COMMITTEE ON FINANCE
NEWS RELEASE

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BAUCUS-GRASSLEY BILL ADDRESSES PUBLICLY TRADED PARTNERSHIPS

Senators seek to clarify tax treatment for partnerships acting as corporations

Washington, DC – U.S. Senators Max Baucus (D-Mont.) and Chuck Grassley (R-Iowa), Chairman and Ranking Republican Member of the Senate Finance Committee, introduced legislation today that would tax as corporations all publicly traded partnerships that directly or indirectly derive income from investment adviser or asset management services. Private equity firms, for instance, derive most of their income directly or indirectly from investment adviser or asset management services.

"The nature of investment vehicles is changing right before our eyes, and the tax code must keep up with the times," said Baucus. **"Creative new structures for investment vehicles may blur the lines for the tax treatment of income. We must make the law clear and apply the law fairly, or risk the erosion of our corporate tax base. If a publicly traded partnership makes its money by providing financial services, that active business should be taxed as a corporation. "**

"Right now, some businesses are crossing the line between reasonably lowering their tax burden and pretending to be something they're not to avoid most, if not all, corporate taxes," said Grassley. **"A hallmark of corporate status is access to the capital markets. It's unfair to allow a publicly traded company to act like a corporation but not pay corporate tax, contrary to the intent of the tax code. We don't have a workable tax code if we don't have structural integrity. If left unaddressed, the tax concerns presented by the public offerings of investment managers, like private equity and hedge fund management firms, could fundamentally erode the corporate tax base. That would leave other individuals and business taxpayers with a greater share of the nation's tax burden."**

Corporations and their shareholders are subject to two levels of tax. Corporations pay taxes, and shareholders pay taxes on distributions received from the corporations. In contrast, partnerships and their partners are subject to only one level of tax. Partners are taxed on their distributive shares of income.

In 1987, Congress became concerned that some partnerships with interests traded on public exchanges were essentially operating as corporations, but avoiding corporate tax. Congress feared that such publicly traded partnerships would erode the corporate tax base and gain an unfair advantage over companies operating as corporations. In response to these concerns, Congress updated the law to generally tax publicly traded partnerships as corporations.

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An exception to that general rule exempts publicly traded partnerships from corporate taxation if they can demonstrate that at least 90 percent of their income is passive – for instance, from dividends, interest, or royalties rather than the provision of services. But today, new structuring of investment vehicles may make it possible for partnerships to argue that their income is passive, when it is actually produced by actively providing financial services. In filing this legislation, Baucus and Grassley are seeking to further clarify the law, both to appropriately preserve the corporate tax base and to assure that such publicly traded partnerships do not gain an unfair advantage over established financial services corporations.

Upon passage, the bill will be effective as of the date of introduction.

Baucus and Grassley do not believe that recent and proposed public offerings of private equity and hedge fund management firms are consistent with the intent of the existing rules regarding publicly traded partnerships. In addition to filing this legislation, Baucus and Grassley have written to Secretary Paulson, asking for Treasury's views on this issue and what plans Treasury and the IRS have to issue guidance and enforce Congressional intent. A copy of that letter and an additional letter were also sent to SEC Commissioner Cox. Text of the letters follows here:

June 14, 2007

The Honorable Henry M. Paulson, Jr.
Secretary
Department of Treasury
Washington, D.C. 20220

Dear Mr. Secretary:

We are writing to you regarding several recent initial public offerings ("IPOs") of private equity and hedge funds. We believe that these IPOs raise serious tax questions that if left unaddressed have the potential to jeopardize the integrity of the tax code and the corporate tax base over the long term. We write to request your views on this matter, to ask what actions Treasury intends to take, and for your views on legislation we introduced to address this threat to the corporate tax base, if a change to statute proves necessary.

The basic structure of these IPOs is that they are classified as publicly traded partnerships ("PTP") under section 7704(b) of the Internal Revenue Code (the "Code"). A PTP is taxed as a corporation unless it satisfies the qualifying income exception under section 7704(c), chiefly directed to passive-type income. Section 7704(c) requires that for any taxable year, 90 percent or more of the gross income must be "qualifying income." Qualifying income is defined in section 7704(d) to include: interest; dividends; rents; gain from sale of a capital asset held for production of income; and gain from commodities contracts.

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These funds clearly state that they are engaged in an active trade or business. For example, one fund states in its public filing that "[w]e believe that we are engaged primarily in the business of providing asset management and financial advisory services and not in the business of investing, reinvesting, or trading securities. We also believe that the primary source of income from each of our businesses is properly characterized as income earned in exchange for the provision of services." In order to avoid failing the 90 percent qualified income test, these PTPs rely on the income from carried interests being treated as qualified income, and have created a subsidiary blocker corporation to absorb all nonqualified income. To the extent that any funds are then transferred from the subsidiary blocker corporation to the parent PTP, this blocker corporation will convert the nonqualified income into a payment of dividends (that is, qualifying income) to the PTP.

We believe that the PTP rules are being circumvented because the majority of the income is from the active provision of services to the underlying funds and limited partner investors in
those funds. The current section 7704 was initiated by the House Ways and Means Committee in 1987. We believe it is beneficial to call to your attention some key excerpts from the Ways and Means Committee report on section 7704:

> Reasons for Change. The recent proliferation of publicly traded partnerships has come to the committee's attention. The growth in such partnerships has caused concern about long-term erosion of the corporate tax base. To the extent that activities would otherwise be conducted in corporate form, and earnings would be subject to two levels of tax (at the corporate and shareholder levels), the growth of publicly traded partnerships engaged in such activities tends to jeopardize the corporate tax base.
> . . .
> These changes [referring to the corporate minimum tax included in the 1986 Act] reflect an intent to preserve the corporate level tax. The committee is concerned that the intent of these changes is being circumvented by the growth of publicly traded partnerships that are taking advantage of an unintended opportunity for disincorporation and elective integration of the corporate and shareholder levels of tax.

Thus, it is clear in these passages and throughout the report that Congress' policy concern in enacting this statute was to protect the corporate tax base. Congress allowed for a very narrow exception for PTPs that were invested in passive investments.

> In certain circumstances, however, the committee believes that the tax-created competitive advantage of publicly traded partnerships may be less significant. 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 to the treatment of publicly traded partnerships as corporations in the case of partnerships whose income is principally from passive-type investments.

Congress envisioned that a PTP could invest in outside corporations as investments and receive dividends and capital gains. It is a far cry to imagine that a PTP – which directly or indirectly gets its income from an asset management and financial services business through carried interests and dividends from a wholly owned corporation that is actively engaged in a trade or business performed by a subsidiary – should also be included within the ambit of Congressional intent. We would note that from the analysis that we have seen in some of the IPOs that it is unlikely that there will be any significant corporate-level tax paid by the subsidiary blocker corporations. Justification for the view that a PTP generating its own income from performance fees structured as carried interests and a wholly owned active trade or business (regardless of its characterization) is not in keeping with Congressional intent is given support throughout the Ways and Means report. To highlight a key statement:

> In general, the purpose of distinguishing between passive-type income and other income is to distinguish those partnerships that are engaged in activities commonly considered as essentially no more than investments, and those activities more typically conducted in corporate form that are in the nature of active business activities.

We ask that you please provide your analysis of the statute as it relates to the recent IPOs and your views on the potential effect on the corporate tax base. Further, please inform us of what guidance Treasury intends to issue to make investors or potential investors aware of how Treasury will enforce the law. If you believe that additional statutory changes are necessary, please inform us of your recommendations in this area. We also ask that you direct your staff to assist us by reviewing the legislation that we have introduced to address this matter. Finally, we ask that you join us in informing the Securities and Exchange Commission of the need to address the tax matters raised by the Blackstone IPO so that we can preserve the integrity of the tax code and also give clear guidance to potential investors and the public of the tax treatment.

We would appreciate a prompt response in light of the recent increased volume of PTP IPOs. Thank you for your time and courtesy on this important issue.

Sincerely,

Max Baucus
Chairman

Charles E. Grassley
Ranking Member

cc: The Honorable Charles B. Rangel, Chairman
Ways and Means Committee
The Honorable James McCrery, Ranking Member
Ways and Means Committee
The Honorable Christopher Cox, Chairman
Securities and Exchange Commission

June 14 2007

The Honorable Christopher Cox
Chairman
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Dear Mr. Chairman:

We are writing to you regarding the proposed Initial Public Offering (IPO) by The Blackstone Group L.P. ("Blackstone"). The Finance Committee staff has met at length with representatives of Blackstone and reviewed the relevant documents and filings.

After careful consideration, we believe that these IPOs raise serious tax questions that if left unaddressed have the potential to jeopardize the integrity of the tax code and the corporate tax base over the long term.

Today, we have written to the Secretary of Treasury to generally describe this matter and have raised with him the question of whether Treasury will take action to address the tax concerns contained in the Blackstone IPO. Additionally, please find enclosed a copy of our letter to Secretary Paulson and legislation that we introduced today.

We trust that you will agree that investors and shareholders should have confidence of the tax treatment of any investments – particularly in a case where the tax treatment is a critical component. Investors and shareholders will be in a more informed position after Congress and the Treasury have had an opportunity to speak to the serious tax policy questions raised by the Blackstone IPO. Most importantly, the public will benefit from a clear understanding and review of the tax policy issues presented.

Thank you for your time and courtesy on this important matter.

Sincerely yours,

Max Baucus
Chairman

Charles E. Grassley
Ranking Member

Enclosures

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