Anthony P. Curatola, Editor

Proposed Legislation for Publicly Traded Partnerships, Part 1

BY MICHAEL L. HOLLAND, LEONARD G. WELD, AND RAYMOND J. ELSON, CPA

In June 2007, the Senate Finance Committee proposed legislation to change the taxation of publicly traded partnerships (PTP). This special designation and tax status began after December 31, 1987, when Congress passed the Revenue Act of 1987 (P.L. 203) and created IRC §7704, which states that, with one exception, a PTP "shall be treated as a corporation." The new legislation proposed by Senators Max Baucus (D.-Mont.) and Charles Grassley (R.-Iowa) expands the definition of PTP to include private equity firms that become publicly traded.

In this article, we explain the origin of PTP legislation, identify the nature of a PTP, and clarify the exception that allows private equity firms to escape classification as a PTP.

Origin of the Legislation

Why does Congress want a partnership to be taxed as a corporation? The genesis of this change in 1987 was Congress's fear that these special partnerships would erode the corporate tax base and reduce corporate tax collections. In addition, corporations distribute earnings—which have already been taxed at the corporate level—to shareholders, where the earnings are taxed again as dividend income. Since partnerships are pass-through entities, they don't pay any federal income tax. Partners are taxed on their distributive share of partnership income, thus avoiding one level of taxation. In the June 14, 2007, Senate Finance Committee release, Sen. Baucus states, "A hallmark of corporate status is access to the capital markets. It's unfair to allow a publicly traded company to act like a corporation but no pay corporate tax, contrary to the intent of the tax code."

What Is a Publicly Traded Partnership?

A PTP is any partnership where interests in such partnership are (1) traded on an established securities market or (2) readily tradable on a secondary market (or substantial equivalent).

Interests in a PTP consist of both capital and profits interests. A capital interest requires an initial investment, while a profits interest is speculative in nature since any value it may achieve depends on that interest's share of profits. An interest also includes any financial investment or contract whose value is determined in some way by looking to partnership distributions, partnership asset value, or partnership income. Note that this rather expansive definition doesn't include any nonconvertible financial instrument or contract that is treated as debt for federal tax purposes.

An established securities market for purposes of §7704(b) includes a national exchange registered under Section 6 of the Securities Exchange Act of 1934; a national exchange exempt from the 1934 Securities Act because of a low volume of transactions; most foreign securities exchanges, such as the Frankfurt Stock Exchange (part of the Deutsche Börse Group), the Tokyo Stock Exchange, and so forth; and a regional or local exchange. Also included as an established securities exchange is an interdealer quotation system that regularly communicates firm buy or sell quotations by identified brokers or dealers.

The definition of an established securities market also covers trades on secondary markets or the substantial equivalent of a secondary market. According to the definition of a PTP, secondary markets (or substantial equivalent) include markets where interests in the partnership are regularly quoted by a person making a market in the interests; where any person routinely announces to the public bid or offer quotes on partnership interests and stands ready to initiate buy or sell transactions at the quoted price for himself or others; or where the holder of an interest has a readily available, regular, and ongoing opportunity to sell, buy, or exchange the interest based on information provided to the public.

Treasury Regulations for §7704 contain a series of exceptions to the rules, but they all involve nonpublic transfers or public transfers of no more than 2% of the total interests in a year. These exceptions could never encompass the large entities envisioned in the general provisions of §7704(b).

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An Important Exception

A partnership can avoid being classified as a PTP if it meets the gross income requirement specified in §7704(c)(2). The exception seems tailor-made for the private equity firms. In order to avoid the PTP rules, a partnership must demonstrate that 90% or more of its income is "qualifying income." IRC §7704(d) defines qualifying income as:

1. Interest;
2. Dividends;
3. Real property rents;
4. Gain from the sale or other disposition of real property;
5. Any gain from the sale or disposition of a capital asset, depreciable property, or real estate owned for more than one year and held for the production of income; and
6. Other special categories not relevant to this discussion, such as gains from mining or developing oil and gas properties.

Since private equity firms make their money by buying struggling companies, streamlining operations, selling off excess assets, and then selling the newly configured profitable company, these firms would have no trouble meeting the 90% qualifying income exception. The June 14, 2007, Senate Finance Committee release, however, posits that private equity firms actually earn their income by "actively providing financial services" that aren't exempted by §7704(c)(2).

This assertion is substantiated by the first paragraph on page one of the Blackstone Group S-1 SEC filing on March 22, 2007, which states:

"We are a leading global alternative asset manager and provider of financial advisory services. We are one of the largest independent alternative asset managers in the world, with assets under management of approximately $78.7 billion as of March 1, 2007. Our alternative asset management businesses include the management of corporate private equity funds, real estate opportunity funds, funds of hedge funds, mezzanine funds, senior debt vehicles, proprietary hedge funds, and closed-end mutual funds. We also provide various financial advisory services, including mergers and acquisitions advisory, restructuring and reorganization advisory, and fund placement services."

Next month we will review the proposed legislation and use data from the IRS *Statistics of Income* report to examine the argument that private equity firm activity is shrinking the corporate tax base. ■

Michael L. Holland, Ph.D., is a professor of accounting at Valdosta State University, Valdosta, Ga. You can contact Michael at (229) 245 3811 or mholland@valdosta.edu.

Leonard G. Weld, Ph.D., is a professor of accounting and head of the Department of Accounting and Finance at Valdosta State University, Valdosta, Ga. You can contact Leonard at (229) 333-5967 or lweld@valdosta.edu.

Raymond J. Elson, CPA, DBA, is an associate professor of accounting at Valdosta State University, Valdosta, Ga. You can contact Raymond at (229) 219-1214 or relson@valdosta.edu.

Anthony P. Curatola is the Joseph F. Ford Professor of Accounting at Drexel University in Philadelphia, Pa. You can reach Tony at (215) 895-1453 or curatola@drexel.edu.