February 10, 2016

# Fiscal Year 2017 Budget Update

***In General***. On Tuesday, February 9, 2016, the White House released President Obama's Budget for Fiscal Year 2017. This memorandum briefly highlights several of the President's tax reform proposals that are particularly relevant in the investment fund context, many of which have been included in prior budget proposals and proposed legislation.

- ***Increase Capital Gains Rate.*** The budget proposes to raise long-term capital gains (LTCG) and qualified dividend income (QDI) rates to 24.2 percent (from the existing 20 percent rate). The existing 3.8 percent tax on net investment income would continue to apply, for an all-in federal rate of 28 percent on LTCG and QDI.

- ***Tax Carried Interest As Ordinary Income.*** The past several budget proposals have included this change, and it is similar to the carried interest legislation that has been introduced numerous times over the past decade. One change in the political atmosphere worth noting is that some Republican presidential candidates have expressed support for similar carried interest proposals; this is a change from prior years, where this concept has been supported primarily by Democratic legislators and President Obama.

- ***Ensure that "Limited Partners" Pay Self-Employment Taxes***. The proposal would ensure that members of limited liability companies and limited partners of limited partnerships that materially participate in the entity's business pay self-employment contribution taxes on their net trade or business income, including their distributive share of business earnings. This is a new addition to the budget proposal this year (although proposed legislation in Congress in past years has included variations of this proposal).

- ***Require Mark-to-Market Treatment for Derivatives.*** The budget would require taxpayers to mark most derivatives contracts to market on an annual basis. For these purposes, a derivative would be defined very broadly, and it would include many contracts and instruments that today are eligible for special tax regimes, e.g., under Section 1256 of the Internal Revenue Code. The mark-to-market gain or loss would be ordinary gain or loss.

- ***Inversions/Earnings Stripping.*** There are numerous proposals concerning inversions. For example, the budget would generally reduce the threshold for an inversion from 80% to 50% (i.e., making it harder for U.S. companies to engage in inversion transactions). It also proposes a more restrictive set of earnings stripping rules that would apply to certain multi-national corporate groups with non-U.S. parents.

The budget contains numerous other proposals that would have wide-ranging implications, including proposals related to controlled foreign corporations, taxing market discount currently, and pension plans. We will continue to monitor developments and keep our clients informed regarding these and other proposals.

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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