

## **A. Treatment of Publicly Traded Partnerships Directly or Indirectly Deriving Income From Investment Adviser Services and Related Asset Management Services**

### **Present Law**

Under present law, a publicly traded partnership generally is treated as a corporation for Federal tax purposes (sec. 7704(a)). For this purpose, a publicly traded partnership means any partnership if interests in the partnership are traded on an established securities market, or interests in the partnership are readily tradable on a secondary market (or the substantial equivalent thereof).

An exception from corporate treatment is provided for certain publicly traded partnerships, 90 percent or more of whose gross income is qualifying income (sec. 7704(c)(2)). However, this exception does not apply to any partnership that would be described in section 851(a) if it were a domestic corporation, which includes a corporation registered under the Investment Company Act of 1940 as a management company or unit investment trust.

Qualifying income includes interest, dividends, and gains from the disposition of a capital asset (or of property described in section 1231(b)) that is held for the production of income that is qualifying income. Qualifying income also includes rents from real property, gains from the sale or other disposition of real property, and income and gains from the exploration, development, mining or production, processing, refining, transportation (including pipelines transporting gas, oil, or products thereof), or the marketing of any mineral or natural resource (including fertilizer, geothermal energy, and timber). It also includes income and gains from commodities (not described in section 1221(a)(1)) or futures, options, or forward contracts with respect to such commodities (including foreign currency transactions of a commodity pool) in the case of partnership, a principal activity of which is the buying and selling of such commodities, futures, options or forward contracts.

### **Reasons for Change**

The rules generally treating publicly traded partnerships as corporations were enacted in 1987 to address concern about long-term erosion of the corporate tax base. At that time, Congress stated, "[t]o the extent that activities would otherwise be conducted in corporate form, and earnings would be subject to two levels of tax (at the corporate and shareholder levels), the growth of publicly traded partnerships engaged in such activities tends to jeopardize the corporate tax base." (H.R. Rep. No. 100-391, 100th Cong., 1st Sess. 1065.) Referring to recent tax law changes affecting corporations, the Congress stated, "[t]hese changes reflect an intent to preserve the corporate level tax. The committee is concerned that the intent of these changes is being circumvented by the growth of publicly traded partnerships that are taking advantage of an unintended opportunity for disincorporation and elective integration of the corporate and shareholder levels of tax." (H.R. Rep. No. 100-391, 100th Cong., 1st Sess. 1066.)

These same concerns hold true today, as industry sectors that have never conducted business as publicly traded partnerships start to shift into that form of doing business. News reports have called attention to transactions set in motion in recent months in which partnerships earning income from investment adviser and related asset management services made or will

make their interests available on an exchange or market.<sup>1</sup> This trend causes deep concern about preservation of the corporate tax base as it presages the transfer of corporate assets to publicly traded partnerships. When corporate assets are moved to partnership form without relinquishing that hallmark of corporate status, access to capital markets, some businesses are able to lower their cost of capital at the expense of the Federal Treasury. This result subverts a principal purpose and policy of the present-law rules treating publicly traded partnerships as corporations: to preserve the corporate tax base.

To the extent these transactions represent a trend toward increased utilization of publicly traded partnerships in the case of businesses earning income from investment adviser and related asset management services, there is the additional concern of distortions caused by inconsistent treatment under the tax law. The present-law exception in the case of partnerships, 90 percent or more of whose gross income is qualifying income, is not intended to encompass income from investment adviser and related asset management services. The bill serves to address this troubling trend by strengthening the rules treating publicly traded partnerships as corporations.

### **Explanation of Provision**

The bill provides generally that the exception from corporate treatment for a publicly traded partnership, 90 percent or more of whose gross income is qualifying income, does not apply in the case of a partnership that directly or indirectly derives income from investment adviser services or related asset management services. Thus, such a partnership is treated as a corporation for Federal tax purposes and is subject to the corporate income tax.

Under the bill, the exception from corporate treatment for a publicly traded partnership does not apply to any partnership that, directly or indirectly, has any item of income or gain (including capital gains or dividends), the rights to which are derived from services provided by any person as an investment adviser, as defined in the Investment Advisers Act of 1940, or as a person associated with an investment adviser, as defined in that Act. Further, the exception from corporate treatment does not apply to a partnership that, directly or indirectly, has any item of income or gain (including capital gains or dividends), the rights to which are derived from asset management services provided by an investment adviser, a person associated with an investment adviser, or any person related to either, in connection with the management of assets with respect to which investment adviser services were provided. For purposes of the bill, these determinations are made without regard to whether the person is required to register as an investment adviser under the Investment Advisers Act of 1940. In the absence of regulatory

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<sup>1</sup> Reuters, "Blackstone I.P.O. in June," New York Times, June 13, 2007; Jenny Anderson, "Scrutiny on Tax Rates that Fund Managers Pay," New York Times, June 13, 2007; Jenny Anderson, "Blackstone Founders Prepare to Count their Billions," New York Times, June 12, 2007; Michael J. de la Merced, "Fortress Goes Public, a First for Hedge Funds Inside U.S.," New York Times, Feb. 9, 2007; Bloomberg, "Hedge Fund is Planning Public Offering," New York Times, Nov. 9, 2006; Randall Smith, "Goldman Takes 'Private' Equity to a New Level," Wall St. Journal, May 24, 2007; "Oaktree to List on New Goldman Market, Reports Say," New York Times, May 11, 2007; Tom Petrino, "A Market for Private Stock Sales," Los Angeles Times, May 11, 2007.

guidance as to the definition of a related person, it is intended that the definition of a related person in section 197(f)(9)(C)(i) apply.

For example, a publicly traded partnership that has income (including capital gains or dividend income) from a profits interest in a partnership, the rights to which income are derived from the performance of services by any person as an investment adviser, is treated as a corporation for Federal tax purposes under the bill. As a further example, a publicly traded partnership that receives a dividend from a corporation that receives or accrues income, the rights to which are derived from services provided by any person as an investment adviser, is treated as a corporation for Federal tax purposes under the bill.

Under the Investment Advisers Act of 1940 definition, an investment adviser means 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, provided criteria specified in that Act are met. These exceptions apply for purposes of the bill. No inference is intended that income from activities described in the exceptions is qualifying income for purposes of section 7704.

#### **Effective Date**

The bill generally is effective for taxable years of a partnership beginning on or after June 14, 2007.

Under a transition rule for certain partnerships, the bill applies for taxable years beginning on or after June 14, 2012. The transition rule applies in the case of a partnership the interests in which on June 14, 2007, were traded on an established securities market, or were readily tradable on a secondary market (or the substantial equivalent thereof). In addition, the transition rule generally applies in the case of a partnership which, on or before June 14, 2007, filed a registration statement with the Securities and Exchange Commission under section 6 of the Securities Act of 1933 (15 U.S.C. 77f) that was required solely by reason of an initial public offering of interests in the partnership. However, the transition rule does not apply if the registration statement is filed with respect to securities that are to be issued on a delayed or continuous basis (pursuant to Rule 415 under the Securities Act of 1933). Thus, a shelf registration on or before June 14, 2007, of interests in a partnership does not cause the partnership to be eligible for the transition rule. Rather, in the case of such a partnership, the bill is effective for taxable years of the partnership beginning on or after June 14, 2007.