
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 attributable to the invested capital would not be recharacterized. Similarly, the portion of any gain recognized on the sale of an ISPI that is attributable 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 attributable 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.

	Fiscal Years											
	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012-2021
	(in millions of dollars)											
Miscellaneous changes:												
Increase the Oil Spill Liability Trust Fund financing rate by one cent	0	35	46	46	46	46	46	46	47	46	47	451
Make unemployment insurance surtax permanent	0	1,375	1,413	1,449	1,477	1,503	1,526	1,543	1,558	1,577	1,594	15,015
Provide short-term tax relief to employers and expand Federal Unemployment Tax Act (FUTA) base	0	-1,714	-3,541	7,477	12,863	10,544	11,814	8,555	-34	-263	167	25,629
Repeal last-in, first-out (LIFO) method of accounting for inventories	0	0	2,598	5,649	6,484	6,457	6,435	6,387	6,337	6,293	6,240	45,868
Repeal gain limitation for dividends received in reorganization exchanges	0	47	79	81	84	86	89	92	94	97	100	52,880
Tax carried (profits) interests in investment partnerships as ordinary income	318	2,274	2,123	2,154	1,927	1,608	1,322	1,089	908	762	640	14,807
Deny deduction for punitive damages	0	0	23	34	35	35	36	36	37	37	39	312
Repeal lower-of-cost-or-market (LCM) inventory accounting method	0	0	188	1,435	2,334	1,532	1,358	309	323	337	352	8,168
Repeal lower-of-cost-or-market (LCM) inventory accounting method	318	2,017	2,929	18,325	25,250	21,811	22,626	18,057	9,270	8,886	9,179	138,350
Subtotal, miscellaneous changes	354	11,498	19,998	38,439	46,248	43,698	46,355	39,366	29,253	29,744	31,068	335,667
Subtotal, other revenue changes and loophole closers												
Eliminate fossil-fuel preferences:												
Eliminate oil and gas preferences:												
Repeal enhanced oil recovery (EOR) credit 6/	0	0	0	0	0	0	0	0	0	0	0	0
Repeal credit for oil and gas produced from marginal wells 6/	0	0	0	0	0	0	0	0	0	0	0	0
Repeal expensing of intangible drilling costs (IDCs)	0	1,875	2,512	1,762	1,403	1,331	1,124	830	640	523	447	8,883
Repeal deduction for tertiary injectants	0	6	10	10	10	10	10	9	9	9	9	46
Repeal exception to passive loss limitation for working interests in oil and natural gas properties	0	23	27	24	22	21	19	18	17	16	16	203
Repeal percentage depletion for oil and natural gas wells	0	607	1,038	1,079	1,111	1,142	1,177	1,211	1,243	1,273	1,321	11,202
Repeal domestic manufacturing deduction for oil and natural gas companies	0	902	1,558	1,653	1,749	1,842	1,932	2,020	2,108	2,200	2,296	18,260
Increase geological and geophysical amortization period for independent producers to seven years	0	59	215	330	306	230	152	75	22	9	10	1,408
Subtotal, eliminate oil and gas preferences	0	3,472	5,360	4,658	4,607	4,576	4,414	4,163	4,039	4,030	4,099	43,612
Eliminate coal preferences:												
Repeal expensing of exploration and development costs	0	27	45	47	49	51	50	48	47	45	38	447
Repeal percentage depletion for hard mineral fossil fuels	0	78	129	129	130	135	139	145	149	154	165	1,353
Repeal capital gains treatment for royalties	6	11	13	22	31	38	43	47	51	55	58	369
Repeal domestic manufacturing deduction for coal and other hard mineral fossil fuels	0	20	35	38	39	41	44	45	48	49	51	410
Subtotal, eliminate coal preferences	6	136	222	236	249	265	276	285	295	303	312	2,579
Subtotal, eliminate fossil-fuel preferences	6	3,608	5,582	5,094	4,850	4,841	4,690	4,448	4,334	4,333	4,411	46,191
Simplify the tax code:												
Allow vehicle seller to claim qualified plug-in electric-drive motor vehicle credit	0	-64	-30	-59	-53	135	166	-232	-103	-11	-18	-269
Eliminate minimum required distribution (MRD) rules for IRA/plan balances of \$50,000 or less	0	-2	-5	-7	-9	-12	-15	-19	-23	-28	-31	-151
Allow all inherited plan and IRA balances to be rolled over within 60 days												
Clarify exception to recapture of unrecognized gain on sale of stock to an employee stock ownership plan (ESOP)												
Repeal non-qualified preferred stock (NQPS) designation	22	101	112	110	105	97	87	77	68	61	54	872
Revise and simplify the "fractions rule"	-5	-19	-22	-24	-23	-24	-24	-26	-26	-26	-28	-242
Repeal preferential dividend rule for publicly traded real estate investment trusts (REITs)												
Reform excise tax based on investment income of private foundations	-1	-4	-4	-5	-5	-5	-6	-6	-6	-7	-7	-55
Simplify tax-exempt bonds:												
Simplify arbitrage investment restrictions	0	-4	-13	-21	-30	-40	-49	-59	-68	-76	-86	-446
Simplify single-family housing mortgage bond targeting requirements	0	0	0	-1	-1	-1	-1	-3	-3	-3	-3	-16
Streamline private business limits on governmental bonds	0	-1	-3	-5	-7	-9	-11	-13	-15	-17	-19	-100
Subtotal, simplify tax exempt bonds	0	-5	-16	-27	-38	-50	-61	-75	-86	-96	-108	-562
Subtotal, simplify the tax code	16	7	35	-12	-23	141	147	-281	-176	-107	-138	-407
Reduce the tax gap and make reforms:												
Expand Information Reporting:												
Repeal and modify information reporting on payments to corporations and payments for property	0	-475	-618	-756	-929	-961	-1,000	-1,047	-1,096	-1,147	-1,180	-9,209
Require information reporting for private separate accounts of life insurance companies	0	0	1	2	3	3	4	5	6	7	8	39
Require a certified Taxpayer Identification Number (TIN) from contractors and allow certain withholding	21	48	81	110	115	121	126	132	138	144	150	1,165
Subtotal, expand information reporting	21	-427	-536	-644	-811	-837	-870	-910	-952	-996	-1,022	-8,005
Improve compliance by businesses:												
Require greater electronic filing of returns												
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	0	4	5	6	6	6	7	7	7	8	8	64