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IRS Issues New Proposed Regulations Under the Section 1061 Carried Interest Rules

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The U.S. Internal Revenue Service (IRS) published proposed regulations (the Proposed Regulations) on August 14, 2020, providing much-needed guidance on the implementation of the carried interest rules under Section 1061.[1] These rules will be of great interest to investment fund managers as well as to any service provider receiving an interest in a partnership in exchange for the provision of services. The discussion below is intended to dive into the key provisions of the new Proposed Regulations, which are detailed, mechanical and complex.

Background

A "carried interest" refers to an interest in a partnership's profits allocable to a partner without regard to such partner's capital investment in the partnership. In the investment fund context, the general partner typically does not contribute significant capital to the fund, but through the carried interest mechanism, the general partner is allocated a significant portion (generally up to roughly 20%) of the fund's profits – often after a minimum investment return hurdle has been achieved for the limited partners of the fund – disproportionate to the capital contributions made by the general partner to the fund. The carried interest is intended to incentivize the general partner to maximize the fund's performance and investment returns for the limited partners of the fund, and in that regard, it can be viewed as compensation for the performance of services.

The U.S. tax treatment of a carried interest has long been a controversial topic subject to much debate. The character of income allocable to the holder of the carried interest retains the character of such income generated by the partnership. As a result, if the fund generates capital gain income, notwithstanding that capital gain treatment typically is reserved for investment income and the general partner typically has not made a significant capital investment in the fund, the income will retain its character as capital gains in the hands of the general partner. To the extent allocable to individuals, the capital gains may be subject to reduced tax rates. As these individuals are receiving profits disproportionate to their capital investments in the fund, some have argued that capital interest allocations should be taxed as ordinary compensation income received in exchange for providing services to the fund.

The tax treatment of carried interests has been politically charged as well since the 2000s, with (i) Democrats generally taking the position that the carried interest provision is a legislative "loophole" that permits investment managers to convert what would otherwise be compensation for labor taxed at ordinary income rates into preferentially taxed capital gains, and (ii) Republicans taking the position that the return to investment managers is more akin to investment income subject to entrepreneurial risk and that the debate, if any, should be focused on a larger review of capital gains taxes as opposed to the targeting of carried interest holders.

Democrats included a measure to end capital gain treatment for carried interest holders in the 2010 American Jobs and Closing Tax Loopholes Act, and President Obama included the proposal in his 2013 budget proposes, but the provision was never enacted. In both instances, the amounts would have been characterized as compensation income, subject to tax at ordinary income rates and subject to employment taxes (e.g., FICA, FUTA). In 2016, candidate Clinton and candidate Trump ran on repealing the preferential tax treatment to carried interest holders.

Upon taking office, President Trump and his administration began focusing on tax reform. The Tax Cuts and Jobs Act (the Act) was enacted in 2017, addressing (in part) this longstanding debate over whether allocations of profits to carried interest holders should retain the character of the income generated by the partnership and potentially qualify for favorable tax treatment and preferential tax rates or

should be taxed at higher ordinary income rates applicable to compensation income, by enacting Section 1061. Generally speaking, the Act took a middle-of-the-road position in that (i) it did not completely eliminate preferential tax treatment to carried interest holders but instead subjected such treatment to a longer holding period than that typically required to obtain long-term capital gains rates (discussed below); (ii) amounts received by holders of carried interest that do not satisfy the holding period would lose long-term capital gain status; and (iii) amounts that were denied long-term capital gain status are instead characterized as short-term capital gain as opposed to compensation income, both of which are subject to tax at ordinary income rates, but the latter of which would also be subject to employment taxes like other compensation income.

Before this discussion gets into the details of Section 1061 and the Proposed Regulations, it is worth noting that the Act, along with Section 1061 and the Proposed Regulations, may not be the final chapter in the carried interest saga. U.S. House Ways and Means Committee member Representative Bill Pascrell, D-N.J., and Senator Tammy Baldwin, D-Wis., introduced companion bills in March 2019 that would generally put an end to capital gain treatment for income from carried interests and would treat such income as wage income subject to employment taxes. Moreover, with a presidential election fast approaching, both President Trump and candidate Biden, in a rare instance of agreement, have as a stated policy position the elimination of the so-called carried interest loophole, so this is a topic we will continue to monitor post-election.

In the absence of Section 1061, a fund holding long-term capital assets could issue a carried interest to the general partner or a sponsor, and the holder of the carried interest might immediately qualify for the pass-through of long-term capital gains if the partnership sold capital assets with a one-year holding period. The same carried interest holder could sell (or have redeemed) its carried interests after two years and potentially claim long-term capital gains treatment. Section 1061, however, requires certain taxpayers that hold a carried interest (also referred to as a "profits interest") in a partnership to satisfy a three-year holding period to qualify for preferential long-term capital gains rates. Where applicable, Section 1061 recharacterizes short-term capital gain as gain from property held for greater than one year but less than three years that would otherwise qualify as long-term capital gain. Specifically, Section 1061 applies to "applicable partnership interests" (APIs), which are partnership interests held by a taxpayer directly or indirectly through a pass-through entity that, in connection with the performance of services by the taxpayer, is transferred to (or held by the taxpayer in) an applicable trade or business (ATB).

Although these rules are expected to have a significant impact on investment funds, generally hedge fund sponsors are less likely to be impacted by them, as hedge funds typically do not generate significant amounts of long-term capital gain that would otherwise pass through to the holders of the carried interest. In addition, real estate fund sponsors seem to avoid the brunt of these rules, as the Proposed Regulations provide a carve-out for Section 1231 gains, which generally includes gains from real property used in a trade or business (discussed further below).

Finally, we note that with proper planning and structuring, various techniques can be used to minimize the impact of the statutory limitations of Section 1061 and the Proposed Regulations.

The Proposed Regulations

The Proposed Regulations implement the statutory framework of Section 1061, largely following taxpayer expectations, and although intended to be comprehensive, they create the need for further guidance and clarity on partnership-related issues left unaddressed. Some of the key takeaways from the Proposed Regulations are as follows.

Applicable Trade or Business

As discussed above, in order for an API to be subject to Section 1061, it must be transferred in connection with the performance of services to an ATB. Section 1061 defines an ATB as any activity conducted on a regular, continuous and substantial basis which, regardless of whether the activity is conducted in one or more entities, consists, in whole or in part, of (i) raising or returning capital, and (ii) either (a) investing in (or disposing of) specified assets, or (b) developing specified assets.

The Proposed Regulations provide some additional guidance in determining whether there is an ATB, by providing that an ATB exists if the taxpayer's activities of (i) raising or returning capital and (ii) investing or developing specified assets constitute a trade or business under Section 162. "Specified assets" includes securities, commodities, real estate, cash and cash equivalents, options, derivative contracts, and interests in a partnership that hold any of the above. For purposes of determining whether there is an ATB, the Proposed Regulations aggregate the activities of the taxpayer and all related persons. Of particular importance is the fact that the Proposed Regulations confirm that interests issued by private equity funds and hedge funds constitute APIs.

Exclusions from the Definition of API

Exclusion for Corporations. Section 1061 does not apply to APIs held by corporations, because corporations are subject to the same tax rate on both ordinary income and capital gains. Although Section 1061 does not specifically state that to qualify for the exception, the corporation must be a C corporation, the IRS clarified in Notice 2018-18 that S corporations are subject to Section 1061. This IRS clarification eliminated the tax strategy of holding the carried interest in an S corporation to avoid the new three-year holding period. The Proposed Regulations confirm the guidance of Notice 2018-18 that APIs held by S corporations are indeed subject to Section 1061.

Moreover, the Proposed Regulations clarify that the exclusion for corporations does not apply to non-U.S. corporations that are passive foreign investment companies (PFICs) and have a qualified electing fund (QEF) election in place. The QEF election permits capital gains recognized by or allocated to the PFIC to flow through to the U.S. shareholders of the PFIC. In the absence of this provision, there would be an opportunity to use a PFIC with a QEF election to hold APIs to circumvent the purposes of Section 1061.

Based on a plain reading of the statute, certain taxpayers may have implemented structures to avoid the three-year holding period of Section 1061 by holding an API through an S corporation or a QEF. The Proposed Regulations make clear that taxpayers cannot circumvent the intent of the Section 1061 rules through these structures.

Capital Interest Exception. Generally, Section 1061 provides that an API does not include certain capital interests in a partnership. For these purposes, Section 1061(c)(4)(B) provides that a capital interest in the partnership includes an interest which provides the taxpayer with a right to share in partnership capital commensurate with the amount of capital contributed (determined at the time of receipt of such partnership interest). Although the Proposed Regulations provide guidance as to the application of this exception, the approach is restrictive and limits the application of the statutory exception in such a manner that will likely create additional uncertainty or require further clarifying guidance.

To qualify for this exception, allocations must be based on the partners' relative capital accounts, and the terms, priority, type and level of risk, rate of return, and rights to cash or property distributions during the partnership's operations and upon liquidation must be the same. In addition, the partnership generally must allocate to the holder of the carried interest on the same terms as allocations are made to unrelated non-service partners with a significant (e.g., at least 5%) aggregate capital account balance.

Despite the lack of statutory authority, the Proposed Regulations ignore capital contributed to the partnership to the extent such amounts are borrowed from, or guaranteed by, the management company, the general partner or another partner.

The narrow approach taken by the Proposed Regulations, which essentially limit this capital interest exception to partnerships that allocate pro rata, provides limited comfort to the many partnerships that have more complex distribution waterfalls reflecting a negotiated economic deal among the partners. In addition, for funds that generally allocate profits and losses on an investment-by-investment basis, sponsors may face challenges when trying to satisfy this exception, because such allocations may differ from allocations made in accordance with relative capital accounts due to either multiple closings or certain partners opting out of certain investments.

Based on the importance of the capital interest exception to funds, the limited approach taken by the Proposed Regulations and the uncertainty that remains in qualifying for the exception, we expect this area to be the subject of many questions or comments prior to finalization of the regulations.

Family Office Exception. Section 1061(b) provides the U.S. Treasury Department authority to promulgate regulations to exclude from Section 1061 income or gain attributable to any asset not held for portfolio investment on behalf of third-party investors. For these purposes, a third-party investor is a person who does not provide substantial services for a partnership or an ATB and who holds an

interest in such partnership which does not constitute property held in connection with an applicable ATB. Commentators have suggested, and the Treasury agrees, that the Section 1061(b) exception is intended to apply to family offices (i.e., portfolio investments made on behalf of the service providers and persons related to the service providers as opposed to on behalf of third-party investors).

Although the Proposed Regulations refrain from specifically addressing this exception, the Preamble to the Proposed Regulations indicates that there is at least some coverage for family offices pursuant to the capital interest exception. Notwithstanding the Preamble and the capital interest exception, we expect further clarification and specific rules addressing the family offices exception when the regulations are finalized.

Bona Fide Third-Party Purchaser Exception. The Proposed Regulations added a new exception not provided by Section 1061 that terminates a partnership interest's status as an API upon acquisition by an unrelated party for fair market value, provided that the unrelated party does not directly or indirectly provide services to the partnership or any lower-tier partnership. This exception presumably will permit certain financial institutions to acquire interests in general partners of investment funds without triggering adverse consequences pursuant to Section 1061.

Employees of Non-ATB Entities. In accordance with the exception set forth in Section 1061, the Proposed Regulations exclude from the definition of an API an interest transferred to a person who is an employee of, or is performing services for, an entity that is not engaged in an ATB. This exception is believed to apply to recipients of a profits interest for the performance of services with respect to a portfolio company engaged in an active trade or business.

Recharacterization Amount and Holding Period Determination

General

Section 1061 recharacterizes gain that would otherwise be eligible for long-term capital gain treatment as short-term capital gain unless a three-year holding period requirement is satisfied. Prior to the release of the Proposed Regulations, there was some uncertainty as to whether the relevant holding period which had to be satisfied was that of the API or that of the underlying fund assets.

The Proposed Regulations clear up this confusion by clarifying the relevant holding period as that of the asset being disposed (regardless of whether the asset being disposed is an underlying asset of the fund or the API). As a result,

- if a fund sells a portfolio company that it has held for more than three years, the portion of the gain allocated to a general partner or manager that has held the API in the fund will not be recharacterized under Section 1061, even if the API was held for less than three years; and
- if a holder of an API sells the API at a time when such holder has held the API for two years, the gain from the sale of the API will be subject to recharacterization as short-term capital gain under Section 1061, even if the underlying assets of the fund have been held for more than three years.

For investment funds it will be important to consider the holding period of the underlying asset being sold, because different holding periods may apply to different assets held by such fund, to different blocks of a portfolio company's stock or when the fund makes a follow-on investment for an existing portfolio company.

Look-Through Rule

Notwithstanding the general rule that the three-year holding period is determined with respect to the holder of the asset being sold, the Proposed Regulations provide a look-through rule that can recharacterize gain from the disposition of an API that otherwise satisfies the three-year holding period requirement as short-term capital gain under Section 1061. For the look-through rule to apply to the disposition of an interest in an API that otherwise satisfied the three-year holding period requirement, at least 80% of the partnership's assets (i) must be assets which would produce capital gain or loss that is not excluded from Section 1061 if disposed of by the partnership (e.g., Section 1231 gains) and (ii) must have a holding period of three years or less (the Substantially All Test).

In a tiered partnership structure wherein the holder of the API holds its API through one or more pass-through entities, the look-through rule can still apply if (i) such holder disposes of the interest in the intermediary pass-through entity held for more than three years in a taxable transaction; (ii) the holder recognizes capital gain; and (iii) either (a) the pass-through entity which is sold has a holding period in a directly or indirectly held API of three years or less, or (b) the assets of the partnership in which the API is held meet the Substantially All Test.

Computational Rules

In addition to clarifying confusion about determining whether the three-year holding period is satisfied, the Proposed Regulations provide clarification on how to calculate the amount of gain that has to be recalculated. Generally, the amount of gain subject to recharacterization under Section 1061 is the difference between (i) the amount of long-term capital gain determined based on the Section 1221 one-year holding period requirement and (ii) the amount of long-term capital gain determined in accordance based on the Section 1061 three-year holding period requirement.

For taxpayers that indirectly hold APIs in lower-tier partnerships, the amount that is recharacterized under Section 1061 is determined at the taxpayer level by applying the above calculation to the taxpayer's distributive share of (i) income from the lower-tier API, (ii) gain from dispositions of the lower-tier API, and (iii) gain on dispositions of assets previously distributed with respect to a lower-tier API. Note that even where the holding period with respect to a sold lower-tier API exceeds three years, the gain from the disposition of such lower-tier API may be subject to the look-through rule discussed above.

Exclusion from the Recharacterization Rules

The Proposed Regulations provide exclusions from the Section 1061 recharacterization rules for certain types of incomes and gain, including Section 1231 gains (referring to real or depreciable business property held for more than one year), Section 1256 gains (referring to gains from certain Section 1256 contracts and straddles) and qualified dividend income. Specifically, the Proposed Regulations provide that Section 1061 will not recharacterize gain as short-term capital gain if it is eligible for long-term capital gain treatment under a provision that contains its own holding period requirements (separate from the general rules of Section 1222, which provides long-term capital gain treatment for capital assets with a greater-than-one-year holding period).

Based on the rules as described above, the Proposed Regulations generally exempt from Section 1061 gains on real estate held in a trade or business for more than one year, as such gains typically are eligible for long-term capital gain treatment pursuant to Section 1231 and not Section 1222. In addition, the Proposed Regulations expand this exception from the Section 1061 recharacterization rules to include capital gain dividends paid by a real estate investment trust (REIT) or a regulated investment company (RIC) to the extent attributable to Section 1231 gain on a look-through basis, provided that certain disclosure requirements are satisfied. As a result, a holder of an API attributable to RIC or REIT investments can get long-term capital gain treatment with respect to capital gain dividends from underlying investments held by the RIC or REIT that satisfy the three-year holding period requirement, regardless of how long the holder of the API indirectly held its RIC or REIT shares. A similar exclusion, look-through rule and disclosure requirement apply to net capital gain inclusions in respect of a QEF.

Related-Party Transfers

Section 1061(d) provides that certain transfers of an API to a related person may trigger a portion of the gain in the underlying assets. Specifically, the Proposed Regulations interpret Section 1061(d) as requiring the transferor of an API to a related party to look through to the underlying assets of the partnership whose API is being transferred, and to recognize as short-term capital gain an amount equal to the built-in gain in the underlying assets that do not satisfy the three-year holding period. Gain recognition is required notwithstanding that the transfer of the API may otherwise qualify for non-recognition treatment (whether as a contribution, distribution, exchange, gift, etc.). Gain recognition is not required, however, on a transfer of an API to a partnership that is not taxable under Section 721, as the Proposed Regulations require partnerships to track built-in gain that would otherwise be subject to Section 1061 by applying Section 704(c)-type principles.

A related party for purposes of these rules generally includes certain family members (but not siblings), certain persons who performed services with respect to the ATB during the year in which the API was issued or the preceding three years, or any pass-through entity in which any such family member or service provider owns a direct or indirect interest.

Further consideration should be given to how this related-party recharacterization rule could impact common structures. For example, in an UPREIT structure where a publicly traded REIT owns and operates its properties through an operating partnership controlled by the REIT, in lieu of cash compensation, service providers can be compensated with long-term incentive plan (LTIP) units of the operating partnership. The LTIP units would appear to be APIs to the extent the service provider is performing services with respect to the ATB of the partnership. Assuming the REIT is a general partner of the operating partnership, the REIT will similarly be a person performing services with respect to the ATB. Therefore, the conversion by the service provider of the LTIP units into shares of the related REIT could be covered by these rules. Although even in the absence of these rules, the conversion typically would be a taxable exchange triggering the gain in the LTIP units, the rules of Section 1061(d) and the Proposed Regulations could recharacterize some or all of what would otherwise be long-term capital gain into short-term capital gain.

In light of the current lifetime gift tax exemption amount of $11.58 million, coupled with the risk that an upcoming change in presidential administration could result in legislation that would reduce the exemption amount, many fund managers have been considering gifts of their carried interests to the next generation of family members prior to any such reduction in the gift tax exemption amount. (Even in the absence of legislation, the exemption amount is scheduled to revert back to the pre-Act exemption of $5 million, adjusted for inflation, in 2026.) In order to effect such a transfer without triggering gift tax and valuation issues deemed to be adverse that can result when an interest in an entity is transferred by gift to a family member, these transfers are often structured as "vertical slice" transfers. For a transfer to qualify as a vertical slice transfer, the fund manager transferring a portion of its carried interest to family members must transfer a proportionate amount of every other equity interest in the fund held by such fund manager (and certain other related parties). Based on the Proposed Regulations and their potential application to gifts to related parties, there must be careful consideration when planning gratuitous transfers of interests of an API to family members, including a vertical slice transfer.

In-Kind Distributions of Property

Section 1061 safeguards against holders of APIs trying to avoid the application of Section 1061 by making an in-kind distribution of property that has not yet satisfied the three-year holding period requirement to a holder of an API and then having the holder sell the distributed property. The Proposed Regulations provide that if a partnership distributes property in kind to a holder of an API, then (i) the distribution will not trigger gain in the distributed property and (ii) gain from the sale of the distributed property will be subject to Section 1061 if the holding period of the property is not more than three years at the time of the sale (for this purpose, tacking on the holding period of the partnership in the asset). While in-kind distributions cannot be used to sidestep Section 1061, they can permit a recipient of an in-kind distribution to dispose of the distributed asset at the recipient's determination and then individually determine whether the three-year holding period will be met.

Effective Date

The Proposed Regulations generally provide that final regulations will apply to taxable years beginning on or after the date the final regulations are promulgated – provided, however, that taxpayers may rely on the Proposed Regulations for taxable years beginning prior to the date the final regulations are published, as long as taxpayers consistently apply the proposed rules. The Proposed Regulations' rule providing that S corporations are not eligible for exception for APIs held by corporations is effective for taxable years beginning after December 31, 2017, and the rule excluding PFICs making a QEF election from the exception for APIs held by corporations is effective for taxable years beginning after August 6, 2020.

Conclusion

Although the Proposed Regulations provide helpful guidance for interpreting and applying the carried interest rules of Section 1061, these rules are quite complex and in some instances leave questions unanswered or pose additional questions that we hope will be addressed

when the Proposed Regulations are finalized. As some of the provisions of the Proposed Regulations can be viewed as controversial, we expect there to be significant input and questions during the comment period.

[1] Unless otherwise indicated, "Section" references are to the Internal Revenue Code of 1986, as amended (the Code).

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