

American Jobs Act – Carried Interest Proposal – released September 12, 2011

Subtitle B -- Tax Carried Interest in Investment Partnerships as Ordinary Income

Section 411 -- Partnership Interests Transferred in Connection With Performance of Services. Current law allows service partners to receive capital gains treatment on labor income without limit, which creates an unfair and inefficient tax preference. This section would tax as ordinary income, and make subject to self-employment tax, a service partner's share of the income of an investment partnership attributable to a carried interest because such income is derived from the performance of services.

Section 412 -- Special Rules for Partners Providing Investment Management Services to Partnerships. To the extent that a service partner 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. This subtitle would be effective for taxable years beginning after December 31, 2012.

SUBTITLE B -- TAX CARRIED INTEREST IN INVESTMENT PARTNERSHIPS AS ORDINARY INCOME

SEC. 411. PARTNERSHIP INTERESTS TRANSFERRED IN CONNECTION WITH PERFORMANCE OF SERVICES.

(a) MODIFICATION TO ELECTION TO INCLUDE PARTNERSHIP INTEREST IN GROSS INCOME IN YEAR OF TRANSFER. -- Subsection (c) of section 83 of the Internal Revenue Code of 1986 is amended by redesignating paragraph (4) as paragraph (5) and by inserting after paragraph (3) the following new paragraph:

"(4) PARTNERSHIP INTERESTS. -- Except as provided by the Secretary --

"(A) IN GENERAL. -- In the case of any transfer of an interest in a partnership in connection with the provision of services to (or for the benefit of) such partnership --

"(i) the fair market value of such interest shall be treated for purposes of this section as being equal to the amount of the distribution which the partner would receive if the partnership sold (at the time of the transfer) all of its assets at fair market value and distributed the proceeds of such sale (reduced by the liabilities of the partnership) to its partners in liquidation of the partnership, and

"(ii) the person receiving such interest shall be treated as having made the election under subsection (b)(1) unless such person makes an election under this paragraph to have such subsection not apply.

"(B) ELECTION. -- The election under subparagraph (A)(ii) shall be made under rules similar to the rules of subsection (b)(2)."

(b) EFFECTIVE DATE. -- The amendments made by this section shall apply to interests in partnerships transferred after December 31, 2012.

SEC. 412. SPECIAL RULES FOR PARTNERS PROVIDING INVESTMENT MANAGEMENT SERVICES TO PARTNERSHIPS.

(a) IN GENERAL. -- Part I of subchapter K of chapter 1 of the Internal Revenue Code of 1986 is amended by adding at the end the following new section:

"SEC. 710. SPECIAL RULES FOR PARTNERS PROVIDING INVESTMENT MANAGEMENT SERVICES TO PARTNERSHIPS.

"(a) TREATMENT OF DISTRIBUTIVE SHARE OF PARTNERSHIP ITEMS. -- For purposes of this title, in the case of an investment services partnership interest --

"(1) IN GENERAL. -- Notwithstanding section 702(b) --

"(A) an amount equal to the net capital gain with respect to such interest for any partnership taxable year shall be treated as ordinary income, and

"(B) subject to the limitation of paragraph (2), an amount equal to the net capital loss with respect to such interest for any partnership taxable year shall be treated as an ordinary loss.

"(2) RECHARACTERIZATION OF LOSSES LIMITED TO RECHARACTERIZED GAINS. -- The amount treated as ordinary loss under paragraph (1)(B) for any taxable year shall not exceed the excess (if any) of --

"(A) the aggregate amount treated as ordinary income under paragraph (1)(A) with respect to the investment services partnership interest for all preceding partnership taxable years to which this section applies, over

"(B) the aggregate amount treated as ordinary loss under paragraph (1)(B) with respect to such interest for all preceding partnership taxable years to which this section applies.

"(3) ALLOCATION TO ITEMS OF GAIN AND LOSS. --

"(A) NET CAPITAL GAIN. -- The amount treated as ordinary income under paragraph (1)(A) shall be allocated ratably among the items of long-term capital gain taken into account in determining such net capital gain.

"(B) NET CAPITAL LOSS. -- The amount treated as ordinary loss under paragraph (1)(B) shall be allocated ratably among the items of long-term capital loss and short-term capital loss taken into account in determining such net capital loss.

"(4) TERMS RELATING TO CAPITAL GAINS AND LOSSES. -- For purposes of this section --

"(A) IN GENERAL. -- Net capital gain, long-term capital gain, and long-term capital loss, with respect to any investment services partnership interest for any taxable year, shall be determined under section 1222, except that such section shall be applied --

"(i) without regard to the recharacterization of any item as ordinary income or ordinary loss under this section,

"(ii) by only taking into account items of gain and loss taken into account by the holder of such interest under section 702 with respect to such interest for such taxable year,

"(iii) by treating property which is taken into account in determining gains and losses to which section 1231 applies as capital assets held for more than 1 year, and

"(iv) without regard to section 1202.

"(B) NET CAPITAL LOSS. -- The term 'net capital loss' means the excess of the losses from sales or exchanges of capital assets over the gains from such sales or exchanges. Rules similar to the rules of clauses (i) through (iv) of subparagraph (A) shall apply for purposes of the preceding sentence.

"(5) SPECIAL RULES FOR DIVIDENDS. --

"(A) INDIVIDUALS. -- Any dividend allocated to any investment services partnership interest shall not be treated as qualified dividend income for purposes of section 1(h).

"(B) CORPORATIONS. -- No deduction shall be allowed under section 243 or 245 with respect to any dividend allocated to any investment services partnership interest.

"(b) DISPOSITIONS OF PARTNERSHIP INTERESTS. --

"(1) GAIN. --

"(A) IN GENERAL. -- Any gain on the disposition of an investment services partnership interest shall be --

"(i) treated as ordinary income, and

"(ii) recognized notwithstanding any other provision of this subtitle.

"(B) EXCEPTIONS. -- CERTAIN TRANSFERS TO CHARITIES AND RELATED PERSONS.
-- Subparagraph (A) shall not apply to --

"(i) a disposition by gift,

"(ii) a transfer at death, or

"(iii) other disposition identified by the Secretary as a disposition with respect to which it would be inconsistent with the purposes of this section to apply subparagraph (A),

if such gift, transfer, or other disposition is to an organization described in section 170(b)(1)(A) (other than any organization described in section 509(a)(3) or any fund or account described in section 4966(d)(2)) or a person with respect to whom the transferred interest is an investment services partnership interest.

"(2) LOSS. -- Any loss on the disposition of an investment services partnership interest shall be treated as an ordinary loss to the extent of the excess (if any) of --

"(A) the aggregate amount treated as ordinary income under subsection (a) with respect to such interest for all partnership taxable years to which this section applies, over

"(B) the aggregate amount treated as ordinary loss under subsection (a) with respect to such interest for all partnership taxable years to which this section applies.

"(3) ELECTION WITH RESPECT TO CERTAIN EXCHANGES. -- Paragraph (1)(A)(ii) shall not apply to the contribution of an investment services partnership interest to a partnership in exchange for an interest in such partnership if --

"(A) the taxpayer makes an irrevocable election to treat the partnership interest received in the exchange as an investment services partnership interest, and

"(B) the taxpayer agrees to comply with such reporting and recordkeeping requirements as the Secretary may prescribe.

"(4) DISTRIBUTIONS OF PARTNERSHIP PROPERTY. --

"(A) IN GENERAL. -- In the case of any distribution of property by a partnership with respect to any investment services partnership interest held by a partner, the partner receiving such property shall recognize gain equal to the excess (if any) of --

"(i) the fair market value of such property at the time of such distribution, over

"(ii) the adjusted basis of such property in the hands of such partner (determined without regard to subparagraph (C)).

"(B) TREATMENT OF GAIN AS ORDINARY INCOME. -- Any gain recognized by such partner under subparagraph (A) shall be treated as ordinary income to the same extent and in the same manner as the increase in such partner's distributive share of the taxable income of the partnership would be treated under subsection (a) if, immediately prior to the distribution, the partnership had sold the distributed property at fair market value and all of the gain from such disposition were allocated to such partner. For purposes of applying paragraphs (2) and (3) of subsection (a), any gain treated as ordinary income under this subparagraph shall be treated as an amount treated as ordinary income under subsection (a)(1)(A).

"(C) ADJUSTMENT OF BASIS. -- In the case a distribution to which subparagraph (A) applies, the basis of the distributed property in the hands of the distributee partner shall be the fair market value of such property.

"(D) SPECIAL RULES WITH RESPECT TO MERGERS, DIVISIONS, AND TECHNICAL TERMINATIONS. -- In the case of a taxpayer which satisfies requirements similar to the requirements of subparagraphs (A) and (B) of paragraph (3), this paragraph and paragraph (1)(A)(ii) shall not apply to the distribution of a partnership interest if such distribution is in connection with a contribution (or deemed contribution) of any property of the partnership to which section 721 applies pursuant to a transaction described in paragraph (1)(B) or (2) of section 708(b).

"(c) INVESTMENT SERVICES PARTNERSHIP INTEREST. -- For purposes of this section -
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"(1) IN GENERAL. -- The term 'investment services partnership interest' means any interest in an investment partnership acquired or held by any person in connection with the conduct of a trade or business described in paragraph (2) by such person (or any person related to such person). An interest in an investment partnership held by any person --

"(A) shall not be treated as an investment services partnership interest for any period before the first date on which it is so held in connection with such a trade or business,

"(B) shall not cease to be an investment services partnership interest merely because such person holds such interest other than in connection with such a trade or business, and

"(C) shall be treated as an investment services partnership interest if acquired from a related person in whose hands such interest was an investment services partnership interest.

"(2) BUSINESSES TO WHICH THIS SECTION APPLIES. -- A trade or business is described in this paragraph if such trade or business primarily involves the performance of any of the following services with respect to assets held (directly or indirectly) by the investment partnership referred to in paragraph (1):

"(A) Advising as to the advisability of investing in, purchasing, or selling any specified asset.

"(B) Managing, acquiring, or disposing of any specified asset.

"(C) Arranging financing with respect to acquiring specified assets.

"(D) Any activity in support of any service described in subparagraphs (A) through (C).

"(3) INVESTMENT PARTNERSHIP. --

"(A) IN GENERAL. -- The term 'investment partnership' means any partnership if, at the end of any calendar quarter ending after December 31, 2012 --

"(i) substantially all of the assets of the partnership are specified assets (determined without regard to any section 197 intangible within the meaning of section 197(d)), and

"(ii) more than half of the contributed capital of the partnership is attributable to contributions of property by one or more persons in exchange for interests in the partnership which (in the hands of such persons) constitute property held for the production of income.

"(B) SPECIAL RULES FOR DETERMINING IF PROPERTY HELD FOR THE PRODUCTION OF INCOME. -- Except as otherwise provided by the Secretary, for purposes of determining whether any interest in a partnership constitutes property held for the production of income under subparagraph (A)(ii) --

"(i) any election under subsection (e) or (f) of section 475 shall be disregarded, and

"(ii) paragraph (5)(B) shall not apply.

"(C) ANTIABUSE RULES. -- The Secretary may issue regulations or other guidance which prevent the avoidance of the purposes of subparagraph (A), including regulations or other guidance which treat convertible and contingent debt (and other debt having the attributes of equity) as a capital interest in the partnership.

"(D) CONTROLLED GROUPS OF ENTITIES. --

"(i) IN GENERAL. -- In the case of a controlled group of entities, if an interest in the partnership received in exchange for a contribution to the capital of the partnership by any member of such controlled group would (in the hands of such member) constitute property not held for the production of income, then any interest in such partnership held by any member of such group shall be treated for purposes of subparagraph (A) as constituting (in the hands of such member) property not held for the production of income.

"(ii) CONTROLLED GROUP OF ENTITIES. -- For purposes of clause (i), the term 'controlled group of entities' means a controlled group of corporations as defined in section 1563(a)(1), applied without regard to subsections (a)(4) and (b)(2) of section 1563. A partnership or any other entity (other than a corporation) shall be treated as a member of a controlled group of entities if such entity is controlled (within the meaning of section 954(d)(3)) by members of such group (including any entity treated as a member of such group by reason of this sentence).

"(4) SPECIFIED ASSET. -- The term 'specified asset' means securities (as defined in section 475(c)(2) without regard to the last sentence thereof), real estate held for rental or investment, interests in partnerships, commodities (as defined in section 475(e)(2)), cash or cash equivalents, or options or derivative contracts with respect to any of the foregoing.

"(5) RELATED PERSONS. --

"(A) IN GENERAL. -- A person shall be treated as related to another person if the relationship between such persons is described in section 267(b) or 707(b).

"(B) ATTRIBUTION OF PARTNER SERVICES. -- Any service described in paragraph (2) which is provided by a partner of a partnership shall be treated as also provided by such partnership.

"(d) EXCEPTION FOR CERTAIN CAPITAL INTERESTS. --

"(1) IN GENERAL. -- In the case of any portion of an investment services partnership interest which is a qualified capital interest, all items of gain and loss (and any dividends) which are allocated to such qualified capital interest shall not be taken into account under subsection (a) if --

"(A) allocations of items are made by the partnership to such qualified capital interest in the same manner as such allocations are made to other qualified capital interests held by partners who do not provide any services described in subsection (c)(2) and who are not related to the partner holding the qualified capital interest, and

"(B) the allocations made to such other interests are significant compared to the allocations made to such qualified capital interest.

"(2) AUTHORITY TO PROVIDE EXCEPTIONS TO ALLOCATION REQUIREMENTS. -- To the extent provided by the Secretary in regulations or other guidance --

"(A) ALLOCATIONS TO PORTION OF QUALIFIED CAPITAL INTEREST. -- Paragraph (1) may be applied separately with respect to a portion of a qualified capital interest.

"(B) NO OR INSIGNIFICANT ALLOCATIONS TO NONSERVICE PROVIDERS. -- In any case in which the requirements of paragraph (1)(B) are not satisfied, items of gain and loss (and any dividends) shall not be taken into account under subsection (a) to the extent that such items are properly allocable under such regulations or other guidance to qualified capital interests.

"(C) ALLOCATIONS TO SERVICE PROVIDERS' QUALIFIED CAPITAL INTERESTS WHICH ARE LESS THAN OTHER ALLOCATIONS. -- Allocations shall not be treated as failing to meet the requirement of paragraph (1)(A) merely because the allocations to the qualified capital interest represent a lower return than the allocations made to the other qualified capital interests referred to in such paragraph.

"(3) SPECIAL RULE FOR CHANGES IN SERVICES AND CAPITAL CONTRIBUTIONS. -- In the case of an interest in a partnership which was not an investment services partnership interest and which, by reason of a change in the services with respect to assets held (directly or indirectly) by the partnership or by reason of a change in the capital contributions to such partnership, becomes an investment services partnership interest, the qualified capital interest of the holder of such partnership interest immediately after such change shall not, for purposes of this subsection, be less than the fair market value of such interest (determined immediately before such change).

"(4) SPECIAL RULE FOR TIERED PARTNERSHIPS. -- Except as otherwise provided by the Secretary, in the case of tiered partnerships, all items which are allocated in a manner which meets the requirements of paragraph (1) to qualified capital interests in a lower-tier partnership shall retain such character to the extent allocated on the basis of qualified capital interests in any upper-tier partnership.

"(5) EXCEPTION FOR NO-SELF-CHARGED CARRY AND MANAGEMENT FEE PROVISIONS. -- Except as otherwise provided by the Secretary, an interest shall not fail to be treated as satisfying the requirement of paragraph (1)(A) merely because the allocations made by the partnership to such interest do not reflect the cost of services described in subsection (c)(2) which are provided (directly or indirectly) to the partnership by the holder of such interest (or a related person).

"(6) SPECIAL RULE FOR DISPOSITIONS. -- In the case of any investment services partnership interest any portion of which is a qualified capital interest, subsection (b) shall not apply to so much of any gain or loss as bears the same proportion to the entire amount of such gain or loss as --

"(A) the distributive share of gain or loss that would have been allocated to the qualified capital interest (consistent with the requirements of paragraph (1)) if the partnership had sold all of its assets at fair market value immediately before the disposition, bears to

"(B) the distributive share of gain or loss that would have been so allocated to the investment services partnership interest of which such qualified capital interest is a part.

"(7) QUALIFIED CAPITAL INTEREST. -- For purposes of this subsection --

"(A) IN GENERAL. -- The term 'qualified capital interest' means so much of a partner's interest in the capital of the partnership as is attributable to --

"(i) the fair market value of any money or other property contributed to the partnership in exchange for such interest (determined without regard to section 752(a)),

"(ii) any amounts which have been included in gross income under section 83 with respect to the transfer of such interest, and

"(iii) the excess (if any) of --

"(I) any items of income and gain taken into account under section 702 with respect to such interest, over

"(II) any items of deduction and loss so taken into account.

"(B) ADJUSTMENT TO QUALIFIED CAPITAL INTEREST. --

"(i) DISTRIBUTIONS AND LOSSES. -- The qualified capital interest shall be reduced by distributions from the partnership with respect to such interest and by the excess (if any) of the amount described in subparagraph (A)(iii)(II) over the amount described in subparagraph (A)(iii)(I).

"(ii) SPECIAL RULE FOR CONTRIBUTIONS OF PROPERTY. -- In the case of any contribution of property described in subparagraph (A)(i) with respect to which the fair market value of such property is not equal to the adjusted basis of such property immediately before such contribution, proper adjustments shall be made to the qualified

capital interest to take into account such difference consistent with such regulations or other guidance as the Secretary may provide.

"(C) TECHNICAL TERMINATIONS, ETC., DISREGARDED. -- No increase or decrease in the qualified capital interest of any partner shall result from a termination, merger, consolidation, or division described in section 708, or any similar transaction.

"(8) TREATMENT OF CERTAIN LOANS. --

"(A) PROCEEDS OF PARTNERSHIP LOANS NOT TREATED AS QUALIFIED CAPITAL INTEREST OF SERVICE PROVIDING PARTNERS. -- For purposes of this subsection, an investment services partnership interest shall not be treated as a qualified capital interest to the extent that such interest is acquired in connection with the proceeds of any loan or other advance made or guaranteed, directly or indirectly, by any other partner or the partnership (or any person related to any such other partner or the partnership). The preceding sentence shall not apply to the extent the loan or other advance is repaid before January 1, 2013 unless such repayment is made with the proceeds of a loan or other advance described in the preceding sentence.

"(B) REDUCTION IN ALLOCATIONS TO QUALIFIED CAPITAL INTERESTS FOR LOANS FROM NONSERVICE-PROVIDING PARTNERS TO THE PARTNERSHIP. -- For purposes of this subsection, any loan or other advance to the partnership made or guaranteed, directly or indirectly, by a partner not providing services described in subsection (c)(2) to the partnership (or any person related to such partner) shall be taken into account in determining the qualified capital interests of the partners in the partnership.

"(e) OTHER INCOME AND GAIN IN CONNECTION WITH INVESTMENT MANAGEMENT SERVICES. --

"(1) IN GENERAL. -- If --

"(A) a person performs (directly or indirectly) investment management services for any investment entity,

"(B) such person holds (directly or indirectly) a disqualified interest with respect to such entity, and

"(C) the value of such interest (or payments thereunder) is substantially related to the amount of income or gain (whether or not realized) from the assets with respect to which the investment management services are performed,

any income or gain with respect to such interest shall be treated as ordinary income. Rules similar to the rules of subsections (a)(5) and (d) shall apply for purposes of this subsection.

"(2) DEFINITIONS. -- For purposes of this subsection --

"(A) DISQUALIFIED INTEREST. --

"(i) IN GENERAL. -- The term 'disqualified interest' means, with respect to any investment entity --

"(I) any interest in such entity other than indebtedness,

"(II) convertible or contingent debt of such entity,

"(III) any option or other right to acquire property described in subclause (I) or (II), and

"(IV) any derivative instrument entered into (directly or indirectly) with such entity or any investor in such entity.

"(ii) EXCEPTIONS. -- Such term shall not include --

"(I) a partnership interest,

"(II) except as provided by the Secretary, any interest in a taxable corporation, and

"(III) except as provided by the Secretary, stock in an S corporation.

"(B) TAXABLE CORPORATION. -- The term 'taxable corporation' means --

"(i) a domestic C corporation, or

"(ii) a foreign corporation substantially all of the income of which is --

"(I) effectively connected with the conduct of a trade or business in the United States, or

"(II) subject to a comprehensive foreign income tax (as defined in section 457A(d)(2)).

"(C) INVESTMENT MANAGEMENT SERVICES. -- The term 'investment management services' means a substantial quantity of any of the services described in subsection (c)(2).

"(D) INVESTMENT ENTITY. -- The term 'investment entity' means any entity which, if it were a partnership, would be an investment partnership.

"(f) REGULATIONS. -- The Secretary shall prescribe such regulations or other guidance as is necessary or appropriate to carry out the purposes of this section, including regulations or other guidance to --

"(1) provide modifications to the application of this section (including treating related persons as not related to one another) to the extent such modification is consistent with the purposes of this section, and

"(2) coordinate this section with the other provisions of this title.

"(g) CROSS REFERENCE. -- For 40 percent penalty on certain underpayments due to the avoidance of this section, see section 6662."

(b) APPLICATION OF SECTION 751 TO INDIRECT DISPOSITIONS OF INVESTMENT SERVICES PARTNERSHIP INTERESTS. --

(1) IN GENERAL. -- Subsection (a) of section 751 of the Internal Revenue Code of 1986 is amended by striking "or" at the end of paragraph (1), by inserting "or" at the end of paragraph (2), and by inserting after paragraph (2) the following new paragraph:

"(3) investment services partnership interests held by the partnership,".

(2) CERTAIN DISTRIBUTIONS TREATED AS SALES OR EXCHANGES. -- Subparagraph (A) of section 751(b)(1) of the Internal Revenue Code of 1986 is amended by striking "or" at the end of clause (i), by inserting "or" at the end of clause (ii), and by inserting after clause (ii) the following new clause:

"(iii) investment services partnership interests held by the partnership,".

(3) APPLICATION OF SPECIAL RULES IN THE CASE OF TIERED PARTNERSHIPS. -- Subsection (f) of section 751 of the Internal Revenue Code of 1986 is amended by striking "or" at the end of paragraph (1), by inserting "or" at the end of paragraph (2), and by inserting after paragraph (2) the following new paragraph:

"(3) investment services partnership interests held by the partnership,".

(4) INVESTMENT SERVICES PARTNERSHIP INTERESTS; QUALIFIED CAPITAL INTERESTS. -- Section 751 of the Internal Revenue Code of 1986 is amended by adding at the end the following new subsection:

"(g) INVESTMENT SERVICES PARTNERSHIP INTERESTS. -- For purposes of this section --

"(1) IN GENERAL. -- The term 'investment services partnership interest' has the meaning given such term by section 710(c).

"(2) ADJUSTMENTS FOR QUALIFIED CAPITAL INTERESTS. -- The amount to which subsection (a) applies by reason of paragraph (3) thereof shall not include so much of such amount as is attributable to any portion of the investment services partnership interest which is a qualified capital interest (determined under rules similar to the rules of section 710(d)).

"(3) RECOGNITION OF GAINS. -- Any gain with respect to which subsection (a) applies by reason of paragraph (3) thereof shall be recognized notwithstanding any other provision of this title.

"(4) COORDINATION WITH INVENTORY ITEMS. -- An investment services partnership interest held by the partnership shall not be treated as an inventory item of the partnership.

"(5) PREVENTION OF DOUBLE COUNTING. -- Under regulations or other guidance prescribed by the Secretary, subsection (a)(3) shall not apply with respect to any amount to which section 710 applies."

(c) TREATMENT FOR PURPOSES OF SECTION 7704. -- Subsection (d) of section 7704 of the Internal Revenue Code of 1986 is amended by adding at the end the following new paragraph:

"(6) INCOME FROM CERTAIN CARRIED INTERESTS NOT QUALIFIED. --

"(A) IN GENERAL. -- Specified carried interest income shall not be treated as qualifying income.

"(B) SPECIFIED CARRIED INTEREST INCOME. -- For purposes of this paragraph --

"(i) IN GENERAL. -- The term 'specified carried interest income' means --

"(I) any item of income or gain allocated to an investment services partnership interest (as defined in section 710(c)) held by the partnership,

"(II) any gain on the disposition of an investment services partnership interest (as so defined) or a partnership interest to which (in the hands of the partnership) section 751 applies, and

"(III) any income or gain taken into account by the partnership under subsection (b)(4) or (e) of section 710.

"(ii) EXCEPTION FOR QUALIFIED CAPITAL INTERESTS. -- A rule similar to the rule of section 710(d) shall apply for purposes of clause (i).

"(C) COORDINATION WITH OTHER PROVISIONS. -- Subparagraph (A) shall not apply to any item described in paragraph (1)(E) (or so much of paragraph (1)(F) as relates to paragraph (1)(E)).

"(D) SPECIAL RULES FOR CERTAIN PARTNERSHIPS. --

"(i) CERTAIN PARTNERSHIPS OWNED BY REAL ESTATE INVESTMENT TRUSTS. -- Subparagraph (A) shall not apply in the case of a partnership which meets each of the following requirements:

"(I) Such partnership is treated as publicly traded under this section solely by reason of interests in such partnership being convertible into interests in a real estate investment trust which is publicly traded.

"(II) 50 percent or more of the capital and profits interests of such partnership are owned, directly or indirectly, at all times during the taxable year by such real estate investment trust (determined with the application of section 267(c)).

"(III) Such partnership meets the requirements of paragraphs (2), (3), and (4) of section 856(c).

"(ii) CERTAIN PARTNERSHIPS OWNING OTHER PUBLICLY TRADED PARTNERSHIPS. -- Subparagraph (A) shall not apply in the case of a partnership which meets each of the following requirements:

"(I) Substantially all of the assets of such partnership consist of interests in one or more publicly traded partnerships (determined without regard to subsection (b)(2)).

"(II) Substantially all of the income of such partnership is ordinary income or section 1231 gain (as defined in section 1231(a)(3)).

"(E) TRANSITIONAL RULE. -- Subparagraph (A) shall not apply to any taxable year of the partnership beginning before the date which is 10 years after January 1, 2013".

(d) IMPOSITION OF PENALTY ON UNDERPAYMENTS. --

(1) IN GENERAL. -- Subsection (b) of section 6662 of the Internal Revenue Code of 1986 is amended by inserting after paragraph (7) the following new paragraph:

"(8) The application of section 710(e) or the regulations or other guidance prescribed under section 710(h) to prevent the avoidance of the purposes of section 710.".

(2) AMOUNT OF PENALTY. --

(A) IN GENERAL. -- Section 6662 of the Internal Revenue Code of 1986 is amended by adding at the end the following new subsection:

"(k) INCREASE IN PENALTY IN CASE OF PROPERTY TRANSFERRED FOR INVESTMENT MANAGEMENT SERVICES. -- In the case of any portion of an underpayment to which this section applies by reason of subsection (b)(8), subsection (a) shall be applied with respect to such portion by substituting '40 percent' for '20 percent'.".

(B) CONFORMING AMENDMENT. -- Subparagraph (B) of section 6662A(e)(2) is amended by striking "or (i)" and inserting ", (i), or (k)".

(3) SPECIAL RULES FOR APPLICATION OF REASONABLE CAUSE EXCEPTION. -- Subsection (c) of section 6664 is amended --

(A) by redesignating paragraphs (3) and (4) as paragraphs (4) and (5), respectively;

(B) by striking "paragraph (3)" in paragraph (5)(A), as so redesignated, and inserting "paragraph (4)"; and

(C) by inserting after paragraph (2) the following new paragraph:

"(3) SPECIAL RULE FOR UNDERPAYMENTS ATTRIBUTABLE TO INVESTMENT MANAGEMENT SERVICES. --

"(A) IN GENERAL. -- Paragraph (1) shall not apply to any portion of an underpayment to which section 6662 applies by reason of subsection (b)(8) unless --

"(i) the relevant facts affecting the tax treatment of the item are adequately disclosed,

"(ii) there is or was substantial authority for such treatment, and

"(iii) the taxpayer reasonably believed that such treatment was more likely than not the proper treatment.

"(B) RULES RELATING TO REASONABLE BELIEF. -- Rules similar to the rules of subsection (d)(3) shall apply for purposes of subparagraph (A)(iii)."

(e) INCOME AND LOSS FROM INVESTMENT SERVICES PARTNERSHIP INTERESTS TAKEN INTO ACCOUNT IN DETERMINING NET EARNINGS FROM SELF-EMPLOYMENT. --

(1) INTERNAL REVENUE CODE. --

(A) IN GENERAL. -- Section 1402(a) of the Internal Revenue Code of 1986 is amended by striking "and" at the end of paragraph (16), by striking the period at the end of paragraph (17) and inserting "; and", and by inserting after paragraph (17) the following new paragraph:

"(18) notwithstanding the preceding provisions of this subsection, in the case of any individual engaged in the trade or business of providing services described in section 710(c)(2) with respect to any entity, investment services partnership income or loss (as defined in subsection (m)) of such individual with respect to such entity shall be taken into account in determining the net earnings from self-employment of such individual."

(B) INVESTMENT SERVICES PARTNERSHIP INCOME OR LOSS. -- Section 1402 of the Internal Revenue Code is amended by adding at the end the following new subsection:

"(m) INVESTMENT SERVICES PARTNERSHIP INCOME OR LOSS. -- For purposes of subsection (a) --

"(1) IN GENERAL. -- The term 'investment services partnership income or loss' means, with respect to any investment services partnership interest (as defined in section 710(c)), the net of --

"(A) the amounts treated as ordinary income or ordinary loss under subsections (b) and (e) of section 710 with respect to such interest,

(B) all items of income, gain, loss, and deduction allocated to such interest, and

"(C) the amounts treated as realized from the sale or exchange of property other than a capital asset under section 751 with respect to such interest.

"(2) EXCEPTION FOR QUALIFIED CAPITAL INTERESTS. -- A rule similar to the rule of section 710(d) shall apply for purposes of applying paragraph (1)(B)(ii)."

(2) SOCIAL SECURITY ACT. -- Section 211(a) of the Social Security Act is amended by striking "and" at the end of paragraph (15), by striking the period at the end of paragraph (16) and inserting "; and", and by inserting after paragraph (16) the following new paragraph:

"(17) Notwithstanding the preceding provisions of this subsection, in the case of any individual engaged in the trade or business of providing services described in section 710(c)(2) of the Internal Revenue Code of 1986 with respect to any entity, investment services partnership income or loss (as defined in section 1402(m) of such Code) shall be taken into account in determining the net earnings from self-employment of such individual."

(f) CONFORMING AMENDMENTS. --

(1) Subsection (d) of section 731 of the Internal Revenue Code of 1986 is amended by inserting "section 710(b)(4) (relating to distributions of partnership property)," after "to the extent otherwise provided by".

(2) Section 741 of the Internal Revenue Code of 1986 is amended by inserting "or section 710 (relating to special rules for partners providing investment management services to partnerships)" before the period at the end.

(3) The table of sections for part I of subchapter K of chapter 1 of the Internal Revenue Code of 1986 is amended by adding at the end the following new item:

"Sec. 710. Special rules for partners providing investment management services to partnerships."

(g) EFFECTIVE DATE. --

(1) IN GENERAL. -- Except as otherwise provided in this subsection, the amendments made by this section shall apply to taxable years ending after December 31, 2012.

(2) PARTNERSHIP TAXABLE YEARS WHICH INCLUDE EFFECTIVE DATE. -- In applying section 710(a) of the Internal Revenue Code of 1986 (as added by this section) in the case of any partnership taxable year which includes January 1, 2013, the amount of the net income referred to in such section shall be treated as being the lesser of the net income for the entire partnership taxable year or the net income determined by only taking into account items attributable to the portion of the partnership taxable year which is after such date.

(3) DISPOSITIONS OF PARTNERSHIP INTERESTS. --

(A) IN GENERAL. -- Section 710(b) of such Code (as added by this section) shall apply to dispositions and distributions after December 31, 2012.

(B) INDIRECT DISPOSITIONS. -- The amendments made by subsection (b) shall apply to transactions after December 31, 2012.

(4) OTHER INCOME AND GAIN IN CONNECTION WITH INVESTMENT MANAGEMENT SERVICES. -- Section 710(e) of such Code (as added by this section) shall take effect on January 1, 2013.