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CLIENT ALERT

IRS Finalizes Carried Interest Regulations

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The IRS has issued final regulations on the taxation of carried interest under Section 1061 of the tax code (the "Carried Interest Regulations"). Section 1061 was added to the tax code as part of the 2017 tax reform legislation and generally provides that capital gain allocated under certain carried interest arrangements is eligible for the favorable 20% U.S. federal income tax rate only if the underlying asset was held for more than three years at the time of sale.

The Carried Interest Regulations are, on the whole, consistent with the manner in which most taxpayers have been applying Section 1061 since its enactment. The Carried Interest Regulations are also largely consistent with the carried interest regulations that the IRS proposed in August (the "Proposed Regulations"), but with helpful changes to the application of the three-year holding period rule to capital gain allocated on a private equity sponsor's own capital and somewhat less helpful changes to the rules applicable to related party loans used to fund a sponsor's capital contributions.

While the Carried Interest Regulations will generally be effective starting in 2022 for existing partnerships, taxpayers may choose to apply them in their entirety before that time and, for new partnerships, the Carried Interest Regulations will take effect this year.

Partnership Interests Covered by Section 1061

Section 1061 applies to a partnership interest (an "applicable partnership interest" or "API") which is (directly or indirectly) transferred to (or held by) a taxpayer in connection with the performance of substantial services by the taxpayer (or a related person) in an "applicable trade or business." An applicable trade or business (referred to below as a "Fund Business") is generally defined in the Carried Interest Regulations as a trade or business that consists in whole or in part of (i) raising or returning capital and (ii) investing or developing "specified assets" (generally including securities, commodities, real estate held for rental or investment, and certain derivatives).

Exceptions to Section 1061

Section 1061, as interpreted by the Carried Interest Regulations, provides five exceptions to the definition of API:

- *Interests Held by Corporations (But Not S Corporations or Certain PFICs).* Section 1061 does not apply to a partnership interest that is held by a corporation. Consistent with prior IRS guidance, the Carried Interest Regulations provide that taxpayers do not avoid Section 1061 by holding an API through an S corporation. The Carried Interest Regulations similarly provide that an API held by a so-called "passive foreign investment company" (or "PFIC") is subject to Section 1061 if the taxpayer makes a so-called "qualified electing fund" election with respect to the PFIC.
- *Capital Interests (But Not Capital Interests Funded with Debt Incurred From or Guaranteed by Another Partner, the Partnership or Related Parties).* A partner that holds an API is generally not subject to Section 1061 with respect to the portion of his or her partnership interest that is a "capital interest" (the "Capital Interest Exception"). As discussed in greater detail below, an interest is eligible for the Capital Interest Exception if (i) the interest is a capital interest, and (ii) the partnership's allocations to the partner are commensurate with capital contributed by such partner and determined in a similar manner as allocations made to third-party investors who have made significant aggregate capital contributions. As discussed below, in response to a number of comments on the rigidity of the rule as originally introduced in the Proposed Regulations, the Carried Interest Regulations substantially relax the Capital Interest Exception. If a partner's capital interest is funded with debt that is incurred from or guaranteed by another partner, the partnership or related parties, the Carried Interest Regulations generally provide that the Capital Interest

Exception does not apply, unless the debt is fully recourse to the individual partner and satisfies certain other criteria discussed below.

- *Interests Held by Employees of Non-Fund-Businesses.* Section 1061 does not apply to a partnership interest held by a person who is employed by another entity that is conducting a trade or business that is not a Fund Business, and provides services only to such other entity. In this regard, Treasury declined to provide an example analyzing how Section 1061 applies in the case of a taxpayer holding a profits interest in a partnership the sole asset of which is stock of a portfolio company (i.e., a so-called “top hat” arrangement).
- *Bona Fide Unrelated Purchasers*. The Carried Interest Regulations provide that Section 1061 does not apply to an API acquired in a taxable purchase for its fair market value if the purchaser has not been, is not and does not anticipate becoming a service provider to (or for the benefit of) a relevant Fund Business and is not related to a person who provides services or has provided services to the relevant Fund Business in the past.
- *Gain Not Attributable to Third-Party Investors.* The Carried Interest Regulations reserve on the application of Section 1061(b), which provides regulatory authority to establish an exception for gain attributable to any assets not held for portfolio investment on behalf of third-party investors. The preamble to the Carried Interest Regulations states that the IRS is still considering how the three-year holding period rule applies to gain from the sale of an interest in a management company.

Application of the Three-Year Holding Period to Income from Investments

The Carried Interest Regulations clarify the application of the three-year holding period requirement in several respects:

- *Which Holding Period?* The relevant holding period for purposes of determining whether gain from the sale of an asset is “more-than-three-year gain” or “three-year-or-less gain” is generally the holding period of the person that sells the underlying asset. For example, if a fund sells an investment that it has held for more than three years, the gain from the sale will satisfy the three-year holding period requirement under Section 1061 for all taxpayers allocated a portion of the gain from the sale, including a taxpayer who was admitted to the general partner (the “GP”) of the fund (and received a share of the carry on a go-forward basis) within three years of the sale of the asset.
- *Excluded Gains.* The Carried Interest Regulations confirm that Section 1061 does not apply to qualified dividend income, long-term capital gain determined under Section 1231 (which generally treats net gains from the sale of property used in a trade or business as long-term capital gains), mark-to-market gains from “Section 1256 contracts” (generally applying to certain futures and options contracts) and any other capital gain that is characterized as long-term or short-term without regard to the holding period rules in Section 1222.
- *Netting at Individual Owner Level.* The Carried Interest Regulations clarify that if a taxpayer owns one or more APIs, either directly or through tiers of partnerships or other pass-through entities, the calculations required under Section 1061 are made at the individual owner level, rather than at the entity level.
- *Distributions in Kind.* The Carried Interest Regulations provide that, if a partnership distributes property in kind to an API holder, gain from the sale of the distributed property is subject to Section 1061 unless the property has been held on a cumulative basis for more than three years. As a consequence, an API holder cannot avoid Section 1061 by causing a fund to distribute an investment in kind in lieu of causing the fund to sell the investment if the fund’s holding period is three years or less. The Carried Interest Regulations also provide that any long-term capital gain from the disposition of property that, if sold by the partnership, would be excluded from Section

1061 (e.g., Section 1231 and 1256 gain, qualified dividend income and any other capital gain that is characterized as long-term or short-term without regard to the holding period rules in Section 1222), is not subject to Section 1061.

Capital Interest Exception

As discussed above, Section 1061 generally does not apply to gain derived by the taxpayer with respect to its capital interest in the partnership. Under the Carried Interest Regulations, an allocation of capital gain (or loss) is generally eligible for the Capital Interest Exception if the allocation is (i) with respect to a capital interest and (ii) determined and calculated in a similar manner to the allocations with respect to similarly situated unrelated non-service partners who have made significant aggregate capital contributions to the partnership (defined to be at least 5% of the total capital contributed at the time of the allocation) (the “Third-Party Capital Requirement”). In determining whether allocations are made in a similar manner, the terms, priority, type and the level of risk, rate of return, and rights to cash or property distributions during the partnership’s operations and on liquidation are all taken into account. Moreover, the similar manner test may be applied on an investment-by-investment basis and on a class-by-class basis and generally applies to allocations made through tiered partnerships.

Subject to the points noted below, we expect that, in the typical private equity fund, the sponsor’s capital will qualify for the Capital Interest Exception.

The Carried Interest Regulations provide that the Capital Interest Exception is available only if the partnership’s books and records and the partnership agreement clearly segregate capital interest allocations from allocations with respect to APIs. Application of this requirement is not entirely clear, and some fund sponsors may seek amendments to their partnership agreements to confirm compliance.

The Carried Interest Regulations provide that allocations with respect to a sponsor’s capital will not fail to satisfy the Third-Party Capital Requirement solely because the sponsor does not pay management fees or a carried interest. Oddly, the Carried Interest Regulations include an example of a fund where the fund agreement provides that distributions are made: first to all partners pro rata to return capital, second to the GP in an amount equal to 20% of the profits of the fund, and finally to all partners pro rata in an amount equal to the remaining 80% of the profits of the fund. The example concludes on these facts that 80% of the profits on the GP’s capital is eligible for the Capital Interest Exception, but 20% of the profits on the GP’s own capital is not eligible for the Capital Interest Exception. Although the Carried Interest Regulations do not include an example where, as is typically the case, the fund agreement provides that a carried interest is not payable on the GP’s own capital, we believe that, when this is the case, 100% of the profits on the GP’s capital generally should be eligible for the Capital Interest Exception.

Some sponsors invest capital through a separate co-investment vehicle that invests in parallel with the fund rather than as a partner of the fund. Because these co-investment vehicles typically have no third-party capital, application of the Third-Party Capital Requirement to these vehicles is not entirely straightforward. The preamble to the Carried Interest Regulations states that Treasury and the IRS are continuing to study the application of the Capital Interest Exception to co-investment vehicles.

The Carried Interest Regulations further provide that, for purposes of the Capital Interest Exception, a sponsor’s capital interest includes “API Gains” allocated to the sponsor (that is, long-term capital gains and capital losses allocated in respect of an API) but no similar rule is provided for unrealized gains allocated to the sponsor. In the hedge fund context, this means that, to the extent the fund sponsor’s capital account is made up of items that are neither contributed capital nor treated as contributed capital under the Carried Interest Regulations (for example, items of unrealized gain), future allocations of long-term capital gain to the fund sponsor will not be eligible for the Capital Interest Exception even if those future allocations are made by reference to the sponsor’s capital account rather than pursuant to the incentive allocation. The Carried Interest Regulations do not expressly treat as part of the sponsor’s

contributed capital either (i) allocations of short-term gain and ordinary income in respect of an API and (ii) allocations that previously qualified for the Capital Interest Exception, although it is not clear that the omission of these items was intentional.

Borrowing Arrangements

Under the Carried Interest Regulations, allocations will generally not be eligible for the Capital Interest Exception to the extent that the allocation is attributable to the contribution of capital to a partnership that (directly or indirectly) results from (or is attributable to) any borrowing if the borrowing is from (or is guaranteed by) another partner, the partnership or a related party. However, this rule ceases to apply once the borrowing is repaid so long as the repayment was not funded with other borrowing.

Under a limited exception, capital funded through borrowing will be eligible for the Capital Interest Exception if (1) the loan is borrowed by an individual, (2) the loan is fully recourse to the individual, (3) the individual has no right to reimbursement from another person and (4) the loan is not guaranteed by another person. It is not entirely clear how the borrowing rules apply to allocations from a fund to the GP in respect of the GP's capital commitment if, for example, one partner of the GP (but not the other partners) borrows on a partially recourse basis to fund the partner's share of the GP's capital commitment to the fund.

The Carried Interest Regulations do not grandfather existing borrowing arrangements.

Sale of APIs

Sales to Third-Party Buyers

Under the Carried Interest Regulations, in the event of a sale of an API to a third-party buyer, the seller's holding period in the API for purposes of Section 1061 is generally the holding period of the API (rather than the holding period of the underlying partnership assets). Accordingly, a taxpayer who sells an API will be eligible for the favorable 20% federal income tax rate if the taxpayer's holding period in the API is more than three years but will not be eligible for this favorable rate if the taxpayer's holding period in the API is three years or less.

However, the Carried Interest Regulations provide an anti-avoidance rule under which gain otherwise meeting the three-year holding period requirement must be tested on a limited "look through" basis. Specifically, the look-through rule applies where, at the time of disposition of the API, (1) the API would have a holding period of three years or less if the holding period of such API were determined by excluding any period prior to the date that an unrelated non-service provider is legally obligated to contribute substantial money or property to the partnership to which the API relates or (2) a transaction or series of transactions has taken place with a principal purpose of avoiding the application of the three-year holding period requirement under Section 1061. An unrelated non-service provider is legally obligated to contribute substantial money or property to the partnership if the unrelated non-service provider is obligated to contribute value that is at least 5% of the partnership's total capital contributions *at the time of the API disposition*.

The preamble to the Carried Interest Regulations notes that this limited look-through rule is designed to prevent fund managers seeking to avoid the recharacterization of gain by forming partnerships that are inactive and without third-party capital for three years, thereby sidestepping Section 1061. However, application of the look-through rule may be difficult in the context of "open-ended" hedge funds which, unlike certain other types of private investment funds, typically accept new commitments throughout the life of the fund. Moreover, it is not entirely clear how the look-through rule applies in the case of partnerships that do not have (and were never expected to have) third-party capital. The Carried Interest Regulations provide that the look-through rule does not apply to the disposition of an API to the extent the gain recognized upon the disposition of the API is attributable to any asset not held for portfolio investment on behalf of third-party investors. As a result, the look-through rule would seem to have less impact upon the sale of an interest in a management company.

Short-Term Gain on Sales to Family Members or Colleagues

Section 1061(d) generally recharacterizes gain as short-term capital gain to a taxpayer who (directly or indirectly) transfers an API to (i) a family member (as determined under certain attribution rules), (ii) a

person who has performed services to the relevant Fund Business within the current calendar year or the preceding three calendar years, or (iii) a pass-through entity to the extent a person described above directly or indirectly owns an interest. The amount that is recharacterized as short-term capital gain is equal to the excess of (1) the net long-term capital gain from assets held for three years or less that would have been allocated to the transferor partner upon a hypothetical taxable liquidation of the partnership's assets, over (2) any amount already treated as short-term capital gain under Section 1061.

Unlike the Proposed Regulations, the Carried Interest Regulations do not interpret Section 1061(d) as requiring gain to be recognized on an applicable transfer even if the transfer was not otherwise taxable (e.g., gifts and certain transfers resulting from death). Instead, under the Carried Interest Regulations, Section 1061(d) applies only to transfers in which long-term capital gain is recognized.

Carried Interest Waivers and Deferrals

Many fund sponsors include provisions in their funds' partnership agreements that permit the GP to waive or defer capital gains from investments that do not meet the three-year holding period requirement, and receive "make-up" allocations of long-term capital gains from future profits derived by the fund (so-called "carried interest waivers"). If properly structured, these arrangements can have the effect of allocating gains that would otherwise be subject to the higher tax rate applicable to short-term capital gains under Section 1061 to the fund investors (who are not subject to Section 1061), and instead allocating more-than-three-year gains to the sponsor, who holds an API and is subject to Section 1061. The Carried Interest Regulations do not address carried interest waivers, but the preamble to the Proposed Regulations stated that such arrangements may be subject to challenge under other provisions of existing law.

Increased Compliance Burdens

Not surprisingly, given the complexity of the Section 1061 regime, the Carried Interest Regulations impose significant additional reporting requirements on partnerships that have issued APIs and other investment entities. While the Carried Interest Regulations roll back significant aspects of the reporting regime described in the Proposed Regulations, because the "owner taxpayers" must comply with Section 1061 on their individual returns, private investment funds will still be required to implement new systems to track more-than-three-year gains, three-year-or-less gains, "capital interest" gains and losses and other items. The failure to report these items will be subject to penalties.

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