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New Proposed Legislation Would Tax Certain Publicly Traded Partnerships As Corporations

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On June 13, Senators Max Baucus, Senate Finance Committee Chair, and Charles Grassley, the Committee's ranking member, introduced a Bill designed to stop private equity firms and hedge fund advisors from going public as publicly traded partnerships while continuing to be treated as partnerships for federal income tax purposes. The Bill includes a five-year "grandfather" for existing transactions and deals that were filed with the Securities and Exchange Commission ("SEC") on or before June 14, 2007, such as the Blackstone Group, L.P. transaction.

Background

In 1987, Congress added section 7704 to the Internal Revenue Code. That section generally taxes a publicly traded partnership as a corporation for federal income tax purposes. An exception (the "Passive Income Exception") to this general rule exists for certain publicly traded partnerships that earn mostly "qualifying income" — passive-type income or certain types of natural resources-related income. Under the Passive Income Exception, a publicly traded partnership is not taxed as a corporation for federal income tax purposes if at least 90 percent of its gross income consists of (i) interest, (ii) dividends, (iii) rent, (iv) capital gains from the sale of real estate or other property that produces dividend or interest income, (v) income and gains from commodities and (vi) certain mineral or natural resource related income. Since 1987, most publicly traded partnerships have been formed to conduct mineral or natural resources-related activity.

Seeking to capitalize on the current success of private equity transactions, a number of U.S. private equity firms have contemplated going public. While only two firms, Fortress Investment Group LLC and Blackstone Group, L.P., have gone public to date, many believe that these transactions will open the floodgates for other private equity or hedge fund firms.[1]

According to the Senate Finance Committee's press release, the Bill was motivated by a concern about the long-term erosion of the U.S. corporate tax base. The Bill's sponsors assert that if activities that would otherwise be conducted in corporate form (where the income from such activities is subject to two levels of taxation – corporate and shareholder levels) are instead conducted through publicly traded partnerships, then income from such activities would avoid the corporate level of taxation. According to Senator Grassley: "[I]t's unfair to allow a publicly traded company to act like a corporation but not pay corporate tax, contrary to the intent of the tax code."[2]

Proposed Legislation

Before describing the proposed legislation, it is important to note what the Bill does not do. Although there has been much recent debate about the proper tax treatment of "carried interests,"[3] the Bill would not change the current taxation of "carried interests." Moreover, the Bill does not propose any changes in the flow-through treatment currently afforded partnerships under the Code. For example, it would not change the character of income derived from a partnership, such as income allocable to the holder of a "carried interest." Thus, the taxation of partnership capital gains in the hands of an individual holder of a "carried interest" would continue to receive favorable federal income tax treatment.[4] In addition, partnerships that are not publicly traded would not be affected by the Bill as currently proposed.

If enacted, the Bill would, however, exclude a publicly traded partnership from the Passive Income Exception if the publicly traded partnership directly or indirectly has income or gain (including capital gains or dividends) the rights to which are derived from two types of "prohibited" investment advisory services. These prohibited investment advisory services are (i) services provided by any person as an investment adviser as defined in the Investment Advisers Act of 1940 ("Advisers Act") or a person associated with an investment adviser, or (ii) asset management services provided by a person described in (i) in connection with management of assets with respect to which such investment advisory services were provided. Even though the Bill refers to the Advisers Act definition of "investment adviser," application of the provision does not actually require that the taxpayer be registered as an investment adviser under the Advisers Act.[5]

The Bill treats income from investment advisory services as active business income rather than passive income for purposes of the Passive Income Exception to the publicly traded partnership rules. Thus, the impact of the Bill is limited to partnerships that derive income from investment advisory services in cases where the partnership interests are publicly traded. However, the Bill's effect is not limited to cases in which the income of the publicly traded partnership is principally derived from investment services. Instead, as currently proposed, there is a "cliff effect" inherent in the Bill. Even $1 of income from investment advisory services would cause the partnership to be denied the use of the Passive Income Exception, and thus would subject the partnership to corporate tax on all of its income.

If enacted, the Bill would impose a tax on the public's share of the publicly traded partnership's income and therefore reduce the attractiveness of going public. It would not affect the taxation of the private equity fund managers directly, however. For example, if the managers in a private equity firm hold partnership interests directly in partnership "subsidiaries" of the publicly traded partnership, their share of the subsidiary partnership's income (including their "carried interest") would not be subject to corporate-level tax under the Bill. Additionally, long-term capital gains would continue to flow through to these individuals.

The Bill would apply to taxable years of a partnership beginning on or after June 14, 2007. A grandfather rule would permit publicly traded partnerships that have already completed their IPOs or that have filed with the SEC to do an IPO to operate as partnerships rather than corporations for federal income tax purposes for five taxable years (i.e., until partnership years beginning after June 14, 2012). On June 20, Representative Peter Welch (D. Vt.) introduced a bill in the House that is similar to the Senate Bill, except that it contains no grandfather provisions for firms currently traded or for firms that have already filed with the SEC. Chairman Baucus has indicated that he is receptive to reconsidering the grandfather provision.

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Footnotes:

[1] In February, Fortress Investment Group LLC raised approximately $634 million from its IPO. Blackstone went public on June 21. Also, on June 21 KKR announced plans to go public.

[2] Press Release, Senate Finance Committee, Baucus-Grassley Bill Addresses Publicly Traded Partnerships (June 14, 2007) *available at* http://www.senate.gov/~finance/press/Bpress/2007press/prb061407e.pdf.

[3] *See, e.g.*, Thomas A. Humphreys, et al., *The Current Debate About the Federal Income Tax Treatment of "Carried" Interests – Status and Possible Approaches*, April 13, 2007, *available at* http://www.mofo.com/news/updates/files/12183.html.

[4] The Senate Finance Committee has been studying the federal income tax treatment of "carried interests" in partnerships. It has not yet announced the results of that study. On June 22 Rep. Sander Levin (D. Mich) introduced a bill to treat the "carried interest" of partners performing investment management services as ordinary income.

[5] The Advisers Act defines "investment adviser" as: any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for

compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities. Under this definition, exceptions are provided in the case of certain banks, certain brokers or dealers, as well as certain others. According to the explanation accompanying the Bill, these exceptions apply for purposes of the Bill.