

INSIGHTS

Differing Objectives and Consequences of Recent MLP Conversions to Corporations

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In recent weeks, two more master limited partnerships (MLPs) have announced their intention to convert to corporations for federal income tax purposes. Such transactions will take different forms and are driven by different considerations, including, in large part, tax considerations.

First, Tallgrass Energy, which owns, operates and develops midstream assets in North America, announced that each publicly-held unit of Tallgrass Energy Partners, LP, an MLP, will be exchanged for two shares of stock of Tallgrass Energy GP, LP, the corporate general partner of the MLP, for purposes of simplifying the Tallgrass Energy structure and eliminating the MLP's incentive distributions rights (IDRs). The Tallgrass Energy exchange will be taxable to the public unit holders of the MLP, but the resulting corporation is not expected to pay federal cash taxes for approximately ten years.

Generally, IDRs are structured to allow the general partner of the MLP to receive an increasing share of cash flow of the MLP as the MLP's distribution rate increases. Accordingly, because the IDRs are most lucrative when the MLP performs well for an extended period of time, the general partner takes greater risk than the limited partners, in exchange for an opportunity for higher returns.

Business analysts have noted that the IDRs of the general partner of the Tallgrass Energy MLP represented 38% of total distributions paid by the MLP, which was high relative to its peers. Analysts further estimated that by eliminating the IDRs, Tallgrass Energy could cut its cost of capital in half, from approximately 14% to 16% to approximately 6% to 8%.

Viper Energy Partners L.P. also recently announced that it will convert from an MLP to a corporation for federal income tax purposes. Unlike Tallgrass Energy, which is a midstream company, Viper primarily holds minerals interests in domestic oil and gas properties. Viper will effect its conversion by making a check-the-box election, causing the current MLP, which will remain a limited partnership for state law purposes, to be classified as a corporation for federal income tax purposes. Public unit holders of the MLP will continue to hold their outstanding units following the transaction, and the conversion will not be a taxable transaction to such public holders.

The resulting corporation will maintain its business through an operating subsidiary, which will continue to be classified as a partnership. Viper's general partner will hold an interest in such operating partnership with a right to priority allocations.

Viper reported that its decision to convert to a corporation for federal income tax purposes was spurred by the appeal of the larger investor base associated with corporate issuers. Historically, tax-exempt and foreign investors, which are significant sources of capital in the energy sector, have not favored MLP investments because ownership of the partnership units typically results in unrelated business taxable income, which is subject to federal income tax and tax reporting when received by otherwise tax-exempt entities, and effectively connected income, which is subject to federal income tax and tax reporting when received by foreign investors. In contrast, tax-exempt investors generally are not subject to federal income tax on corporate stock investments. Similarly, foreign investors generally are not subject to federal income tax on corporate stock gains, subject to the FIRPTA rules, although they are subject to U.S. withholding on dividends, subject to reduction or elimination by treaty.

Because conversions of MLPs into corporations may be driven by multiple incentives, including the elimination of IDRs, broadening the investor base or possibly minimizing taxes through the application of the reduced corporate tax rate introduced pursuant to the Tax Cuts and Jobs Act, we may see more conversions in the remainder of 2018. Further, because the conversions can be achieved through different transaction structures, current MLP unit holders cannot assume a future conversion would be taxable or not taxable, or have certainty regarding how their after-tax returns would be affected by such conversion.