NATIONAL ASSOCIATION OF PUBLICLY TRADED PARTNERSHIPS

Facts & Answers about Publicly Traded Partnerships

Are PTPs the same as MLPs?

For most purposes, they are the same as MLPs, as the two terms are used interchangeably to refer to a publicly traded business entity which has chosen to be treated as a partnership under the tax laws. Technically, however, they are not quite the same thing. The term "master limited partnership, " or MLP refers to a tiered limited partnership structure (i.e., a general partner manages the partnership and limited partners contribute capital) in which operations are conducted by lower-tier partnerships or other subsidiaries held by the publicly traded, "master" limited partnership. Not all MLPs are PTPs--while most are publicly traded, a few are not. And, not all PTPs are really MLPs, even though they may be referred to as such. Some PTPs are actually publicly traded limited liability companies (LLCs) that have chosen to be taxed as partnerships. LLCs do not have a general partner, and investors have greater rights vis à vis management than in a limited partnership *(see last question below).*

Which companies can be PTPs?

Rules added to the tax code in 1987 require any partnership that is publicly traded to receive 90 percent of its income from specified sources. A PTP not meeting this test will be treated as a corporation for tax purposes (see below). Qualifying income for PTPs includes interest, dividends, real estate rents, gain from the sale or disposition of real property, income and gain from commodities or commodity futures, and income and gain from mineral or natural resources activities. Mineral or natural resources activities include exploration, development, production, mining, refining (including fertilizers), marketing and transportation (including pipelines), of oil and gas, minerals, geothermal energy, or timber.

Most PTPs today are in energy related businesses. (For more specific legal references, please see the "Law and Regulation" section found in the PTP 101 area of the website.)

Recently, as part of the Emergency Economic Stabilization Act (EESA) (P.L. 110-343), the qualifying income definition was expanded. PTPs can now earn income and gains from industrial carbon dioxide, and from the transportation and storage of alcohol and biodiesel fuel mixtures; various alternative fuels; neat alcohol not derived from alcohol, gas, or coal or having a proof under 190; and neat biodiesel.

At the time the 1987 rules were enacted, there were some PTPs already trading that did not have the right kind of income. These PTPs (known as the "grandfathered" PTPs) were given a transition period of ten years, until December 31, 1997, before they would have to either meet the test or be taxed as corporations. The Taxpayer Relief Act of 1997 extended this transition rule indefinitely for grandfathered PTPs electing to pay a small (3.5 percent) tax on their gross income from partnership business activities. About a dozen PTPs made this election; however, only two are still trading.

What is the difference between a PTP and a corporation?

A corporation is a distinct legal entity, separate from its shareholders and employees. The corporate entity carries the liability for all the obligations of the corporation; the shareholders contribute capital but have no liability to business creditors, tax authorities, litigants, or any of the numerous other parties, which may have a claim on corporate earnings and assets.

A corporation is treated as a separate entity for tax purposes as well. Like individual taxpayers, it must pay a tax on its income. After taxes are paid, some or all corporate income is retained at the corporate level and used for capital investment and other purposes. Some may be passed through to shareholders in the form of dividends, and the shareholders pay tax on the dividends they receive. For this reason, it is said that corporate income is "double-taxed," or taxed at two levels.

A PTP, as a partnership, is not considered to be a separate entity, but rather is an aggregate of all the partners. All partners are liable for the obligations of the partnership; although limited partners enjoy limits on their liability, they are not fully shielded in the way shareholders are. Creditors generally have the right to seek return of capital distributed to a limited partner if the liability for which payment is sought arose before the distribution. This right survives the termination of a partner's interest. Limited partners may also be liable for substantial tax liabilities that could be determined through the audit process long after they have sold their interest. As a practical matter, however, this is unlikely to happen to a PTP investor.

A partnership is referred to for tax purposes as a "pass-through" entity. No tax is paid at the partnership level. A partnership's income is considered earned by all the partners; it is allocated among all the partners in proportion to their interests in the partnership, and each partner pays tax on his or her share of the partnership income. All the other items that go into determining taxable income and tax owed are passed through to the partners as well--capital gains and losses, deductions, credits, etc. Partnership income is thus said to be "single-taxed," or taxed only at one level--that of the individual partner.

What does this mean for PTP investors?

Because the PTP itself does not pay tax, it is able to pass along more of its earnings to its investors than it could if it were in corporate form. It does this in the form of quarterly cash distributions. Although they resemble corporate dividends, PTP distributions are treated differently, and better, for tax purposes. Rather than taxable investment income, they are treated as a return of capital and reduce the partner's basis in his partnership units. [The investor's original basis is the price paid for the units. The basis is adjusted downwards with each distribution and allocation of deductions (such as depreciation) and losses, and upwards with each allocation of income.

When the units are sold, the difference between the sales price and the adjusted basis equals taxable gain (or loss). The partner will not be taxed on distributions until 1) he sells his PTP units and pays tax on his gain, which includes the distributions; or 2) his basis reaches zero. Some of the tax on the capital gain from selling the interest will be paid at the capital gains rate. That portion of the gain that results from a downward adjustment of the basis after allocation of depreciation or other deductions will be taxed at the ordinary income rate.

At tax filing season a PTP investor will receive a K-1 form showing his share of each item of partnership income, gain, loss, deductions, and credits. He will use that information to figure his taxable partnership income (PTPs provide their investors with material that walks them through all the steps). If the result is net income, the partner pays tax on it at his individual tax rate. If the result is a net loss, it is considered a “passive

loss" under the tax code and may not be used to offset income from other sources, but must be carried forward and offset against future income from the same PTP.

It is important to note that a PTP investor is taxed on his share of partnership income whether or not he actually receives any cash from the partnership. His tax is based not on money he actually receives, but his proportionate share of what the partnership earns. However, most PTPs make it a policy to make quarterly distributions to their partners that will comfortably exceed any tax owed. For more information on investing in PTPs, please see the Investor Relations section of the website, or click here.

What about institutional investors?

An important aspect of corporate vs. pass-through taxation is the way tax-exempt investors, such as IRAs and pension funds, are treated. Tax-exempt entities are subject to "unrelated business income tax" (UBIT) on income they earn from business activities unrelated to their exempt purpose. If a tax-exempt entity invests in a PTP, it will, like any partner, be considered to have "earned" its share of the partnership's business income as if it were directly involved in the business. If that income is not one of the types that are exempted from UBIT (interest, rent, royalties, and dividends) the exempt organization will have to pay tax on its share of the PTP's net income. This makes it much more difficult for PTPs to attract institutional investors than it is for corporations (note, however, that the first $1,000 of unrelated business income is not taxed, which may make it possible for a small holder such as an IRA to hold PTP units).

In addition, under the tax code, mutual funds must receive 90 percent of *their* income from qualifying sources such as interest and dividends. Until recently, distributions and allocated income from a PTP would not have qualified, which discouraged mutual funds from investing in PTPs. In 2004, however, Congress enacted legislation, for which the Association had been working for several years, adding income from a PTP investment to the list of qualifying sources.

What is an LLC, and how can it be a PTP?

A limited liability company, or LLC, is a hybrid between the corporate and the partnership form that has been developed over the past several years. Investors in LLCs enjoy the limited liability associated with corporations, combined with the pass-through tax treatment of partnerships. The Internal Revenue Service and state tax authorities have specifically ruled that properly structured LLCs will be treated as partnerships for tax purposes if they so elect. LLC interests may be (and in some cases are) traded on public exchanges. When that is the case, an LLC which has elected partnership tax treatment is in effect a PTP, and is subject to the PTP rules of the tax code.

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