

DESCRIPTION OF S. 1393
RELATING TO THE
TREATMENT OF PARTNERSHIP ROLLUP TRANSACTIONS

Scheduled for a Hearing
Before the
SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION
of the
SENATE COMMITTEE ON FINANCE
on July 16, 1991

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION
July 10, 1991

JCX-12-91

CONTENTS

	<u>Page</u>
INTRODUCTION	ii
I. PRESENT LAW AND BACKGROUND	1
II. DESCRIPTION OF S. 1393	2
III. ISSUES	3

INTRODUCTION

This document,¹ prepared by the staff of the Joint Committee on Taxation, provides a description of S. 1393 (relating to the treatment of certain partnership rollups). S. 1393 (introduced by Senator Daschle on June 26, 1991) is scheduled for a hearing on July 16, 1991, before the Subcommittee on Energy and Agricultural Taxation of the Senate Committee on Finance.

Part I of the document discusses present law. Part II describes the provisions of S. 1393. Part III discusses certain issues relating to the bill.

¹ This document may be cited as follows: Joint Committee on Taxation, Description of S. 1393 Relating to the Treatment of Partnership Rollup Transactions (JCX-12-91), July 10, 1991.

I. PRESENT LAW AND BACKGROUND

A partnership rollup generally is a transaction in which two or more partnerships are combined and "rolled up" into a single surviving entity (such as a partnership, corporation or real estate investment trust). The original partnerships' property generally is transferred to the surviving entity, and holders of interests in the original partnerships generally receive interests in the surviving entity in exchange for their interests in the original partnerships.

Under present Federal tax law, the transfer of property to the surviving entity may be tax-free to the transferor partnerships and to the surviving entity, and the exchange of interests in the original partnerships for interests in the surviving entity may also be tax-free to the holders, depending on the form of the transaction.²

Present Federal tax law imposes no penalty tax or excise tax on payments received or accrued by persons performing services or relinquishing rights in connection with a partnership rollup transaction. Present Federal tax law does, however, impose excise taxes intended to discourage certain types of transactions. A 50-percent excise tax is imposed under present law on any person who receives "greenmail." Greenmail is any consideration transferred by a corporation to acquire its own stock from a shareholder in certain attempted corporate takeover transactions. Excise taxes are also imposed on a variety of transactions involving pension plans, public charities, private foundations, and certain trusts.³

² If the surviving entity is a partnership, present law provides that no gain or loss is recognized to the partnership or to the contributing partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership. If the surviving entity is a corporation, present law provides that no gain or loss is recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in the corporation, and immediately after the exchange such person or persons are in control of the corporation. For this purpose, control means ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation. Notwithstanding these rules providing for tax-free transfers, recapture of depreciation or amortization is required with respect to personal property and with respect to certain amortization deductions for real property, in the event of certain transfers of the property.

II. DESCRIPTION OF S. 1393⁴Explanation of ProvisionsIn general

Under the bill, in the case of a partnership rollup that does not provide cash-out or similar rights to dissenting investors, a 50-percent excise tax would be imposed on certain persons providing services (such as promoters, general partners, and others) on certain gain or other income realized in connection with the rollup.

Prohibited rollup transaction

Under the bill, the excise tax would apply to payments received in connection with a prohibited rollup transaction. A prohibited rollup transaction is a transaction that converts certain types of limited partnership interests into interests with different rights, but only if the following two requirements are met: (1) specified dissenters' rights are not provided; and (2) in connection with the rollup, there is a securities offering that must be registered with the SEC or comparable State or local government agency, or there is a request for a proxy or vote. The type of limited partnership interest converted by the rollup must be one in which the holder is entitled to receive a share of all net proceeds from all sales or refinancings of partnership assets which occur on or after a specified date.

Dissenters' rights

In order to avoid the excise tax under the bill, each limited partner must have a reasonable opportunity to dissent to the rollup. In addition, each partner who dissents must have the right to require the redemption of his interest for an amount equal to his share of the net value of the partnership's assets immediately before the rollup. Such value cannot be less than the amount represented in any document filed with the SEC or any other governmental authority as the value of the partnership's assets. The partner's interest must be redeemed for (1) cash, (2) marketable securities that have traded for at least three years on a national exchange, (3) negotiable promissory notes issued by the entity resulting from the rollup (with terms to be specified in regulations), or (4) securities that have substantially the same value, rights, powers and privileges

³ See Chapters 41, 42, 43, 44, 46, and 47 of the Internal Revenue Code.

⁴ S. 1393 was introduced by Senator Daschle on June 26, 1991.

as the limited partnership interest exchanged in the rollup.

Disqualified rollup-related payment

The excise tax would apply to the receipt of a disqualified rollup-related payment by a disqualified person. Such payment is any payment, fee or other consideration received (1) on account of services rendered in connection with a prohibited rollup transaction, (2) in exchange for an interest in a limited partnership which is a party to the rollup, or for the relinquishment of any right arising under an agreement with any such entity, or (3) on account of services rendered to any entity resulting from the rollup or on account of holding any interest in such entity. A disqualified rollup-related payment would not include any amount received by the disqualified person for services to the extent the payment does not exceed the amount the disqualified person would have been entitled to receive for such services from a limited partnership had such entity not entered into the rollup.

Disqualified person

Under the bill, the excise tax would apply only to the receipt of payments by a disqualified person. A disqualified person is (1) any person who, immediately before or after a rollup, was or is a general partner, manager or investment adviser with respect to a limited partnership which is a party to the rollup, (2) any person performing services as a broker, dealer, underwriter, promoter, investment banker or appraiser in connection with the rollup, or (3) any person related to any of the persons described above.

Effective Date

The excise tax under the bill would apply to rollups occurring after April 23, 1991, unless the converted limited partnership interest was traded on a national securities exchange before April 23, 1991.

III. ISSUES

Arguments in favor of the bill

1. Limited partnership investments are sufficiently similar to investments in corporate stock that the same protections afforded under State corporate law to minority shareholders should be afforded to minority investors in limited partnerships.

2. If Congress determines that certain investor rights and protections should be provided in partnership rollups, an

excise tax imposed on failure to provide such rights and protections could be as effective as a direct requirement imposed under State business law. Congress has imposed excise taxes on other types of transactions it determines should be controlled or discouraged.

3. Limited partnership investors may be unsophisticated or may have inadequate information to reach an informed decision whether to approve a rollup transaction. Allowing dissenters to cash out of their limited partnership interests would reduce promoters' incentives to over-value the rolled-up entity.

4. Imposing additional conditions on rollup transactions will not significantly affect the liquidity of existing limited partners, because secondary markets already exist for limited partnership interests.

Arguments against the bill

1. Federal tax sanctions are an inappropriate and inefficient means of providing investor protection and specifying investor rights. If necessary, such protection and rights should be created directly by State or Federal business and securities legislation and enforced by the appropriate business and securities regulatory agencies or by private cause of action.

2. Imposing an additional cost on partnership rollups interferes with the operation of the free market. Requiring that investors be provided with cash-out or similar rights in a rollup is inappropriate if the original price of the limited partnership interests took into account the lack of liquidity and other risks associated with the investment.

3. Limited partners should be deemed to have known the terms of the partnership agreement they have executed, particularly with respect to provisions regarding transfers of partnership property and dissenters' rights. If investors in limited partnerships are not sufficiently sophisticated to understand the terms of the partnership agreement, then limitations should be placed on who can invest initially, not on the terms of subsequent rollup transactions.

4. Rollup transactions do not, by themselves, reduce the value of a partner's investment. Rather, low trading values for interests in the rolled-up entities reflect the low value of the underlying partnership assets and a payment for the benefit of increased liquidity (i.e., the ability to trade interests on a securities exchange).