NATIONAL ASSOCIATION OF
PUBLICLY TRADED PARTNERSHIPS

WRITTEN STATEMENT OF THE
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SUBMITTED FOR THE
SENATE COMMITTEE ON FINANCE HEARING ON

TAX REFORM: EXAMINING THE TAXATION OF BUSINESS ENTITIES

August 1, 2012

National Association of Publicly Traded Partnerships
4350 N. Fairfax Drive, Suite 815
Arlington, VA 22203

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The National Association of Publicly Traded Partnerships (NAPTP) is pleased to provide its views on the taxation of business entities and the treatment of pass-through entities. NAPTP is a trade association representing publicly traded partnerships, more commonly known as master limited partnerships (MLPs),[1] and other companies that provide services to MLPs or otherwise have an interest in their welfare. We currently have 122 full and associate members and represent 75 MLPs.

NAPTP strongly recommends that Congress continue to preserve the ability of business enterprises to choose the structure that is the most efficient and effective for their particular business activities, whether it be a pass-through structure or a C-corporation, in any future tax legislation. In particular, we ask that publicly traded entities that are currently able to choose pass-through taxation be allowed to continue doing so. To do otherwise, in our view, would not be good policy and would slow our nation's progress towards energy independence by reducing the capital available for needed energy infrastructure. It would also cost jobs in an economy that cannot afford to lose them, and would deprive a growing number of individual investors, many of whom are seniors, of a dependable source of income.

Background

MLPs have been in existence since 1981, and were first created to add liquidity to partnership investments. In doing so, they provided businesses that had traditionally operated in partnership form with the ability to raise capital from individual investors who could not afford the sizeable, illiquid, investment demanded by nontraded partnerships. By creating partnership investments that came in affordable units (the term for an ownership interest in an MLP) which were liquid, MLPs allowed smaller investors to invest in energy and real estate development while providing those industries with a valuable new source of capital.

In 1987 Congress enacted section 7704 of the Internal Revenue Code to limit MLPs to the industries that had traditionally used partnerships. Section 7704 limits pass-through tax treatment to publicly traded partnerships receiving at least 90 percent of their gross income from a narrow range of business activities, primarily those related to natural resources, or passive income sources such as interest and dividends.[2] Natural resources for this purpose include oil

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[1] There are several dozen PTPs which are merely commodity pools and not entities conducting business operations. These are generally not thought of as MLPs.

[2] Section 7704 also permits real estate operations including the development, sale, and rental of real estate.

and natural gas (and products thereof), coal and other minerals, fertilizer, and timber, while permissible activities include exploration, development and production; mining; gathering and processing; natural gas compression; transportation by pipeline, ship, or truck; storage; refining; marketing; and distribution. Other than propane sales, permissible activities stop short of the retail level, so that revenue from operating gas stations, for example, would not be qualifying income. In 2008 Congress expanded section 7704 to also permit MLPs to engage in the transportation and storage of biofuels and to include industrial source carbon dioxide in the definition of natural resource.

When section 7704 was being considered by Congress, the continued use of the MLP structure by natural resources industries was supported by the Treasury Department, which had otherwise supported imposing corporate taxation on publicly traded business entities. In 1987 testimony before subcommittees of both the House Ways and Means and the Senate Finance Committees, Assistant Secretary for Tax Policy J. Roger Mentz stated that “consideration should be given to continued authorization of pass-through entities providing direct investment opportunities traditionally conducted in non-corporate form” -- and, more specifically, “Given the importance of natural resource development to the nation’s security, Congress should consider carefully whether such traditionally non-corporate activities should be subjected to corporate level tax.”

MLPs Today

Today MLPs are primarily engaged in natural resource activities. Natural resource MLPs comprise about 80 percent of MLPs by number, and about 90 percent of MLP market capital. The great majority operate in the midstream sector, which is focused on logistics and includes activities such as gathering and processing; natural gas compression; transportation by pipeline, ship, or truck; storage; and distribution services. Over 70 percent of MLP market capital, and over 80 percent of the market capital of natural resource MLPs, is in the midstream sector.

Midstream MLPs own approximately 300,000 miles of natural gas, NGL, refined product, and crude oil pipelines, a vast network ranging from local gathering lines that bring products from the field to processing plants to major interstate pipelines traversing thousands of miles. These pipelines are the backbone of our domestic energy system, serving as the link between energy producers and end-use consumers.

In addition to the MLPs that build and operate energy infrastructure, a number of MLPs provide consumers throughout the United States with propane for home heating and other uses. Some natural resource MLPs earn revenue from oil, gas, and coal properties. Some manufacture fertilizer, and others own timber properties either as a primary business or in addition to other natural resource activities. MLPs operate in every state, producing, processing, transporting, storing, and distributing energy products to meet the needs of that state’s residents.

On August 1, 2012, the total market capital of MLPs was about $340 billion, of which about $300 billion was in the natural resource sector. MLPs raised over $9 billion in equity capital during the first seven months of 2012.[3] As noted, a large part of this equity capital is devoted to expanding the nation's domestic energy infrastructure.

According to surveys done by some of our members, the majority of the investors providing this capital—up to 80 percent--are individual investors. Many of the investors are seniors--roughly 75 percent are over the age of 50. For the most part, they are individuals seeking a relatively secure income-oriented investment providing a reasonable return, something that is hard to come by in today's market. These investments are particularly attractive to fixed income investors because MLPs are contractually required to distribute all of their operating cash flow each quarter, providing investors with a reliable income stream. In addition to the individuals investing directly in MLPs, there are millions more who are investing in MLPs through one of approximately 45 MLP-oriented closed- and open-end mutual funds and ETFs. These funds provide individual investors with a comparable income stream without the tax complications of being a partner that direct investment entails.

In addition to providing income for investors, MLPs create jobs. As entities that distribute their cash flow rather than retain earnings, MLPs depend upon access to capital. Nevertheless, during the recent economic downturn, when capital was relatively scarce, they were among the first to recover, raising and investing billions of dollars in job-creating infrastructure projects at a time when most corporations were downsizing and laying off employees. A recent study performed for NAPTP by Quantria Strategies LLC found that midstream energy MLPs support approximately 323,000 U.S. jobs as of 2012, both directly and through supply chain linkage.[4] To the extent that growth in every sector of the economy depends on the free flow of energy supplies, MLPs may have an even greater impact on domestic employment.

Why MLPs Are Important

The majority of the growth in MLPs has been in midstream energy services because in the years since 1987, the energy industry has discovered that the MLP structure is uniquely well-suited for midstream operations. Midstream businesses require considerable capital for the construction of pipelines, processing plants, and other assets, and thus the cost of capital is a very important consideration for them. Once these assets are in place, they last a long time and generate a steady and reliable stream of revenue. This is a fee-for-service industry, generally not exposed to commodity price shifts but rather generating moderate revenue through contracts to process and transport natural gas, oil, and petroleum products.

While steady and reliable, the income from midstream assets is somewhat low in relation to the amount of capital expended, particularly in the case of rate-regulated pipelines. For this reason, corporate energy companies have increasingly preferred to divest themselves of these low-return assets and put their capital into more profitable exploration and drilling operations;

[3] Wells Fargo Securities, LLC, *MLP Monthly: August 2012.*

[4] John F. O'Hare and Judy Xanthopolous, *Midstream Energy Master Limited Partnerships Economic Analysis – Contributions to Employment and Income*, June 2012.

and when they do, these assets are typically acquired by MLPs. The single-taxed MLP structure lowers the cost of capital, allowing a more reasonable return on investment in these assets.

Moreover, the steady income stream allows midstream MLPs to meet a key demand of MLP investors: reliable cash distributions. As with any pass-through entity, MLP unitholders must pay tax on their share of the MLP's income every year, whether they receive it or not. Thus, an MLP will attract investors only if it pays out enough cash to cover the unitholder's tax and provide a reasonable return on top of that. Accordingly, MLPs' organizational documents contain a requirement that MLPs distribute their available cash flow to investors rather than retain earnings, and MLPs that fail to meet that standard do not do well in the market.

MLPs do not just own and acquire existing midstream assets; they are busily constructing new ones. Today it is increasingly MLPs that are building, expanding, and operating pipelines and other energy infrastructure in the United States. It is MLPs that ensure that domestic oil and gas get from the places they are produced to the places where they are consumed, in the forms which consumers need. Most importantly, it is MLPs that will advance the potential for energy independence by allowing natural gas and oil produced from the recently discovered shale plays to be fully utilized. Some of these shale plays are in areas with little of the infrastructure required to process and transport the underlying resources; others have overwhelmed the infrastructure that does exist.

A paper published by the INGAA Foundation in 2011 estimated that over the next ten years, we will need to invest $130 billion in natural gas, NGL, and oil pipelines and related infrastructure.[5] Over 25 years (2011-2035), $251 billion will be needed. Those investments are being made to a large extent by MLPs. Since 2007, the largest MLPs have made non-acquisition capital investments of approximately $66 billion, many of them in the shale-play areas. This year they are expected to invest another $21.8 billion, bringing total investment to approximately $88 billion.

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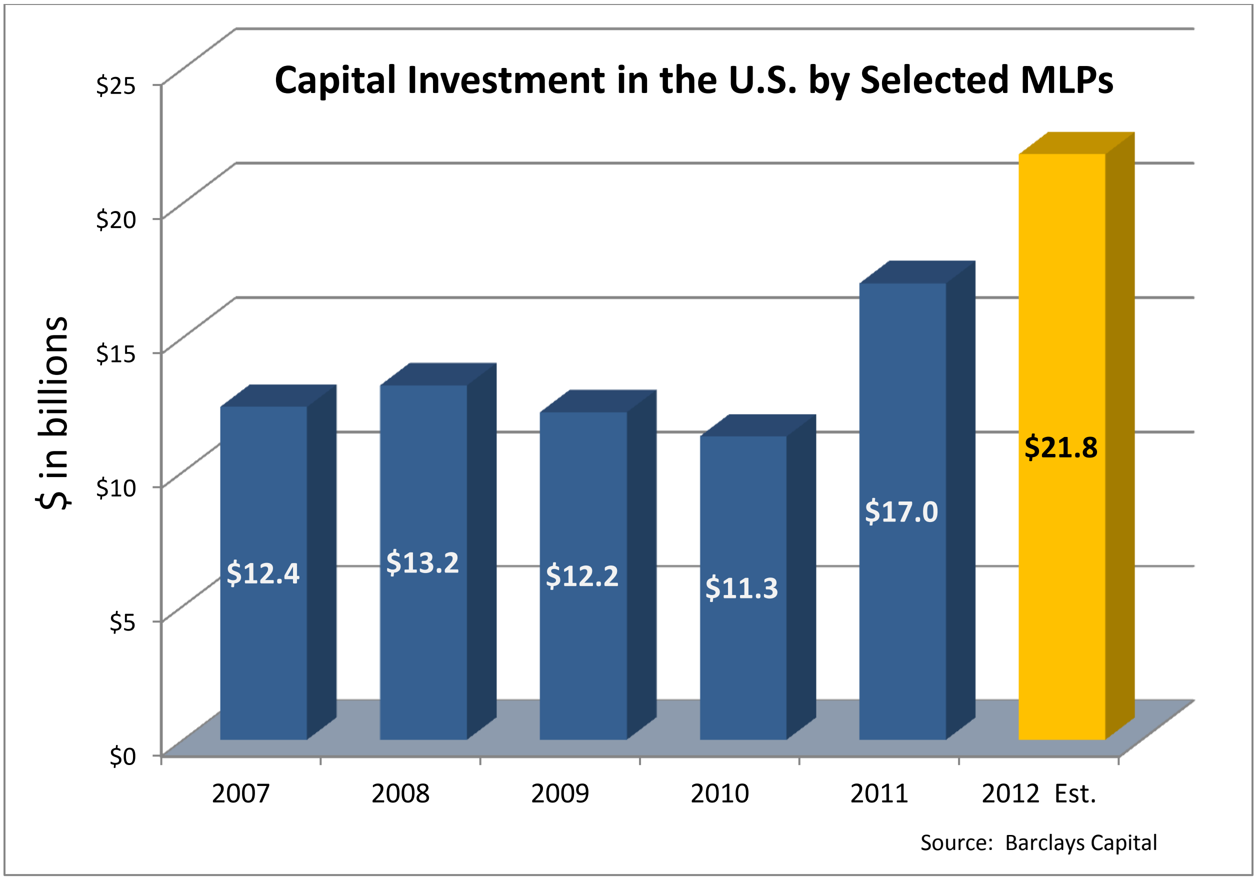
[5] ICF International, North American Midstream Infrastructure Through 2035 – a Secure Energy Future, June 28, 2011.



According to the Quantria Strategies study, over the next five years the midstream MLP industry will support more than 1.6 million jobs on an annual equivalent basis,[6] or about 330,000 jobs per year, and will pay cumulative wages totaling $147 billion.

Consequences of Corporate Taxation

While MLPs are formed for a number of reasons, it is the pass-through tax treatment that makes the MLP structure such an effective vehicle for midstream assets. Pass-through taxation lowers the cost of capital for a capital-intensive industry with a very modest rate of return and provides ordinary investors with a reliable income source in return for participating in the build-out of U.S. energy infrastructure.

For these reasons eliminating the pass-through tax treatment of MLPs would significantly and adversely impact future investment in our nation's domestic energy infrastructure at a time when such investment is urgently needed. If such a change were made, there would initially be significant disruptions in the financing and construction of pipelines and related facilities during the transition, as MLPs coped with the new rules, and investors dealt with this significant

[6] Annual equivalent employment is defined by Quantria Strategies as the number of full-time jobs supported over a 12-month period.

change. After that, the build out would not be halted, but it would proceed more slowly and at a lower level than it would have if the law had not been changed,

A study by Phillip Swagel, former Assistant Treasury Secretary for Economic Policy, and Robert Carroll, former Deputy Assistant Treasury Secretary for Tax Analysis, found that the higher cost of capital resulting from corporate taxation of MLPs would reduce pipeline investment by close to 30 percent--or more--immediately following the change to corporate tax status, with investment still 13 percent to 20 percent lower ten years after the change. As a result of such a delay in building the infrastructure needed to deliver energy to consumers, U.S. businesses and households would face over $13 billion in higher annual energy costs, and possibly considerably more if reduced investment in energy transportation infrastructure led to serious bottlenecks that impacted energy prices.[7] It is likely that higher energy costs would in turn have a negative impact on the overall economy.

There would be a cost in jobs and wages as well. The Quantria Strategies analysis found that if midstream energy MLPs were subject to corporate-level tax, total annual employment would decrease by more than 27,000 jobs over the next five years and wages paid to workers directly and indirectly by the sector would decrease by about $2 billion.

Finally, imposing corporate taxation on MLPs would impact millions of individual investors, particularly seniors, who have turned to MLPs as one of the few remaining investments that reliably generate income in a low interest rate environment. The change would affect the value of over 100 MLPs, adversely impacting their direct investors, as well as the investors in dozens of open- and closed-end mutual funds, ETFs, and other investment vehicles whose assets consist wholly or largely of MLPs. Billions of dollars of assets would be devalued with one stroke of the pen. This is in marked contrast to 1987, when only about 35 MLPs with “nonqualifying income” were impacted by the new law, and MLPs were still a relatively obscure investment, with no MLP-oriented investment funds in existence.

Conclusion

Twenty-five years ago, Congress examined the question of whether MLPs should continue to be taxed as partnerships or whether all MLPs should have to pay corporate tax. It decided that while MLPs were not appropriate for industries that had historically used corporate structures, the energy industry, which was and is vital to our country’s well-being and which had always raised capital through partnerships, should continue to be allowed to expand its access to investor capital through the use of MLPs.

In the years since, that decision has proven to be a wise one. MLPs have operated as Congress envisioned in 1987 and are now an integral part of the way our nation is positioned to move forward in achieving greater energy independence by developing our own domestic energy supplies. Over the past several years, MLPs have raised tens of billions of dollars of capital, and have invested it in building new and vitally needed energy infrastructure, while at the same

[7] Phillip Swagel and Robert Carroll, *The Impact of Changes to the Tax Treatment of Master Limited Partnerships*, January 2012.

time seeing that energy products make their way efficiently and in numerous forms from the production fields, through processing facilities, and across the country to end users.

MLPs have also grown to be an important investment option for many individuals, in particular older Americans looking for a safe and reliable income source to fund their retirement. Millions of individual investors are enjoying an investment opportunity that before the advent of MLPs was available only to the very affluent, while at the same time contributing to the achievement of energy independence.

As the saying goes, “If it ain’t broke, don’t fix it.” There is no compelling reason as a matter of tax or other policy to subject MLPs to an entity-level tax. Neither public trading nor a particular size requires corporate taxation. As is often noted, the vast majority of entities paying corporate tax are both small and nontraded, and as was noted by witnesses at this hearing, entities both large and small now raise capital in a variety of ways.

Any concern over MLPs eroding the corporate tax base was ended in 1987 by the enactment of section 7704. The substantial growth in pass-through entities in recent years, noted by so many, did not come from MLPs. Imposing corporate tax on MLPs would do a great deal of harm to our efforts at achieving energy independence, to tens of thousands of workers, and to millions of investors, in return for a benefit that, if it exists at all, is very difficult to perceive.