NATIONAL ASSOCIATION OF
PUBLICLY TRADED PARTNERSHIPS
1801 K STREET, N.W., SUITE 500, WASHINGTON, D.C. 20006
PHONE 202.973.3150 FAX 202.973.3101
WWW.NAPTP.ORG

STATEMENT OF THE NATIONAL ASSOCIATION OF PUBLICLY TRADED PARTNERSHIPS

Testimony Submitted to the
House Committee on Ways and Means
Hearing on Fairness and Equity for America's Working Families

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The National Association of Publicly Traded Partnerships (NAPTP) is pleased to have this opportunity to submit a statement for the record with respect to the "Hearing on Fairness and Equity for America's Working Families" held by the Committee on Ways and Means on September 6, 2007. NAPTP, formerly the Coalition of Publicly Traded Partnerships, is a trade association representing publicly traded partnerships[1] (PTPs) and those who work with them. Our current membership includes sixty PTPs and thirty-five other companies.

PTPs are provided for under section 7704 of the Internal Revenue Code. This section generally provides that a very limited universe of companies–those engaged in active natural resource or real estate business as well as those generating passive investment income–can be publicly traded partnerships.

I. Publicly Traded Partnerships and Carried Interest

A primary focus of this hearing is the fact that certain private equity and hedge fund managers, among others, are compensated for their services via a "carried interest"—a partnership profits interest—and that this compensation is received and taxed as capital gains. Awareness of and concern about this practice escalated early this year when a few such funds went public as PTPs or expressed the intention of doing so. It is important to remember, however, that the ability of these managers to receive carried interest in the form of capital gains arises not because their companies are *publicly traded* partnerships—the vast majority are not—but because they are *partnerships* whose investments produce capital gain. The tax treatment of carried interest is based on long established rules of Subchapter K regarding the tax treatment of partnership interests received in return for services provided to the partnership, and not on the publicly traded partnership rules of section 7704.

Moreover, it is important to recognize that not all carried interests, nor all partnership profits interests, pass through capital gains to the holder of the interest. The rate at which the income from "carried interest" is taxed is dependent on (i) the organizational nature of the company receiving the carried interest (C corporation, partnership, etc.) and (ii) the character or nature of the underlying income. If the recipient is a C corporation, the income will be taxed at ordinary income tax rates. If it is a partnership, then it is not taxed at the entity level and the rate at which it is taxed is dependent on the nature of the income. The nature of the income received by the partner will depend upon the nature of the income generated by the business. Typically, the private equity funds receive the bulk of their income when they sell the companies in which they invest, and the proceeds from a sale are usually characterized as long-term capital gains. In

[1]Publicly traded partnerships are also referred to as "master limited partnerships" or MLPs.

contrast, the business of "traditional" PTPs, i.e., those PTPs clearly and purposefully treated as partnerships in 1987, generates ordinary income.

The general partners of many PTPs (ten of which are themselves PTPs) have profits interests known as an incentive distribution rights (IDRs), under which the general partner receives a 2 percent interest in the PTP's income. This percentage share increases in steps as distributions to the limited partners reach target levels. This profits interest, however, gives rise to ordinary business income and is taxed as such in the hands of the general partner.

While private equity firms are not part of NAPTP, we take no position on whether the carried interest rules for investment partnerships should be changed. However, as an association that was organized in the 1980s when the tax treatment of PTPs was a subject of debate, and which played a role in the enactment of the current law that preserves partnership treatment for certain PTPs, NAPTP is happy to provide its perspective on the history and intent of section 7704 and to provide information on the PTPs that we represent.

As we do so, we strongly urge that Congress avoid changing the law that for two decades has governed the "traditional" PTPs. Those PTPs operating in the energy industry in particular are a long-established segment of that industry and play an important role in the development of the national energy infrastructure needed to insure our continued economic growth and security. This role is widely recognized by observers ranging from FERC to energy analysts on Wall Street. There is no policy reason to overturn twenty years of settled and successful tax law by changing the tax treatment of these traditional PTPs.

II. Early History of PTPs

The first publicly traded partnership was Apache Petroleum Company, which was created in 1981 by Apache Oil through the roll-up of several smaller partnerships. It was soon followed by a number of oil and gas exploration and production PTPs as well as by real estate PTPs. Some, like Apache, were formed by partnership roll-ups; some by spin-offs of corporate assets; some (until the Tax Reform Act of 1986 repealed the *General Utilities* doctrine) through corporate liquidations; and a few through IPOs for new business operations.

The energy and real estate industries had traditionally used limited partnerships as a means of raising capital and conducting operations. The pass-through structure of partnerships allowed investors to share directly in both the profits and the tax attributes of these industries. Traditional limited partnerships, however, could attract only a limited pool of investors. They required investors to commit large amounts of money and were very illiquid. Thus, only very affluent investors could afford to participate.

By dividing partnership interests into thousands or tens of thousands of units which were affordably priced and could be traded on public exchanges, PTPs were able attract a far broader range of investors than private limited partnerships, providing a new flow of equity capital to the energy and real estate industries. Unlike many of the limited partnerships that were formed during the 1980s as tax shelters aimed at providing investors with a tax loss, PTPs were created to be income-generating investments. Companies with energy, real estate, or other assets providing positive income streams over a number of years were able to attract investors seeking steady cash distributions.

As the 1980s progressed, PTPs began to emerge in other industries, e.g., the Boston Celtics and the Cedar Fair amusement park company. This became a source of concern to tax policymakers.

A. Development of the1987 Legislation

Until 1987 there were no provisions in the Internal Revenue Code specifically addressing publicly traded partnerships. However, the growth of PTPs led to fears on the part of the Treasury Department and some Congressional policymakers that the expansion of PTPs would cause a substantial loss of corporate tax revenue. In addition, the 1980s were the decade of tax reform, and some felt as a policy matter that the fact that public trading of securities was an inherently corporate characteristic--an idea with which we have always disagreed.[2]

After several years of debate over the issue of whether large and/or publicly traded partnerships should continue to receive pass-through tax treatment, the Treasury Department and Congressional tax writers determined to address the issue in 1987. It was clear from the beginning that while there were varying views on the degree to which PTPs should be restricted, there was considerable support for the idea that the natural resources industry, which had always raised capital through partnerships, should continue to be able to do so through PTPs.

Hearings on publicly traded partnerships were held by this Committee on June 30 and July 1, 1987 and by the Senate Finance Subcommittee on Taxation and Debt Management on July 21, 1987. At both the House and Senate hearings, Assistant Treasury Secretary for Tax Policy J. Roger Mentz, one of the primary advocates of restricting the use of PTPs, testified that partnership tax treatment should be retained for PTPs engaged in natural resources development:

> If Congress changes the classification of MLPs for tax purposes, we suggest that it consider extending the current statutory pass-through models to include activities such as natural resource development. Thus, as with REITs, RICs, and REMICs, entities engaged principally in developing timber, coal, oil, and gas, and other natural resources serve a relatively passive function, generating income from wasting assets and distributing it to investors. *Given the importance of natural resource development in the nation's security, Congress should consider carefully whether such traditionally noncorporate activities should be subjected to corporate level tax....* [Emphasis added]

B. Final Legislation

The provisions that we now know as section 7704 of the Code, which were enacted as part of the Revenue Act of 1987, originated in this Committee. This Committee retained partnership tax treatment for PTPs generating the type of income, such as interest and dividends, that one would receive as a passive investor, explaining in its report,

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[2] The vast majority of corporations are never publicly traded.

> If the publicly traded partnership's income is from sources that are commonly considered to be passive investments, then there is less reason to treat the publicly traded partnership as a corporation, either because investors could earn such income directly (e.g., interest income), or because it is already subject to corporate-level tax (in the case of dividends). Therefore, under the bill, an exception is provided….in the case of partnerships whose income is principally from passive-type investments.

This Committee did not allow interest to be treated as qualifying income if it was earned in conducting a financial or insurance business, "as deriving interest is an integral part of the active conduct of the business." Dividends, unlike interest, were not specifically restricted in the statutory language, but this Committee's report states, "Similarly, it is not intended that dividend income derived in the ordinary conduct of a business in which dividend income is an integral part (e.g., a securities broker/dealer) be treated as passive-type income."

Importantly, this Committee also retained partnership tax treatment for PTPs engaged in two types of active businesses: real estate and natural resource activities, noting in its report that these activities "have commonly or typically been conducted in partnership form" and that it "considers it inappropriate to subject net income from such activities to the two-level corporate tax regime to the extent the activities are conducted in forms that permit a single level of tax under present law." Natural resources activities were purposely defined very broadly to include "income and gains from exploration, development, mining or production, refining, transportation (including through pipelines transporting gas, oil or products thereof), or marketing of, any mineral or natural resource, including geothermal energy and timber."[3] This is essentially the rule that Congress adopted in the final bill.

In summary, Congress' intent in 1987 was to allow partnership tax treatment for PTPs generating investment-type income, i.e., income such as interest and dividends which a passive investor might earn without directly participating in a business. Partnership tax treatment for active business operations was also allowed to continue for two industries which had traditionally used the partnership structure, real estate and natural resources. Importantly, however, the evidence is that Congress also intended that qualifying income should include dividends received by PTPs from taxpaying corporate subsidiaries.

C. Non-Qualifying Income and Corporate Subsidiaries

As noted above, while the legislative history of section 7704 clearly indicated that interest and dividends earned as part of a financial business should not be considered to be qualifying income, it did not state or imply that dividends from corporate subsidiaries of PTPs would not be qualifying income to the PTP. To the contrary, it is apparent that Congress condoned the use of corporate subsidiaries.

The 1987 Treasury testimony noted above, which suggested that partnership tax treatment be retained for entities engaged principally in developing natural resources, also

[3] "In the case of natural resources activities, special considerations apply. Thus passive-type income from such activities is considerably broader…."

acknowledged that if this exception was enacted into law, many "downstream" operations such as milling, processing, refining, or marketing activities would remain in corporate form. Thus Congress aware of the potential use of corporate subsidiaries for this purpose and did not exclude or restrict dividends from such subsidiaries as qualifying income in enacting section 7704.

In addition, as the legislative history makes clear, section 7704 was resulted from the concern that the widespread use of PTPs would lead to a loss of corporate income tax revenue. Thus, there could be no objection to a PTP receiving dividend income from a subsidiary earning non-qualifying income that had been subject to corporate tax. Finally, the transition rules provided by Congress for existing PTPs with non-qualifying income allowed them to remain in existence after the transition period ended if they were able to change their income stream to meet the qualifying income test of 7704, and placed no restrictions on PTPs' ability to place operations in corporate subsidiaries for this purpose.

Some NAPTP members form corporate subsidiaries for related activities that generate non-qualifying income.[4] This is done to ensure that the qualifying income test is met. Although the amounts involved are usually quite small, it is important to remember that the penalty for exceeding the 10 percent limit on non-qualifying income is extremely severe—the conversion of the PTP into a corporation, with resulting adverse tax consequences to the company and its investors. We therefore feel it is entirely appropriate to use a corporate subsidiary, which is not afforded flow-through treatment, to act as a "safety valve" for the qualifying income test.
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Since 1987 no additional restrictions have been placed on the activities of publicly traded partnerships and there have been some small liberalizations in their tax treatment. For example, in 1993 the rule enacted in 1987 which treated all income from a PTP as unrelated business income for tax-exempt investors, regardless of the nature of the income, was repealed; and in 2004, with bipartisan support, Congress added PTPs to the list of qualifying income sources for mutual funds.

III. PTPs Today

A. PTP Businesses

The PTP universe today looks very different from the one in 1987. Most of the PTPs doing business in 1987 are gone, eliminated not by Congress, but by the marketplace. Changes in economic conditions for the energy and real estate industries in the latter part of the 1980s led to a wholesale change in the composition of the PTP universe.

Gradually over the course of the 1990s and early 2000s, the exploration and production PTPs were replaced by companies in the "midstream" sector of the energy business: pipeline and marine transportation, processing, refining, gathering, marketing, etc. This sector is much less affected by oil and gas prices, receiving a contracted fee for services regardless of the price of the commodity, and thus is better able to maintain steady distributions through the ups and

[4] Some members also have corporate subsidiaries which generate qualifying income, as part of an acquisition or joint venture, or for other reasons.

downs of the markets. Companies with these types of assets, particularly regulated pipelines, found that they were able to attract more capital in PTP form than in corporate form.

Today, by the Association's count, there are some 80 publicly traded partnerships trading on the major exchanges, including the Fortress and Blackstone entities. The great majority of these are energy-related partnerships, as demonstrated in Table 1. The total market capital of these 80 PTPs is about $163 billion as of August 31, of which about $134 billion or 82% comes from the energy-related sectors.

Table 1

Publicly Traded Partnerships on Major Exchanges

	Number*	Percent of Total	Market Capital ($B)	Percent of Total
Oil and Gas Midstream Operations	39	48.8%	$ 91.7	56.2%
Marine Transportation	6	7.5%	$ 3.8	2.3%
Propane & Heating Oil	9	11.3%	$ 23.6	14.4%
Oil & Gas E&P	7	8.8%	$ 7.6	4.6%
Coal	5	6.3%	$ 7.4	4.5%
All Energy	**65**	**82.3%**	**$ 134.0**	**82.2%**
Other Minerals, Timber	2	2.5%	$ 2.2	1.4%
Real Estate- Income Properties	3	3.8%	$ 8.5	5.2%
Real Estate - Mortgage Securities	3	3.8%	$ 1.8	1.1%
Miscellaneous	6	7.5%	$ 16.5	10.1%
All PTPs	**80**	**100%**	**$ 163.0**	**100.0%**

Numbers include 10 PTPs which are publicly traded general partners of other PTPs. This includes 6 in Midstream Operations, 2 in Propane & Heating Oil, and 2 in Coal.

B. PTPs in the Energy Industry

Of the various sectors of the energy industry in which PTPs operate, the largest by far, representing over half of the PTP market capital, is the midstream sector: PTPs which gather oil and natural gas in gathering pipelines; compress natural gas for transportation; refine or process crude oil and natural gas into natural gas liquids; fuels, and other products; transport oil, gas, and refined products in intra- and interstate transmission pipeline systems; and store them in terminals. Another group of PTPs, currently six in number, transports petroleum products by water to areas not reached by pipelines.

In other energy niches, several PTPs are engaged in the distribution of heating oil and propane. In addition, seven to date have returned to the place where PTPs originally started—exploration and production of oil and gas. For various reasons, these PTPs are considered by analysts to be more conservative and less risky than their 1980s counterparts. Finally, three

PTPs and two PTP general partners are in the coal industry; one engaged in active production; the others as lessors of coal reserves.

As midstream energy operations have become an increasingly important part of the businesses conducted by PTPs, PTPs have conversely become an increasingly important part of the midstream energy industry, and particularly the ownership and operation of oil and gas pipelines. As shown below in Figures 1 and 2, the midstream energy PTPs dominate the PTP world in both numbers and market capital.

Figure 1
Publicly Traded Partnerships by Sector

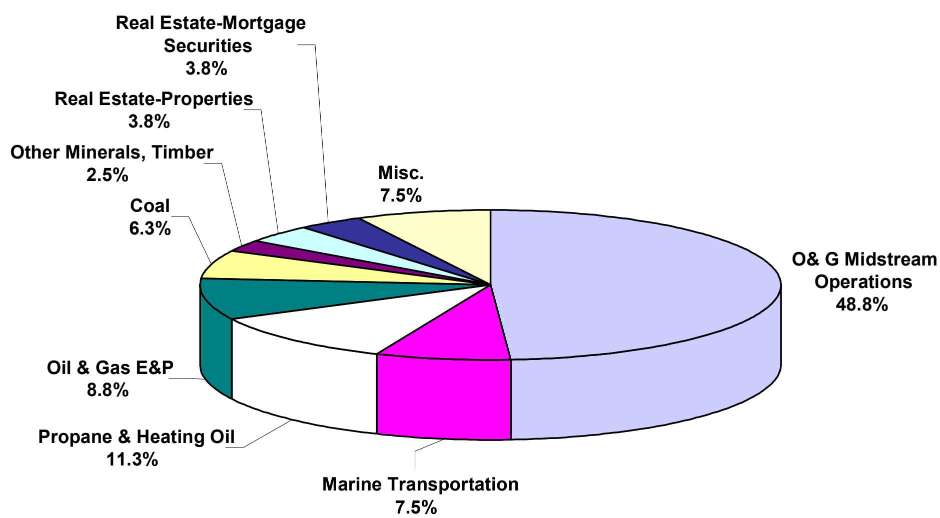
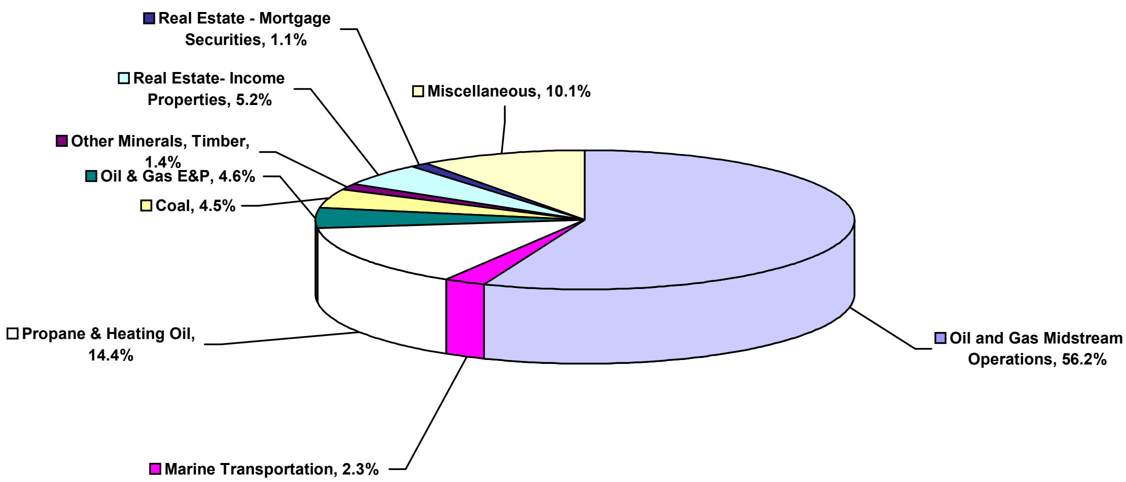


Figure 2
PTP Market Capital by Sector



Why has so much midstream energy capital moved into PTPs? Over the past decade, many corporate energy companies have realized that they had a good deal of capital tied up in pipeline assets which, although dependable generators of cash, produce only a modest return, particularly for those pipelines subject to rate regulation. By selling these assets to PTPs, they could monetize them and reinvest the capital in areas closer to their core business and with higher returns. PTP unitholders, meanwhile, would receive the benefit of the steady cash distributions generated by pipeline fees.

PTPs, for their part, have proven to be a highly efficient means of raising and investing capital in pipeline systems. Their structure affords such PTPs a lower cost of capital, allowing them to spend more on building or acquiring pipelines. PTPs need to pay out most of their earnings as cash distributions due to their pass-through tax status, which requires the unitholders to pay tax on their shares of partnership income regardless of whether they receive a corresponding amount in cash; therefore, PTPs cannot retain earnings for building or acquiring pipelines and other assets. The need to go to the equity or credit markets to raise capital lends discipline to their capital expenditures, helping to ensure the most efficient use of capital.

For these reasons, the proportion of oil and gas pipelines owned by MLPs has steadily increased over the years. We estimate that PTPs today own over 200,000 miles of pipelines--gathering and transmission, onshore and offshore, carrying natural gas, natural gas liquids, crude oil, and refined products, as shown in Table 2. Of the $163 million of PTP market capital, $102 million is in pipeline PTPs. To an increasing extent, PTPs are building and maintaining the pipeline infrastructure on which we depend for energy security.

Table 2 PTP-Owned Pipeline Mileage as of August 2007	
	PTP-Owned Mileage (1)
Crude Oil	29,496
Refined Petroleum Products	37,527
Natural Gas	123,942
Natural Gas Liquids(3)	20,641
TOTAL	211,606

(1) Sources: PTP 10-Ks and websites. When a PTP owns a partial interest in a pipeline, the mileage included is equal to (pipeline miles) x (percentage interest).

This fact has been increasingly recognized by, among others, the Federal Energy Regulatory Commission (FERC), which oversees a number of pipelines owned and operated by PTPs. Most recently, on July 19, 2007, FERC Chairman Kelliher issued a policy statement stating that PTPs will henceforth be included in the proxy group for calculation of returns under the discounted cash flow model for natural gas pipelines. Kelliher noted that PTPs have been included in oil pipeline proxy groups for a number of years due to the lack of corporate owners and stated"

> [T]he reality is that both sectors have increasingly adopted the MLP structure as the framework for the pipeline business. This raises a policy question: have we reached a tipping point, have we reached the point where the natural gas pipeline sector has adopted the MLP to such an extent that it is perverse to exclude MLPs from the proxy group? In my view we have reached that point. It seems clear we reached that point with respect to oil pipelines some time ago.

It was in recognition of this fact that the Senate Finance Committee this year included in its energy tax provisions a measure that would include transportation and storage of blended ethanol, biodiesel, and other renewable fuels in the definition of "natural resource activities" under section 7704. If the federal policy of dramatically increased use of these fuels is to be achieved, pipelines will have to be built or converted to carry them. The past decade has shown that if large amounts of capital are to be put into pipelines, it will be PTPs that will do it.

The energy PTPs that are doing exactly what Congress intended them to do in 1987, including building and maintaining the pipeline infrastructure on which we depend for energy security. Accordingly, the PTP provisions are working well and should be allowed to continue doing so.

IV. Conclusion

Twenty years ago Congress and the Treasury Department undertook a lengthy and careful consideration of the issue of publicly traded partnerships and who should have access to this particular business structure. The result was the enactment of section 7704 of the tax code. It is clear from the legislative history that those in Congress and the Executive Branch who participated in the development of section 7704 intended that—

- Activities generating passive investment income such as interest and dividends should be able to use publicly traded partnerships. However, companies for whom interest and dividends *were* their business income, such as those in the financial services industry, should not qualify as PTPs.

- Two types of active businesses, natural resources and real estate, which had traditionally raised capital through partnerships and whose existence was important to the national economy, should continue to be able to access the capital markets in partnership form.

- As long it is not "business" income to a PTP, dividend income, including income received from a corporate subsidiary, is qualifying income.

Over the ensuing years, the economics of the midstream energy transportation and storage industry and the interest of many integrated energy companies in finding more lucrative investments for their capital, have led to an increasingly important role for PTPs in this sector. The PTP rules have worked well in allowing capital to be channeled into the infrastructure needed to move traditional energy sources out of the ground, process them into useable products, and transport them from production areas to the areas where they are consumed. As the country moves to alternative forms of energy, PTPs will continue to play a central role. The ongoing debate on the pros and cons of carried interest should not be allowed to change this fact.