

A possible wallop for master limited partnerships

By Robert N. Gordon

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Washington tax talk these days seems focused on hedge funds, their investors and their managers

Much of the talk involves leveraged-buyout firms and hedge fund managers, such as The Blackstone Group LLP of New York, and the consequences of any tax law changes on these newly public master limited partnerships.

Most press reports mention how the proposals would increase the tax rate levied on managers and MLP investors to 35%, from 15%. What's often not discussed, however, is the likelihood that MLP investors will bear a much higher total tax burden (although no worse than investors in any corporation) should the proposals wending their way through Capitol Hill become law.

Under current taxation, publicly traded limited partnerships are flow-through entities that pay no tax. One proposal would deny the MLP structure to leveraged-buyout and hedge fund managers, and force these entities to become tax-paying corporations.

Twenty years ago, when the MLP structure first was allowed, there was a movement for taxpaying corporations to convert into MLPs. Household names such as Borden (Elsie the Cow) made the switch.

But the government changed the law, and only certain types of income now qualify an MLP for flow-through status. Early MLPs that were already trading were given until 1997 to change back to corporate form; they would be taxed as corporations whether or not they reverted.

One current tax proposal makes clear that the earnings interest received by today's MLP managers is not the type of income allowed an MLP. As a result, tax at the entity level would go from 0% to 35%.

Proposal two

A second proposal deals with the taxation of the shared profits managers earn. Many managers choose to take their earnings as a carried interest, which has benefits for them and for investors. Currently, investors who cannot utilize miscellaneous deductions can be forced to pay phantom income tax on performance fees paid in cash, but not on carried interests. Neither tax proposal would change the current treatment for individuals.

It's the possible benefit to the manager that is being debated. Under the second proposal, a manager earning cash performance fees or carried profits interest would be taxed at the highest rate (35%) no matter how profits were realized by the fund.

To recap, MLPs currently pay no tax at the entity level, while MLP investors pay tax at 15% on their proportionate share of the funds' long-term gains. Taxable investors are keeping 85% of the MLPs' earnings, the government 15%. Tax-exempt investors in the MLP keep 100% of the partnership's earnings.

If both proposals go through, taxable investors will keep about 55% of the MLP's earnings, and tax-exempts about 65%. No wonder investors are watching these proposals closely.

In a related development, The Wall Street Journal has reported that the Internal Revenue Service is going after foreign entities owning dividend-paying shares through derivatives. Currently, withholding taxes as high as 30% are levied on dividends paid to investors domiciled in non-treaty countries. Under that definition, an offshore hedge fund is a foreign entity.

Most hedge funds have both a U.S.-based partnership or limited liability corporation for U.S. taxable investors and an offshore fund primarily for U.S. tax-exempts and foreigners.

Since the value of dividends is usually built into the pricing of a derivative, foreign investors in a forward contract or equity swap currently receive the full value of a dividend without the burden of withholding.

Although we see nothing nefarious in that, some foreign investors reportedly have flipped from stock to derivatives and back to avoid withholding. We believe that it would be these trades that would draw scrutiny.

And if more-stringent regulation emerges, U.S. tax-exempts could wind up keeping less from their dividends received.

While the carried-interest proposal has received the most attention, and faces a greater chance of being stalled in Congress, the master limited-partnership proposal has a high likelihood of passage, and sooner rather than later.

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