PRIVATE EQUITY FUND PTPS

During the first half of 2007 the emergence of a new and different type of publicly traded partnership caught the attention of the markets and the tax policymakers in Washington: the private equity fund PTP. On February 8 Fortress Investment Group (NYSE:FIG) completed its IPO, and on March 22 the Blackstone Group filed a registration statement for a PTP of its own. Blackstone's size and predominance in the investment world made it inevitable that this transaction would attract scrutiny.

Background: Private Equity Funds

Although issuing publicly traded equity is a new development, private equity funds have typically been organized as partnerships. A private equity fund raises money through a general partner which is managed by investment professionals. The money is used to acquire the stock of the various companies in the fund's portfolio. The investment capital comes through investor-limited partners, with the general partner (GP) also contributing a sizeable stake. The funds hold these companies for a number of years and then sell them for a profit.

Private equity funds generate two types of income for the general partner: a two percent management fee and a profits interest, typically 20 percent, in the income generated by the investments, usually dividends and capital gains from the sales of the companies. The senior managers of the funds receive most of their compensation through this "carried interest" in the fund's investments. Because the fund is a partnership, the fund's profits retain their original character when they are received by the managers. It is important to note that compensation for services to a partnership via a profits interest (as opposed to a capital interest) has been an accepted part of partnership tax law for many years.

In the Blackstone transaction, the structure is the same, except that the limited partnership interests in the managing partnership are publicly traded. The various companies in the PTP's investment portfolio will be held by a series of five limited partnerships collectively known as Blackstone Holdings. The income from Blackstone's investments will flow up through these partnerships to their general partners—three of which will be partnerships and two of which will be corporations—and from them on up to the PTP. The management fees and any other income which is non-qualifying for a PTP under section 7704 will flow through the corporate GPs and be paid to the PTP and ultimately its managers as dividends, while the income from the carried interest will pass through the partnerships and retain its character as capital gains or dividends.

Policy Concerns

The principal concern for tax policymakers with regard to both traded and non-traded private equity funds is that compensating fund managers through a carried interest in partnership income allows them to pay a substantially lower tax on their compensation. If the company at the top of the chain were a corporation, the capital gains constituting a major portion of the income would be taxed to the corporation at 35%, and then paid to the senior managers as, depending on the arrangement, salary, bonus or dividends, all of which would be taxed again at ordinary income rates. Because the management entity is a partnership, however, and the senior management is compensated through a profits interest, the capital gains received by the fund will not be taxed at any entity level but rather will flow directly through to the managers and be taxed only once, at the 15% capital gains rate.

Thus the private equity fund allows managers to pay tax on their compensation at the lower capital gains rate. Moreover, because compensation to management takes this form rather than salary or other more usual compensation, none of the usual employee withholding taxes are paid. These benefits do not depend on fund being publicly traded; becoming a PTP simply allows the fund to raise investment capital from a greater number of investors.

Another concern raised by some of the staff of the Congressional tax-writing committees that is particular to the publicly traded funds is the fact that management fees and other income that is non-qualifying under section 7704 are channeled through a corporation which pays dividends to the PTP. They have questioned whether this is an abuse of section 7704 and whether Congress intended that PTPs be able to meet the qualifying income test without the use of an intermediary corporation. This concern appears to have its roots in the use by private equity and hedge funds of offshore "blocker corporations" to allow tax-exempt investors to avoid UBIT and foreign investors to avoid tax on effectively connected income

Private Equity Funds and "Traditional" PTPs

Despite the similarity in structure, there are significant differences between this new type of PTP and the ones that have been created up until now. Important differences with regard to the "carried interest" issue are:

- The business of private equity firms is to generate investment returns by buying and selling other companies. They therefore derive most of their income in the form of capital gains from stock sold and dividends from stock held. Traditional PTPs earn income by operating businesses that produce concrete goods and services. The income passed through to investors is overwhelmingly ordinary business income, with any small amounts of interest or dividends being ancillary to operating the business.

- Managers of traditional PTPs often own partnership units, and such units or unit options may be part of the compensation of senior management. In traditional PTPs, however, unlike private equity funds, this compensation is taxed just as employee stock benefits would be. PTP managers are typically employed by a general partner or other corporate affiliate and receive a salary on which the usual payroll and income taxes are paid.

- General partners of PTPs do own a profits interest in the PTP, the incentive distribution rights (IDRs), under which the GP receives an increasing portion of the additional distributions once a target level is reached. However, for the most part the income flowing to the GPs is not derived from capital gains but is ordinary business income and taxed as such. Moreover, many GPs are corporations and thus will pay corporate tax on the income.

- Some traditional PTPs do have corporate subsidiaries, but they are not used for the purpose of allowing investors to avoid tax (in fact, they result in double taxation), nor to engage in major activities or receiving large amounts of income that are outside the scope of section 7704. Rather, they are used to accommodate such situations as foreign operations generating qualifying income in countries which do not recognize PTPs, acquisitions of and joint ventures with corporations engaged in activities generating qualifying income, uncertainty at start-up over characterization of some types of income that are adjuncts to operations generating clearly qualifying income, and small amounts of non-qualifying income or activity in operations that are otherwise clearly qualifying. The dividends they receive from such subsidiaries represent only a small portion of the PTP's total income.

NAPTP Policy Regarding Private Equity PTPs

The National Association of Publicly Traded Partnerships takes no position with regard to the appropriate tax treatment of the carried interests of private equity fund managers, nor whether Congress should enact legislation restricting particular aspects of private equity funds organized as partnerships. It urges, however, that if Congress does decide to undertake legislation in this area, it do so with great care in order not to detract from the purposes for which Congress enabled the formation of PTPs, and to avoid any adverse effect on the PTPs that have been fulfilling these purposes for two decades. For example, any legislation changing the tax treatment of partnership profits interests should not affect the IDRs received by PTPs' general partners.

With regard to corporate subsidiaries, the Association strongly believes that conducting activities within corporate subsidiaries, whether the resulting income is qualifying or nonqualifying, is entirely within the letter and spirit of section 7704 and was clearly intended by Congress when section 7704 was enacted in 1987.

Action to Date

The Association and its legislative representatives have to date met with Finance Committee staff on two occasions to educate them about PTPs and their operations, clarify the differences between private equity and "traditional" PTPs, and discuss any aspects of PTPs about which they may have questions or concerns. These discussions have included in particular the ways in which the private equity funds' income and carried interests differ from the income earned by PTPs, their managers, and their investors; and the intent of Congress with regard to PTPs which have corporate subsidiaries and the placement in such subsidiaries of activities generating non-qualifying income. A meeting was also scheduled with Ways and Means Committee staff but was cancelled. It should be rescheduled in the near future.

In addition, the Association has developed a white paper and a one-page discussion with regard to the carried interest issue, as well as talking points on the corporate subsidiary issue. These papers follow this report and may be used in discussions with legislators, staff, and the press.