Publicly Traded Partnerships and "Carried Interests"

Congress recently has been reconsidering the tax rules applicable to deferred compensation of corporate executives. In the process, questions have arisen concerning the appropriate tax treatment of the income that investment managers receive from certain interests in private equity funds.

Private Equity Funds

Typically, investment managers organize a private equity fund as a limited partnership or limited liability company to raise investment capital from outside investors. This capital is used to purchase a portfolio of interests in privately-held operating companies, most typically stock in corporations. The general partner of the fund (or managing member of the LLC) receives an annual management fee of two percent of investor capital, along with a significant interest in the future profits of the fund, usually 20 percent. This profits interest in the partnership is commonly referred to as the "carried interest." Individual investment managers provide investment advice and other services to the fund through the general partner, and may receive a profits interest in the general partner or a share of the general partner's profits interest in the fund.

Publicly Traded Partnerships

Publicly traded partnerships (PTPs) are limited partnerships whose limited partner interests trade on public securities exchanges. PTPs, which sometimes are referred to as master limited partnerships (MLPs), typically are managed by a corporate general partner (or a wholly-owned subsidiary of a corporation), that ordinarily owns a two percent interest in the PTP's capital and usually has incentive distribution rights (IDRs) under which the general partner is entitled to increasing shares of cash distributions as distributions to limited partners increase. (A limited liability company also can be a PTP.)

The great majority of publicly traded partnerships are engaged in energy-related businesses. The use of PTPs facilitates capital formation in the energy sector, promoting needed investment in the country's energy infrastructure.

Application of Partnership Tax Principles

The tax law generally does not treat a partnership as a taxable entity. Instead, in computing federal income tax liability, each partner must take into income that partner's share of partnership income, gain, loss, deduction or credit. Under fundamental partnership tax principles, the character of partnership income allocated to the partners will be the same in the hands of the partners as the character of that income to the partnership. Thus, if the partnership generates ordinary income, the income will be ordinary income to its partners, including one with a carried interest or IDRs. If capital gain is generated by the partnership, the income will be capital gain to the partners.

Generally, partnerships whose interests are publicly traded are taxed as corporations for federal income tax purposes. However, section 7704(c) of the Internal Revenue Code of 1986, as amended (the Code), provides that a publicly traded partnership will be treated as a partnership if at least 90 percent of the PTP's income is "qualifying income." In adopting this provision in 1987, Congress recognized that the partnership form had traditionally been used by many companies for energy-related activities, and that subjecting the income generated from these activities to corporate tax would not be appropriate.

Private Equity Funds. The income in a private equity fund primarily consists of (i) long term capital gains from sales of stock in portfolio companies, taxed under current law at the 15 percent capital gains rate, and (ii) dividends from portfolio stock investments, which qualify for the current 15 percent rate of tax on dividends. Thus, an individual investment manager owning a profits interest in the fund or in its general partner will be allocated capital gain or dividend income (in accordance with the character of the income to the fund) taxed at a 15 percent rate.

Publicly Traded Partnerships. The vast majority of income of PTPs is from natural resource and mineral activities and is taxed to the owners of PTP interests under current law at ordinary income rates.

At least 90% of the gross income of a publicly traded partnership must be "qualifying income" within the meaning of section 7704(d) of the Code. Qualifying income includes income and gains from certain natural resource and mineral activities, interest (other than interest derived from the conduct of a financial or insurance business), dividends, real estate rents, income from the sale of real property, gain on the sale of assets that are held for the production of qualifying income and gain from the sale of stock.

Natural resource and mineral activities include 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). Generally, minerals or natural resources mean products that are eligible for depletion allowances under section 611 of the Code. For a variety of reasons, a PTP will often own stock of a corporation which will generate dividend income to the PTP and to its owners. In the norm, only a small percentage, certainly less than half, of a PTP's gross income will be dividend income. The taxable income of the corporation bears a corporate level tax, and dividends paid to the PTP will be qualifying income.

General partners of PTPs in many cases own IDRs which are non-capital interests. As said earlier, these IDRs represent the right to receive an increasing percentage of quarterly distributions of available cash from operations after target distribution levels have been achieved. In the typical PTP, the general partner is allocated income with respect to the IDRs and that income will almost always be ordinary income as it is the same character to the general partner as it is to the PTP – operating income from natural resource or energy activities.[1]

[1] In several instances, the PTP generates substantial capital gains under the provisions of section 631 of the Code. In those cases, the ownership of IDRs results in capital gains, again because the PTP allocates a portion of its income to the owners of the IDRs.

Partnership Equity Received in Exchange for Services

Partnerships other than PTPs issue a variety of interests in connection with the performance of services. Under current law, the receipt of a profits interest in connection with the performance of services to or for the benefit of a partnership is not a taxable event, either for the partnership or for the partner. Proposed Treasury regulations regarding partnership equity received in exchange for services do not distinguish between partnership capital interests and partnership profits interests, since all partnership interests constitute property under state law and give the holder the right to share in future partnership earnings. New York State Bar Association comments on these proposed regulations note that "issuing a compensatory partnership profits interest is a routine transaction undertaken by a vast number of partnerships each year in a variety of businesses, including a wide array of investment partnerships."

Any legislative proposals to change the fundamental tax treatment of partnership profits interests or carried interests could increase tax rates on income from capital, and could have unintended and unexpected consequences. Careful consideration of these issues must take into account the fact that PTPs engaged in energy and natural resource activities primarily generate income that is taxed to owners of PTP interests, including the general partner, at ordinary income rates. Moreover, carried interests and IDRs have always, under general federal income tax principles, resulted in income to the owners of such interests which is of the same character as to the partnership because under those principles those owners are treated as engaged in the same activity as the partnership.