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Carried Interest Proposed Regulations: Key Considerations for Fund Managers

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On July 31, 2020, the Department of Treasury and the Internal Revenue Service ("IRS") released proposed regulations addressing the "carried interest rules" contained in section 1061 of the Internal Revenue Code of 1986, as amended (the "Code"). Section 1061 was enacted on December 22, 2017, as part of the tax legislation commonly referred to as the Tax Cuts and Jobs Act.

Background

Section 1061 generally limits long-term capital gains treatment for carried interests to gains from assets held for more than 3 years, rather than the 1 year period that is normally required. Long-term capital gains that do not meet the 3 year requirement are converted into short-term capital gains, which are taxed at the same federal income tax rates as ordinary income (i.e., up to 37%, as opposed to the 20% rate that generally applies to long-term capital gains of individuals).

More specifically, this rule applies to taxpayers that hold an "applicable partnership interest" as defined in section 1061, which means a partnership interest that is transferred to or held by the taxpayer in connection with the performance of substantial services by the taxpayer, or a related person, in a trade or business of raising or returning capital, and investing in, disposing of or developing various types of investment assets (including securities, commodities and investment real estate). Section 1061 was effective for tax years beginning after December 31, 2017.

Highlights of Proposed Regulations

- Special categories of income, taxed at long-term capital gains rates, are not subject to recharacterization regardless of whether the 3 year holding period is satisfied. This includes qualified dividend income and section 1231 gains.
- The proposed regulations reaffirm the IRS' view that interests held by S corporations are not excepted from section 1061.
- The proposed regulations provide an exception for co-investments that may be difficult or impossible to achieve in many structures.
- An otherwise non-taxable transfer of a carried interest to a related person, such as a gift, could trigger an immediate tax under a rule contained in the proposed regulations.
- Under a lookthrough rule contained in the proposed regulations, a sale of a partnership interest held for more than 3 years can nonetheless result in short-term capital gains in certain cases.
- Carried interest waivers are likely to be scrutinized by the IRS.

Overview of Proposed Regulations

Applicable Partnership Interest

As a threshold matter, a taxpayer must hold an "applicable partnership interest" for section 1061 to apply. The proposed regulations define an "Applicable Partnership Interest" (an "API") to mean a partnership interest which, directly or indirectly, is transferred to (or held by) an Owner Taxpayer or a Passthrough Taxpayer in connection with the performance of substantial services by the Owner Taxpayer or a Passthrough Taxpayer, or any related person, in any Applicable Trade or Business unless an exception applies. An "Owner Taxpayer" means a person subject to federal income tax (such as an individual) with respect to the API, and a "Passthrough Taxpayer" generally means a partnership (including an LLC taxed as such), S corporation and certain passive foreign investment companies (PFICs).

Thus, the existence of an API is tested both at the level of a passthrough entity such as a partnership (Passthrough Taxpayer) as well as at the level of the ultimate persons subject to tax, such as an individual taxpayer (Owner Taxpayer). For example, if an API is held by a Passthrough Taxpayer, the ultimate Owner Taxpayers holding an interest in that entity are subject to section 1061 with respect to their flow-through gains unless an exception applies. Once an interest is an API, it continues to be an API -- even if the API is transferred or the service provider retires -- unless and until an exception applies.

An "Applicable Trade or Business" (an "ATB") exists if one or more related persons engage in actions involving raising or returning capital, and investing in, disposing of, or developing Specified Assets, and those combined actions rise to the level of a "trade or business" under section 162 of the Code. "Specified Assets" means securities (which include corporate stock and interests in publicly traded partnerships), commodities, real estate held for rental or investment, cash, and interests in partnerships (or entities tread as partnerships for federal income tax purposes) to the extent the partnership holds Specified Assets.

For purposes of identifying an ATB, the proposed regulations provide rules to address (and that generally "group") activities that may occur over different taxable years or by related persons, agents, and delegates. For example, actions undertaken by a fund's general partner and a separate management company would be grouped if the management company were related to, or a delegate of, the general partner.

What gains may be recharacterized?

The amount of net long-term capital gain that is required to be treated as short-term under section 1061 is determined at the level of the ultimate person subject to tax with respect to an API (that is, the Owner Taxpayer). If one or more APIs are held through one or more passthrough entities, amounts subject to section 1061 flow through and are netted at the Owner Taxpayer level.

In general, the amount treated as short-term capital gain is determined by combining the Owner Taxpayer's long-term capital gain or loss from all APIs, and then subtracting the portion of such gain or loss that is attributable to assets held for more than 3 years. The recharacterization rule takes into account both "flow-through" net long-term capital gains (such as a fund's gain from the sale of a portfolio company that flows through to the individual owners) as well as gains and losses from the sale of a directly-held API. The relevant holding period is determined with reference to the direct owner of the asset that was sold. For example, gain from a fund's sale of a portfolio company held by the fund for 2 years would be subject to recharacterization, even if the general partner held its API for more than 3 years. If the Owner Taxpayer does not have a combined net long-term capital gain with respect to its APIs for a year (or if such amount if a loss), the recharacterization rule does not apply because there is no gain to recharacterize.

Distributed Property. If a partnership makes an "in kind" distribution of property with respect to an API, section 1061 does not require that any gain be immediately recognized. However, the recipient partner's subsequent sale of that property is subject to section 1061 unless its holding period in the property, inclusive of the partnership's holding period, exceeds 3 years as of the date of sale.

Lookthrough Rule. Under a lookthrough rule, a taxable sale of an interest in a passthrough entity held for more than 3 years can nonetheless produce gains subject to recharacterization in two circumstances. First, if a directly-held API is sold, the rule applies if, generally speaking, 80% or more of the passthrough entity's assets (by value) are capital assets held for 3 years or less. Second, in the case of a sale of an interest in a passthrough entity that holds an API, the rule applies if either the passthrough entity has a holding period in the underlying API of 3 years or less, or the holding period of such API exceeds 3 years but the API-issuing entity's assets meet the 80% test noted above. The amount of gain recharacterized is generally the portion attributable to the relevant underlying assets that do not meet the 3 year requirement.

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Excluded Income. The recharacterization rule does not apply to qualified dividend income ("QDI") included in net capital gain, to long-term capital gain or loss under section 1231 (which applies to certain depreciable property used in a trade or business) or under section 1256 (which provides 60/40 treatment for gains and losses on certain futures and options contracts) or to any other capital gain characterized as long or short-term without regard to the holding period rules in section 1222. Thus, for example, a distribution by a corporate portfolio company that is considered a "dividend" under the Code generally would escape recharacterization (and would be taxed at long-term rates if the general QDI requirements are satisfied), even if paid within 3 years of the portfolio company's acquisition.

RIC/REIT Dividends. Special rules are provided to address capital gain dividends from RICs and REITs. In general, all such amounts are treated as capital gains from assets held for 3 years or less, unless the RIC or REIT reports certain information regarding the nature of its gains.

Treatment of Co-Investments (Capital Interest Exception)

The proposed regulations contain rules that implement the "capital interest" exception set forth in section 1061(c)(4)(B). The purpose of this exception is to generally "carve out" gains and losses that are attributable to a partner's capital investment in partnership (such as a co-investment by a general partner), as opposed to its carried interest. However, the proposed regulations take a fairly mechanical and narrow approach that may make this exception difficult to achieve in many cases.

Specifically, "Capital Interest Gains and Losses" are not subject to recharacterization under the proposed regulations. Such amounts fall into three categories.

The first category (Capital Interest Allocations) is applicable in situations where an API holder (such as a fund's general partner) and unrelated investors are members of the same partnership. In that case, the partnership's allocation of long-term capital gain or loss will qualify for the exception if the allocations are made in the same manner to the API holders and unrelated investors based on their relative capital account balances (although differences to reflect higher preferred returns to the investors, or management fee discounts to the API holder, appear to be permitted), the unrelated investors' capital accounts are at least 5% of the total capital accounts, and the allocations are clearly identified.[1]

The second category (Passthrough Interest Capital Allocations) applies to "tiered" structures such as, for example, where a passthrough entity (such as an LLC serving as the general partner) owns an API in a fund. Using such structure as an example, the exception would apply to Capital Interest Allocations (described above) made *to* the general partner from the fund and that are further allocated *by* the general partner to its owners in proportion to their indirect share of the general partner's capital account in the fund. With respect to any assets held directly by the general partner (other than an API), allocations of long-term gain or loss must generally be made in proportion to the owners' capital accounts in the general partner, disregarding the portion of such capital accounts attributable to the general partner's investment in the fund (or other passthrough entity). Alternatively, a passthrough entity (e.g., the general partner above) may elect to make all Passthrough Interest Capital Allocations to its owners based their on overall capital accounts in the passthrough entity.

The final category (Capital Interest Disposition Amounts) is relevant upon the sale of a partnership interest comprised of both of an API and a capital interest. In that case, the exception generally applies to the portion of the long-term gain or loss on the sale of the interest that is proportional to the Capital Interest Gain or Loss (if any), as a percentage of total long-term gain or loss, that would be allocated to selling partner if the underlying partnership sold all its assets for their fair market value. Special rules are provided to address situations where a selling partner may have a "outside" gain but an "inside" loss, or vice versa.

The general requirement, discussed above, that allocations must be based on relative *capital account* balances will make it difficult to qualify for the capital interest exception in many structures. For example, if a fund makes distributions on an "investment by investment" basis, the non-carried interest allocations of income from each investment typically would track the capital contributions made to fund such investment (in which some but not all investors may participate), and not overall capital accounts. Moreover, a general partner's capital account balance in a fund may include, in addition to its invested capital, undistributed profit allocations (including revaluation gain) attributable to its carried interest. The proposed regulations do not expressly carve out such portion from the API holder's capital account for purposes of determining

[1] For purposes of determining capital accounts in this context, capital contributions of amounts loaned or guaranteed by other partners or the partnership (or a related person) are disregarded until the borrowing is repaid.

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whether subsequent Capital Interest Allocations will be considered pro rata.[2]

APIs Held by Corporations

Under section 1061(c)(4)(A), an API does not include a partnership interest held directly or indirectly by a "corporation." Although the Code uses the term "corporation" without qualification, the proposed regulations provide that the exception for corporations does not apply to S corporations. This is consistent with the position previously stated by the IRS in Notice 2018-18. Going further, the proposed regulations provide that the exception also does not apply to PFICs with respect to which the shareholder has a qualified electing fund election in effect.

Other Exceptions

Non-ATB Employees. An API does not include a partnership interest transferred to a person in connection with the performance of substantial services as an employee of another entity that is conducting a trade or business (other than an ATB) and the person provides services only to such other entity. The language of the proposed regulations generally follows the Code on this point.

Third Party Purchasers. Moreover, an API does not include an interest in a partnership that is acquired in a taxable purchase for fair market value. To qualify for this exception, the purchaser cannot be related to a person providing services to the ATB or the partnership in which the interest is issued, the transfer cannot be taxable under the related party rules (discussed below), and the purchaser must not provide or anticipate providing services to or for the benefit of the partnership. This exception, which is newly added by the proposed regulations, generally would permit fund principals to sell their APIs to an unrelated purchaser, without the API taint continuing over to the purchaser. However, the exception does not apply to an unrelated non-service provider who becomes a partner by making a contribution to a passthrough entity that holds an API and in exchange receives an interest in the passthrough entity's API.

Transition Amount Election

Under a transition rule, a partnership that was in existence as of January 1, 2018 may elect to exclude from the recharacterization rule all long-term gains and losses from assets held more than 3 years as of January 1, 2018. Each direct or indirect partner's share of such excluded amounts is limited to the amount that would have been allocated to such person under the partnership agreement in effect for the 2017 tax year. Although the rules in the proposed regulations are generally not effective until adopted in final form, taxpayers are permitted to make this election for tax years beginning in 2020 or later.

Transfers of APIs to Related Parties

Section 1061(d) provides that if a person transfers an API to certain related persons, the transferor may be required to include additional short-term capital gain in its gross income. Under the proposed regulations, the requirement to recognize gain is triggered in the case of any taxable or non-taxable transfer to a related party, including a gift, but does not apply to a contribution of an API to another partnership in a non-recognition transaction. For these purposes, a related party means a family member as defined in section 318(a)(1) (i.e., a spouse, child, grandchild or parent), a person that performed a service for the Applicable Trade or Business relating to such API in the current or preceding three years, and a partnership to the extent owned by the foregoing.

Under the proposed regulations, the short-term capital gain to be recognized under this rule is (a) the net gain from assets held by the partnership for 3 years or less that would be allocated to the transferor in respect of the transferred interest, based on a hypothetical sale of the assets in the partnership issuing the API less (b) the amount treated as short-term capital gain under section 1061(a). As noted above, this rule can accelerate income in the case of an otherwise non-taxable transfer. Moreover, in the case of a transfer that is otherwise taxable, this rule can cause more gain to be subject to section 1061 than would be the case in a transfer to unrelated person.

Carried Interest Waivers

In the preamble to the proposed regulations, the IRS notes that it is aware of so-called carried interest waiver arrangements. In such an arrangement, a taxpayer may, for example, waive its rights to gains from assets held for three years or less and substitute gains generated by assets held for more than three years (among other techniques). Although the proposed regulations do not provide additional rules in this regard, the IRS cautions that such arrangements may not

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[2] Under the general rule, a taxpayer has a single capital account in a partnership even if the taxpayer holds multiple interests in the partnership. Treasury Regulation section 1.704-1(b)(2)(iv)(*b*).

be respected and may be challenged under existing tax principles. Thus, taxpayers engaging in such arrangements can anticipate increased scrutiny from the IRS.

Reporting Requirements

The proposed regulations would impose various reporting requirements. Failure to comply with such requirements could result in penalties.

Effective Dates

Section 1061 was effective beginning in 2018. The rules in the proposed regulations are generally not effective until they are adopted in final form. However, the provision excluding S corporations from the "corporation" exception is proposed to be effective for tax years beginning after 2017, and the provision excluding PFICs from such exception is proposed to be effective for tax years beginning after the date the proposed regulations are published in the Federal Register. Taxpayers may choose to rely on the proposed regulations until final regulations are issued, provided that taxpayers follow them in their entirety and in a consistent manner. However, taxpayers may rely on the transition amount election rules beginning in 2020 and until final regulations are published without regard to the requirement to apply the remainder of the proposed regulations, as long as the partnership treats gains and losses from the assets identified in the transition amount election as transition amounts under the proposed regulations.

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