NEW LEGISLATION WOULD TAX AS CORPORATIONS PUBLICLY TRADED PARTNERSHIPS DERIVING INCOME FROM INVESTMENT ADVISER OR ASSET MANAGEMENT SERVICES

On June 14, 2007, Senators Max Baucus (D-Mont.) and Chuck Grassley (R-Iowa) introduced legislation that would tax as corporations all publicly traded partnerships that directly or indirectly derive any income from providing investment-advisory or asset-management services. In introducing the bill, Senator Baucus stated, "[i]f a publicly traded partnership makes its money by providing financial services, that active business should be taxed as a corporation." The bill also has the support of Charles B. Rangel (D-N.Y.), the House Ways and Means Committee Chair. The legislation is apparently in response to the recent public offering and proposed offering, respectively, of the advisory firms Fortress and Blackstone as partnerships that would not otherwise bear corporate taxation.

Generally, income of a partnership is imputed to its partners and taxed only in their hands. By contrast, a corporation's income is generally subject to tax at the corporate level and is then taxed again when distributed to its shareholders. In the late '80s, in response to industrial and commercial partnerships becoming traded on public exchanges, Congress enacted rules that generally tax a "publicly traded partnership" (or "PTP") as a corporation unless 90% or more of the partnership's gross income is "qualifying income."

Qualifying income generally consists of interest, dividends, real property rents, gain from the sale or other disposition of securities (as defined in the Investment Company Act of 1940) and real property, mineral and natural resource income and gains; any gain from the sale or disposition of a capital asset held for the production of these types of income; and in certain cases, income and gains from commodities, futures, forwards, and options with respect to commodities. This qualifying income exception from PTP status was intended to allow publicly traded partnerships engaged in businesses traditionally conducted in partnership form (such as oil and gas or real estate partnerships) to continue to be taxed as partnerships instead of corporations.

The qualifying income exception has recently been relied on by partnerships providing investment-advisory and asset-management services in order to become publicly traded without also becoming taxable as corporations.[1] Under current law, this tax result is achieved where the partnership structures its compensation for those services as qualifying income (and its nonqualifying income, if material in amount, is earned by taxable corporate subsidiaries).

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[1] For coverage of these transactions, see Reuters, "Blackstone I.P.O. in June," N.Y. Times, June 13, 2007; Jenny Anderson, "Scrutiny on Tax Rates that Fund Managers Pay," N.Y. Times, June 13, 2007; Jenny Anderson, "Blackstone Founders Prepare to Count their Billions," N.Y. Times, June 12,2007; Michael J. de la Merced, "Fortress Goes Public, a First for Hedge Funds Inside U.S.," N.Y. Times, Feb. 9, 2007; Bloomberg, "Hedge Fund is Planning Public Offering," N.Y. Times, Nov. 9, 2006; Randall Smith, "Goldman Takes 'Private' Equity to a New Level," Wall St. Journal, May 24, 2007; "Oaktree to List on New Goldman Market, Reports Say," N.Y. Times, May 11, 2007; Tom Petruno, "A Market for Private Stock Sales," L.A. Times, May 11, 2007.

The bill would preclude a partnership from relying on the qualifying income exception from PTP status if it earns any income from investment-advisory or asset-management services. In other words, for PTPs seeking to rely on the qualifying income exception, the proposed measure would treat this type of income as deadly. The proposal seems motivated by the view that publicly traded entities earning any compensation for investment-advisory or asset-management services should be subject to corporate taxation. It is not entirely clear what tax policy the proposal (if enacted) would further by not allowing this type of income to be treated like other types of nonqualifying income (such that a PTP would be taxable as a partnership provided its nonqualifying income, including from investment-advisory services, did not exceed 10% of its total income).

The bill specifically provides that a partnership cannot rely on the qualifying income exception to PTP status if it directly or indirectly earns any income or gain, the rights to which are derived from (a) services provided by any person as an investment adviser (as defined in the Investment Advisers Act) or as a person associated with an investment adviser (as defined in the Investment Advisers Act), or (b) asset management services provided by such person in connection with the management of assets with respect to which such services were rendered. It is immaterial whether the partnership in question is required to register as an investment adviser under the Investment Advisers Act.

The proposed effective date for the provision is for taxable years of the partnership beginning on or after June 14, 2007, with transition relief for partnerships already qualified as PTPs on June 14, 2007, or which had filed a registration statement (but not a shelf registration) before such date intending to go public. The proposed transition relief delays the effective date of the provision by five years. Congressman Rangel, however, has been reported in the press as saying that he would consider making the effective date of the legislation retroactive.

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