-corps are more traditionally valued in the market by reference to book earnings-per-share as opposed to dividends distributed. An MLP that converts into a C-corp in the traditional manner will be subject to having less cash (because of potential tax payments) to make distributions. The market may interpret an MLP incorporation, rightly or wrongly, as a signal that it will no longer be a yield driven security, thereby causing a sell-off by the original owners who purchased the security for its yield. (Contrast this with a REIT, which is also typically valued in the market based on its expected yield, is not subject to an entity level tax as long as it distributes most of its taxable income to its owners.)