PROPOSED EITF PROJECT PLAN

Issue: Determining Whether Payments to Incentive Distribution Rights Holders in Master Limited Partnerships Represent Equity Distributions or Compensation Expense

Date Discussed: March 12, 2008 (*During the Administrative Matters Session*)

Introduction

1. At its October 15, 2007 meeting, the EITF Agenda Committee decided not to add the proposed issue "Determining Whether Payments to Incentive Distribution Rights Holders in Master Limited Partnerships Represent Equity Distributions or Compensation Expense," to the EITF agenda. A summary of the proposed issue is attached as Appendix A, which is similar to the description of the issue provided in the Agenda Committee Report. At the November 29, 2007 EITF meeting, several Task Force members expressed concerns with the Agenda Committee's decision. Members of the Agenda Committee stated that the reason for not adding the issue to the EITF agenda was based, in part, on the potential broad implications for partnership accounting that may have to be considered and whether the Task Force or the Board should consider that broader project. As a result, the FASB staff was asked to prepare a proposed project plan for Task Force consideration. This project plan will be discussed during the Administrative Session.

2. After its evaluation of the Agenda Committee materials and the proposed project plan, the Task Force will have the opportunity to decide whether it wants to add this issue to the EITF agenda. If the Task Force adds this issue to the EITF agenda, the staff will ask for input from Task Force members on the proposed project plan. The proposed project plan includes potential alternatives that would need to be researched further by the staff.

Project Plan

3. The outline below represents the FASB staff's proposed project plan if the Task Force decides to add this issue to the EITF agenda. The staff believes that one of the key preliminary decision points is the scope of the issue. If the Task Force selects a broad scope (Alternatives 2 or 3 in the Scope Section of the outline below), the staff will recommend the formation of a

working group to help address this issue. The staff recommends that the working group comprise individuals with diverse backgrounds, including an attorney well versed in partnership matters, a partnership tax specialist, a real estate partnership specialist, and Task Force representatives.

4. The working group would provide recommendations to the Task Force on Section III, Whether Payments to Partners Represent Equity Distributions or Compensation, and Section IV, Disclosures, of the outline below. The focus of the working group would be the identification and consideration of various indicators that would help determine whether a payment to a partner represents compensation or an equity distribution. The preliminary indicators that a partnership distribution includes compensation for services include:

- The return on the partner’s investment is disproportionately greater than the return to other investors in the partnership, and the partner provides services to the partnership that will affect the future return on that partner's investment
- Partnership distributions are linked to providing services to the partnership
- The fees for services rendered to the partnership are below market fees for similar services
- The fair value of a partner’s interest at inception is greater than their initial investment, and the partner is expected to provide services to the partnership in the future that are above and beyond those customary for an investor acting solely as a non-management owner.

Estimated Timeline

- March 2008: EITF agenda decision
- April/May 2008: Working group meeting
- June 2008: Issue Summary including working group recommendations
- July/August: Additional working group meeting, if necessary
- September 2008: Issue Summary Supplement resulting in consensus-for-exposure
- November 2008: Final Issue Summary Supplement to analyze comment letters and affirm consensus-for-exposure as a consensus.

Project Plan Outline

I. Background

II. Scope

  a. Alternative 1 – Payments to IDR holders in an MLP

  b. Alternative 2 – All payments to partners in a <u>public</u> partnership

  c. Alternative 3 – All payments to partners in all partnerships

  d. Other potential alternatives

III. Whether Payments to Partners Represent Equity Distributions or Compensation Expense – Alternatives

  a. Alternative 1 – Presumption that payments are compensation expense with factors to consider to overcome presumption

    i. Scoping decision may impact the operationally of this alternative

  b. Alternative 2 – Presumption that payments are equity distributions with factors to consider to overcome presumption

    i. Scoping decision may impact the operationally of this alternative

  c. Alternative 3 – Form of payment should determine whether it is an equity distribution or compensation expense

    i. Based on guidance in paragraph .22 of SOP 95-2, *Financial Reporting by Nonpublic Investment Partnerships*

    ii. No reliable method to distinguish between return of capital, return on capital, and compensation for services rendered

  d. Alternative 4 – Substance of payment should be evaluated to determine whether it is an equity distribution or compensation expense

    i. Payments could represent a return of capital, a return on capital, and compensation for services provided.

    ii. Provide factors or indicators (linkage of payments to continuation of services, level of fees in comparison to market fees for similar services, and so forth)

  e. Other potential alternatives

IV. Disclosures

a. Expand SOP 95-2 disclosures to public companies (requires presentation of management fees and allocations in the financial statements, and disclosure of the method of computing management fee payments and allocations)

Appendix A

EXPANDED AGENDA COMMITTEE MATERIALS[*]

Background

1. At the November 29, 2007 EITF meeting, the Task Force reached consensuses-for-exposure on EITF Issue No. 07-4, "Application of the Two-Class Method under FASB Statement No. 128, *Earnings per Share*, to Master Limited Partnerships." Issue 07-4 addresses, when applying the two-class method under Statement 128, how current-period earnings of a Master Limited Partnership (MLP) should be allocated to the General Partner (GP), Limited Partners (LPs), and Incentive Distribution Rights (IDR) holders. The scope of Issue 07-4 states that it only applies to MLPs that have accounted for the incentive distributions as equity distributions (as opposed to compensation costs). The Task Force observed that the determination of whether the incentive distribution is an equity distribution or compensation expense is outside the scope of Issue 07-4. During the deliberations of Issue 07-4, some Task Force members (and the SEC Observer) questioned the nature of the GP's involvement with the MLP and the accounting for the payments to the IDR holders as equity distributions (as opposed to compensation expense).

2. Some note that the issue of financial statement classification of partnership distributions is not limited to publicly traded MLPs that contain IDRs. A similar issue could exist for non-public partnerships (for example, certain professional services firms for which annual distributions to partners are treated as equity distributions in the financial statements of the partnership as opposed to compensation expense). In addition, Issue 07-4 notes that MLPs are predominately utilized in the energy industry and certain extractive industries; however, the MLP structure can also be utilized by partnerships in other industries.[1] Some will note that this issue is similar to the recent debate regarding the characterization of "carried interest" in the private equity and hedge fund industry for income tax purposes. The recent tax debate focuses

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[*] **This write-up includes additional analysis that was not included in the original Agenda Committee Report. Additions to the original Agenda Committee materials have been underlined.**

[1] Publicly traded partnerships are generally treated as corporations for tax purposes and are subject to corporate income tax; however, the MLP structure represents an exception for certain partnerships that derive at least 90 percent of their income from passive investments such as dividends, rents, and capital gains from mining and natural resources. MLPs do not pay corporate tax.

on whether carried interest[2] represents compensation for services or an interest in the partnership's capital. Given the potential pervasive nature of the issue to both non-public partnerships and MLPs in other industries, the Task Force will also need to consider whether any guidance should be limited to payments to IDR holders in MLP structures.

3. As discussed in the draft abstract and Issue Summaries for Issue 07-4, publicly traded MLPs often issue multiple classes of securities that participate in partnership distributions according to a formula specified in the partnership agreement. A typical MLP is formed by the general partner contributing mature assets with stable cash flows to the partnership in exchange for its GP Interest and IDRs. Generally, the IDRs represent a separate class of non-voting limited partner interest (LP interest). However, some arrangements are structured such that the IDRs are not a separate LP interest, but are embedded within the GP Interest.

4. Generally, the GP is responsible for conducting, directing, and managing all activities of the MLP. The GP is not compensated for its services as the GP. However, the GP is reimbursed on a monthly basis for all direct and indirect expenses that the GP incurs or payments it makes on behalf of the MLP.

5. Generally, the partnership agreement obligates the GP to distribute 100 percent of the partnership's Available Cash[3] at the end of each quarter to the GP, LPs, and, when certain thresholds are met, the IDR holders via a distribution waterfall (that is, a schedule that prescribes distributions to the GP, LPs, and IDR holders at each threshold). IDRs are generally structured such that the IDR holders (generally, the GP) will receive an increasing percentage of Available Cash based on the overall amount of Available Cash (thus providing the GP with an incentive to increase the amount of Available Cash). For example, some partnership structures provide the

[2] GPs in many private equity and hedge funds generally receive two types of compensation: (a) a management fee based on the percentage of assets under management and (b) a percentage of the fund's earnings once specified benchmarks are met. The latter fee is referred to as "carried interest" and it is characterized as a capital gain under current tax rules (as opposed to ordinary income).

[3] Available Cash is typically defined in the partnership agreement as all cash on hand at the end of each quarter less cash retained by the partnership as capital to (a) operate the business (for example, future capital expenditures), (b) comply with applicable law, debt, and other agreements, and (c) provide funds for distribution to the Common Unit, GP, and IDR holders for any one or more of the next four quarters.

IDR holder with a percentage of Available Cash ranging from 2 percent (for a lower overall level of Available Cash) to 50 percent (for a higher overall level of Available Cash).

Accounting Issues and Alternatives

Issue 1: Whether payments to IDR holders in MLPs represent equity distributions or compensation expense.

View A: Payments to IDR holders in MLPs represent compensation expense.

6. Proponents of View A believe that payments to IDR holders are essentially performance-based pay to the GP for services provided to the partnership. Proponents note the IDR structure is akin to a profit-sharing arrangement in which the GP is compensated for successfully managing the partnership and providing increased cash distributions to the LPs. View A proponents acknowledge that a GP typically makes an equity investment in the partnership; however, the substance of the IDR arrangement (for example, the fact that IDR holders are generally only paid after certain thresholds are reached and the fact that their payout percentage increases as the overall distributable cash increases) and the relatively high allocation of cash flows to the IDR holders in comparison to the equity investment would indicate that the payment represents compensation for the services provided by the GP as opposed to a return of capital.

7. Proponents of View A also note that a GP is generally reimbursed for all direct and indirect expenses that the GP incurs on behalf of the MLP (for example, salaries, bonuses, and incentive compensation paid to employees of the GP who performed services for the MLP). View A proponents believe that if a third party were to provide similar services to the MLP, that party would charge the MLP an amount in excess of the costs incurred (a profit element). Proponents note that the same concept would apply to the expertise and know-how that the GP is providing to the MLP. If a third-party service provider were acting as the GP, the MLP would clearly incur an expense for the services provided by the third party. View A proponents do not believe that the incurrence of the expense or its nature is changed simply because the GP is the party providing the services. Proponents of View A also note that when the IDRs are a separate LP interest, the holders of the IDRs (which is initially the GP) can generally only transfer or sell the

IDRs subject to consent requirements of the LPs. View A proponents note that the consent requirements reflect the fact that the experience and expertise of the GP is something that the LP bargained for as part of its investment in the partnership. Thus, payments under the IDR arrangement represent compensation for that experience and expertise (and the ongoing service). Proponents note that there is no fundamental difference between the substance of this arrangement and a profit-sharing plan or the concept behind a stock option award.

8. View A proponents note that certain GPs recognize revenue for these distributions (or similar distributions) under *EITF Abstracts*, Topic No. D-96, "Accounting for Management Fees Based on a Formula." View A proponents believe that this accounting reflects the fact that these payments represent income to the GP earned in exchange for the provision of services provided by the GP, and not a dividend distribution from the partnership to the GP.

9. View A proponents also consider the example of a GP with an equity interest in an MLP that is accounted for under the equity method of accounting. The SEC staff discussed this fact pattern in remarks made by Sandie Kim, Professional Accounting Fellow, at the 2007 AICPA National Conference on Current SEC and PCAOB Developments. The SEC staff discussed the GP's potential application of FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, to their investment in the partnership. The SEC staff noted:

> That equity interest may also have an embedded feature that provides the investor with a disproportionate allocation of returns. This scenario often occurs in certain partnership agreements, in which the general partner's interest includes an embedded feature commonly known as a "carried interest." If the general partner measured its investment at fair value, the carried interest might be included in that measurement. ***However, if the general partner's investment includes a substantive performance obligation to the equity method investee, such as management services, the carried interest may represent compensation for services to be performed.*** [Emphasis added.]

10. View A proponents note the anomalous result when the investor providing the services to the MLP is required to consider the substance of the transaction when accounting for the transaction in their own financial statements, while the MLP receiving the services would disregard the substance for purposes of the MLP's financial statements.

View B: Payments to IDR holders in MLPs represent equity distributions.

11. View B proponents believe that payments to IDR holders represent equity distributions that reflect a return on the investment made by the GP in the MLP. This equity distribution reflects both the capital invested by the GP in the partnership and the risk taken by the GP in relation to that borne by the LPs. View B proponents believe that the GP is not performing a different role than what they were doing prior to the assets being contributed to the MLP. The GP is attempting to maximize the value of the assets and the cash flows associated with those assets. The GP is rewarded for this effort though higher upside potential on its equity investment.

12. View B proponents cite the guidance related to non-public investment partnerships in paragraph .22 of AICPA Statement of Position 95-2, *Financial Reporting by Nonpublic Investment Partnerships*, which indicates that

> the relatively material allocation of profits provided for in nonpublic partnership agreements may be considered either a disproportionate partnership income allocation, based on the fact that the general partner has incurred material cost and effort in organizing the partnership, managing the partnership, and incurred disproportionate risk as the general partner, or a compensation arrangement.

13. AcSEC concluded that the accounting for payments to GPs should conform to the structure of the partnership agreement because definitive guidance could not be issued without deliberation of broader partnership issues. View B proponents believe that this guidance reflects the fact that the GP has made an investment in the partnership and that there would not be a reliable method to distinguish between the return earned on that investment and compensation for services provided.

14. <u>View B proponents also believe that investors in IDRs would generally focus more on cash flows as opposed to earnings because cash flows will determine what can be paid out to the partnership unit holders. Opponents of this view note that if this were the case, it is unclear why the EITF would address the calculation of EPU for MLPs in Issue 07-4. In addition, View B</u>

proponents note that SOP 95-2 requires nonpublic investment partnerships to present management fees and allocations in the statement of operations or statement of changes in partners' capital accounts, and to disclose the method of computing the payments or allocations. View B proponents believe that existing disclosure requirements provide adequate information regarding these payments in the financial statements.

15. View B proponents also believe that View A or View C could require a broader reconsideration of partnership accounting. Partnerships utilize different methodologies to allocate earnings between general partners and limited partners. The two most common methods are the hypothetical liquidation at book value method (HLBV) and the pro-rata method based on distributions. Both of these methods are based on analogies to other U.S. GAAP (APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, and AICPA Statement of Position 78-9, *Accounting for Investments in Real Estate Ventures*). Although Issue 07-4 proscribes an earnings allocation method for purposes of EPU, it does not require that a partnership follow a similar method when allocating earnings to the partnership accounts in the financial statements. View B proponents believe that if the EITF issues guidance on distributions to partners it might also need to consider how those payments are allocated among the various partner capital accounts, and how that allocation is currently impacted by the actual partnership agreement.

View C: Payments to IDR holders in MLPs should be accounted for in accordance with the substance of the arrangement. In some arrangements the payments may be compensation for management services, in others the payments may be for equity distributions, and in some situations the substance of the payment may comprise both.

16. View C proponents believe that payments to the IDR holders represent a return of capital invested by the GP as well as compensation for services provided by the GP. View C proponents believe that both View A and View B ignore certain critical aspects of the relationship between the IDR holders (generally, the GP) and the MLP. View A ignores the fact that the IDR holders are generally only the GP that has made an equity contribution, and thus some part of the payment from the MLP represents a return of that capital and a return on that capital. View B

ignores the fact that although the GP has made an equity distribution, there are also services being provided by the GP that the GP is being compensated for. Absent some other compensation arrangement between the GP and the partnership, some of that compensation must come from the IDR payments. View C proponents believe that EITF Issue No. 95-8, "Accounting for Contingent Consideration Paid to the Shareholders of an Acquired Business Combination," provides some factors to identify compensation for services and profit sharing arrangements that would be useful when addressing this issue.

Issue 2: Whether guidance to address Issue 1 should consider fact patterns other than payments to IDR holders in an MLP structure.

View A: Guidance should only address payments to IDR holders in MLPs.

View B: Guidance should not be limited to payments to IDR holders in MLPs and should consider payments to partners more broadly.

International Convergence

Currently there is no guidance specific to this issue in international standards.