PUBLICLY TRADED PARTNERSHIPS AND TAXATION OF NON-CAPITAL INTERESTS

Publicly traded partnerships (PTPs), also known as master limited partnerships or MLPs, are limited partnerships (or LLCs taxed as partnerships) which are traded on public exchanges. As with other partnerships, the income, deductions, gains, and losses of a PTP are passed through to the partners, who include these items in their own tax calculations. The PTP itself, like all partnerships, does not incur a tax liability. PTPs pay out most of their earnings to their investors as quarterly cash distributions, making them an attractive option for investors seeking a secure income-generating investment.

For a PTP to qualify for partnership tax status, 90% of its gross income must be "qualifying income"--income and gains from natural resource activities, interest, dividends, real estate rents, income from the sale of real property, and gain from the sale of assets held for production of qualifying income or from the sale of stock. Most PTPs today are engaged in small-scale exploration and production of oil and gas; gathering, processing, storage, transportation, and marketing of various petroleum products; propane distribution; and ownership or operation of coal properties. PTPs are predominantly involved in building, maintaining and operating the infrastructure that moves energy supplies from where they are produced to where they are needed.

As Congress considers the tax rules governing deferred compensation, questions have arisen as to how the income that investment managers receive from certain interests in private equity funds should be treated. Private equity funds are typically organized as limited partnerships or LLCs; however, very few are publicly traded. They raise capital from outside investors and use it to purchase a portfolio of interests in privately-held operating companies, most typically stock in corporations. The general partner of the partnership receives 1) a management fee of 2% of investor capital and 2) a substantial interest (usually 20%) in the fund's future profits, known as a "carried interest."

In a private equity fund investment managers provide services to the fund through the general partner. In turn they may receive a profits interest[1] in the general partner or a share of the general partner's profits interest in the fund. Because much of a private equity fund's profits come from holding and selling stock, income received via the profits interest often takes the form of a dividend or capital gain, both generally taxed at the 15% rate.

General partners of most PTPs in the energy industry also receive a non-capital interest in the partnerships they manage. This is known as an incentive distribution right (IDR) and is a percentage of all cash distributions—typically 2% at the beginning. As distributions grow and a target level is reached, the general partner receives an increasing share of the distributions. This provides an incentive for the general partner to grow the partnership and manage it well so that cash distributions can be increased. The income allocated to the general partners through the IDR is almost always operating income from natural resource or energy activities, and thus is taxed as ordinary income.

For various reasons, PTPs will often own stock of a corporation which will generate dividend income to the PTP and its owners. The corporation will pay tax on its income, and the dividends paid to the PTP will be qualifying income. Normally only a small percentage, certainly less than half, of a PTP's gross income will be dividend income

The tax law has long recognized that partnerships often issue partnership interests in connection with the performance of services, and has not deemed this to be a taxable event for either the partnership or the partner. Neither current law nor proposed Treasury regulations distinguish between profits and capital interests in this regard.

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. Any changes to the law should be carefully tailored to ensure that they do not adversely impact non-abusive partnership arrangements or detract from the purposes for which Congress enabled the formation of PTPs.

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[1] That is, they have an interest in a share of the profits but do not have an ownership ("capital") interest.