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Proposed Legislation for Publicly Traded Partnerships, Part 2

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Last month we discussed the origin of publicly traded partnerships (PTP) legislation, identified the nature of a PTP, and revealed the exception that allows private equity firms to escape classification as a PTP. Although the background to this area is insightful, the better question pertains to the argument that private equity firm activity is shrinking the corporate tax base.

Thus, this month we'll review the proposed legislation and address the argument that private equity firm activity results in lower tax collections because of a smaller corporate tax base.

Proposed Amendment to IRC §7704

The Revenue Act of 1987 (P.L. 203) 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) adds a new paragraph to §7704(c) that specifically targets private equity firms. The working title of the amendment is "Exception Not to Apply to Partnerships Providing

Certain Investment Adviser and Related Asset Management Services." The details of the amendment make it clear that the exception to the PTP classification doesn't apply to any income earned by a person acting in the role of an investment adviser or asset manager regardless as to whether the person is registered with the Securities & Exchange Commission (SEC) as an investment adviser. For purposes of the IRC, the term "person" includes individuals, trusts, estates, partnerships, associations, companies, and corporations. [IRC §7701(a)]

The proposed legislation has a delayed effect for partnerships that filed a registration statement with the SEC on or before June 14, 2007. For those partnerships, Fortress In-

vestment Group and the Blackstone Group, the new amendment doesn't apply until the tax year beginning on or after June 14, 2012, allowing these two firms to avoid the effects of the legislation for five years. Blackstone filed its SEC registration on March 22, 2007, and Fortress filed on November 8, 2006.

Shrinking Corporate Tax Base?

Has the corporate tax base shrunk because of private equity fund activity? The IRS recently released the Statistics of Income (SOI) report. It presents statistical estimates based on a stratified sample of unaudited returns selected from the nearly 5.5 million active corporate returns filed for tax year 2004. Reports from prior years are also available. Table 1 shows the IRS data for tax years 2000 through 2004 (the most recent information available).

It's hard to argue that the corporate tax base was shrinking over this five-year period. The number of returns for active corporations increased each year. While tax collections in 2001 and 2002 are less than in 2000, the end of the dot-com boom and the devastating effects of September 11, 2001, probably go a

Table 1. **Total Returns of Active Corporations by Year**

	Total Number of Returns	Net income	Income Subject to tax	Total income tax before credits	Total income tax after credits
2000	5,045,274	\$1,336,619,605	\$760,404,334	\$266,281,801	\$204,043,788
2001	5,135,591	\$1,112,480,551	\$635,257,416	\$220,874,245	\$166,711,988
2002	5,266,607	\$1,053,126,217	\$600,553,517	\$209,691,130	\$153,612,870
2003	5,401,237	\$1,175,608,990	\$699,336,915	\$243,822,946	\$177,517,404
2004	5,557,965	\$1,455,796,796	\$857,391,889	\$299,555,304	\$224,435,343

Source: IRS Statistics of Income. All money amounts are in thousands of dollars.

long way in explaining the decrease. Tax collections in 2004, however, represent an increase of 9.8% over 2000. Would tax collections have been higher if private equity firms hadn't been actively operating? It's impossible to tell from this data.

Additionally, the pace of private equity fund activity has increased in 2006 and 2007. According to a *Wall Street Journal* article (Dennis Bergman, Jason Singer, and John Wilke, "As Deal Barriers Fall, Takeover Bids Multiply," May 8, 2007), the value of takeovers in 2007 has already passed the value recorded

in all of 2004. The dollar activity in 2007 for the United States is up approximately 40%, which doesn't include the July 3, 2007, announcement by Blackstone Group that it has an agreement to acquire Hilton Hotel Corp. for \$26 billion in cash and debt. In fact, nine of the 10 largest corporate takeovers occurred in either 2006 or 2007—the exception being the 1988 Kohlberg, Kravis, Roberts & Co. \$31 billion takeover of RJR Nabisco (see Table 2).

Increasing Corporate Collections

Will the proposed legislation in-

crease corporate tax collections? The answer is probably "yes." By treating a PTP as a corporation, corporate tax collections are bound to increase. Will the legislation increase overall tax collections? The best answer is "maybe." As partners, public equity firm principals paid tax on partnership earnings whether or not the earnings were distributed. If corporations choose to distribute earnings to owners, it is done via dividends. If the earnings are retained by the PTP, owners will see ownership unit prices increase and will make their money through the sale of these ownership units, paying capital gain tax rates only on the increase in value. ■

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Table 2. **Largest Acquisitions by Dollar Value**

Target	Acquirer	Value (\$billions)	Announced	Status
TXU Corp	KKR & Co., Texas Pacific Group, Goldman Sachs Capital Partners	43.8	Feb. 26, 2007	Completed
Equity Office Properties Trust	Blackstone Real Estate Partners	38.89	Nov. 20, 2006	Completed
HCA Inc.	Bain Capital Inc., KKR & Co., Merrill Lynch Global Private Equity	32.68	July 24, 2006	Completed
Alltel Corp.	TPG Capital, Goldman Sachs Capital Partners	27.87	May 21, 2007	Pending
First Data Corp.	KKR & Co.	27.73	April 2, 2007	Completed
Harrah's Entertainment Inc.	Apollo Management, Texas Pacific Group	27.4	Oct. 2, 2006	Pending
Clear Channel Communications Inc	Bain Capital Inc, Thomas H. Lee Partners	26.44	Nov. 16, 2006	Pending
Hilton Hotels Corp.	Blackstone Group	26.01	July 3, 2007	Pending

Source: Grace Wong, "Private Equity: The Beat Goes On," CNNMoney.com, July 4, 2007.