General Explanations of the Administration’s Fiscal Year 2012 Revenue Proposals

Department of the Treasury
February 2011
TAX CARRIED (PROFITS) INTERESTS IN INVESTMENT PARTNERSHIPS AS ORDINARY INCOME

Current Law

A partnership is not subject to Federal income tax. Instead, an item of income or loss of the partnership retains its character and flows through to the partners, who must include such item on their tax returns. Generally, certain partners receive partnership interests in exchange for contributions of cash and/or property, while certain partners (not necessarily other partners) receive partnership interests, typically interests in future profits (“profits interests” or “carried interests”), in exchange for services. Accordingly, if and to the extent a partnership recognizes long-term capital gain, the partners, including partners who provide services, will reflect their shares of such gain on their tax returns as long-term capital gain. If the partner is an individual, such gain would be taxed at the reduced rates for long-term capital gains. Gain recognized on the sale of a partnership interest, whether it was received in exchange for property, cash or services, is generally treated as capital gain.

Under current law, income attributable to a profits interest of a general partner is generally subject to self-employment tax, except to the extent the partnership generates types of income that are excluded from self-employment taxes, e.g., capital gains, certain interest, and dividends.

Reasons for Change

Although profits interests are structured as partnership interests, the income allocable to such interests is received in connection with the performance of services. A service provider’s share of the income of a partnership attributable to a carried interest should be taxed as ordinary income and subject to self-employment tax because such income is derived from the performance of services. By allowing service partners to receive capital gains treatment on labor income without limit, the current system creates an unfair and inefficient tax preference. The recent explosion of activity among large private equity firms and hedge funds has increased the breadth and cost of this tax preference, with some of the highest-income Americans benefiting from the preferential treatment.

Proposal

The proposal would tax as ordinary income a partner’s share of income on an “investment services partnership interest” (ISPI) in an investment partnership, regardless of the character of the income at the partnership level. Accordingly, such income would not be eligible for the reduced rates that apply to long-term capital gains. In addition, the proposal would require the partner to pay self-employment taxes on such income. Gain recognized on the sale of an ISPI would generally be taxed as ordinary income, not as capital gain.

An ISPI is a carried interest in an investment partnership that is held by a person who provides services to the partnership. A partnership is an investment partnership if the majority of its assets are investment-type assets (certain securities, real estate, interests in partnerships, commodities, cash or cash equivalents, or derivative contracts with respect to those assets), but only if over half of the partnership’s contributed capital is from partners in whose hands the interests...
constitute property held for the production of income. To the extent that the partner who holds an ISPI contributes “invested capital” and the partnership reasonably allocates its income and loss between such invested capital and the remaining interest, income allocable to the invested capital would not be recharacterized. Similarly, the portion of any gain recognized on the sale of an ISPI that is allocable to the invested capital would be treated as capital gain. “Invested capital” is defined as money or other property contributed to the partnership. However, contributed capital that is allocable to the proceeds of any loan or other advance made or guaranteed by any partner or the partnership is not treated as “invested capital.”

Also, any person who performs services for an entity and holds a “disqualified interest” in the entity is subject to tax at rates applicable to ordinary income on any income or gain received with respect to the interest. A “disqualified interest” is defined as convertible or contingent debt, an option, or any derivative instrument with respect to the entity (but does not include a partnership interest or stock in certain taxable corporations). This is an anti-abuse rule designed to prevent the avoidance of the proposal through the use of compensatory arrangements other than partnership interests. Other anti-abuse rules may be necessary.

The proposal is not intended to adversely affect qualification of a real estate investment trust owning a carried interest in a real estate partnership.

The proposal would be effective for taxable years beginning after December 31, 2011.
### Miscellaneous changes:

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>(in millions of dollars)</td>
<td>135</td>
<td>369</td>
<td>312</td>
<td>38</td>
<td>43</td>
<td>47</td>
<td>51</td>
<td>55</td>
<td>58</td>
<td>61</td>
<td>65</td>
<td>127</td>
<td>236</td>
</tr>
</tbody>
</table>

- **Increase the Oil Spill Liability Trust Fund financing rate by one cent**
- **Make unemployment insurance surtax permanent**
- **Provide short-term tax relief to employers and expand Federal Unemployment Compensation**
- **Tax Act (FUTA) base**
- **Repeal last-in, first-out (LIFO) method of accounting for inventories**
- **Repeal gain limitation for dividends received in reorganization exchanges**
- **Tax carried (profits) interests in investment partnerships as ordinary income**
- **Deny deduction for punitive damages**
- **Repeal lower-cost-of-market (LCM) inventory accounting method**
- **Miscellaneous changes**
  - Eliminate oil and gas preferences:
    - **Repeal enhanced oil recovery (EOR) credit**
    - **Repeal credit for oil and gas produced from marginal wells**
    - **Repeal expensing of intangible drilling costs (IDCs)**
    - **Repeal deduction for tertiary injectants**
    - **Repeal exception to passive loss limitation for working interests in oil and natural gas properties**
    - **Repeal percentage depletion for oil and natural gas wells**
    - **Repeal domestic manufacturing deduction for oil and natural gas companies**
    - **Increase geological and geophysical amortization period for independent producers**
    - **Miscellaneous changes**
- **Eliminate fossil-fuel preferences**
  - **Eliminate oil and gas preferences**
  - **Eliminate coal preferences**
  - **Miscellaneous changes**
- **Miscellaneous changes**
  - **Simplify the tax code**
  - **Reduce the tax gap and make reforms**
  - **Expand Information Reporting**
    - **Repeal and modify information reporting on payments to corporations and payments for property**
    - **Require information reporting for private separate accounts of life insurance companies**
    - **Authorize the Department of the Treasury to require additional information to be included in electronically filed Form 5500 Annual Reports**
    - **Implement standards clarifying when employee leasing companies can be held liable for their clients’ Federal employment taxes**

### Miscellaneous changes:

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>(in millions of dollars)</td>
<td>135</td>
<td>369</td>
<td>312</td>
<td>38</td>
<td>43</td>
<td>47</td>
<td>51</td>
<td>55</td>
<td>58</td>
<td>61</td>
<td>65</td>
<td>127</td>
<td>236</td>
</tr>
</tbody>
</table>

- **Simplify the tax code**
  - **Reduce the tax gap and make reforms**
  - **Expand Information Reporting**
  - **Miscellaneous changes**

### Eliminate fossil-fuel preferences:

- **Eliminate oil and gas preferences**
- **Eliminate coal preferences**
- **Miscellaneous changes**
- **Miscellaneous changes**
- **Simplify the tax code**
- **Reduce the tax gap and make reforms**
- **Expand Information Reporting**

### Miscellaneous changes:

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>(in millions of dollars)</td>
<td>135</td>
<td>369</td>
<td>312</td>
<td>38</td>
<td>43</td>
<td>47</td>
<td>51</td>
<td>55</td>
<td>58</td>
<td>61</td>
<td>65</td>
<td>127</td>
<td>236</td>
</tr>
</tbody>
</table>

- **Miscellaneous changes**
  - **Miscellaneous changes**
  - **Miscellaneous changes**
  - **Miscellaneous changes**
  - **Miscellaneous changes**
  - **Miscellaneous changes**
  - **Miscellaneous changes**

### Miscellaneous changes:

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>(in millions of dollars)</td>
<td>135</td>
<td>369</td>
<td>312</td>
<td>38</td>
<td>43</td>
<td>47</td>
<td>51</td>
<td>55</td>
<td>58</td>
<td>61</td>
<td>65</td>
<td>127</td>
<td>236</td>
</tr>
</tbody>
</table>

- **Miscellaneous changes**
  - **Miscellaneous changes**
  - **Miscellaneous changes**
  - **Miscellaneous changes**
  - **Miscellaneous changes**
  - **Miscellaneous changes**
  - **Miscellaneous changes**

### Miscellaneous changes:

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>(in millions of dollars)</td>
<td>135</td>
<td>369</td>
<td>312</td>
<td>38</td>
<td>43</td>
<td>47</td>
<td>51</td>
<td>55</td>
<td>58</td>
<td>61</td>
<td>65</td>
<td>127</td>
<td>236</td>
</tr>
</tbody>
</table>

- **Miscellaneous changes**
  - **Miscellaneous changes**
  - **Miscellaneous changes**
  - **Miscellaneous changes**
  - **Miscellaneous changes**
  - **Miscellaneous changes**
  - **Miscellaneous changes**

### Miscellaneous changes:

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>(in millions of dollars)</td>
<td>135</td>
<td>369</td>
<td>312</td>
<td>38</td>
<td>43</td>
<td>47</td>
<td>51</td>
<td>55</td>
<td>58</td>
<td>61</td>
<td>65</td>
<td>127</td>
<td>236</td>
</tr>
</tbody>
</table>

- **Miscellaneous changes**
  - **Miscellaneous changes**
  - **Miscellaneous changes**
  - **Miscellaneous changes**
  - **Miscellaneous changes**
  - **Miscellaneous changes**
  - **Miscellaneous changes**