IRS Proposes Carried Interest Regulations

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Last Friday, the IRS and Treasury proposed regulations (the "Carried Interest Regulations") on the taxation of carried interest under Section 1061 of the tax code. 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 in most respects with the manner in which most taxpayers have been applying Section 1061 since its enactment. However, while Section 1061 includes a statutory exception for capital gain attributable to a sponsor's own capital interest, the Carried Interest Regulations take a surprisingly narrow view on when this exception is available. Further, the Carried Interest Regulations include a variety of rules designed to prevent taxpayers from avoiding the application of Section 1061, including rules relating to distributions of property that has a holding period of three years or less and rules relating to the sale (directly or indirectly) of a partnership interest that is subject to Section 1061.

While the Carried Interest Regulations will generally be effective for taxable years beginning after the final regulations are published, taxpayers are permitted to rely on the Carried Interest Regulations before that time so long as they follow them in their entirety and in a consistent manner.

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 clarified 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,[1] the Carried Interest Regulations provide that taxpayers cannot 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

[1] Notice 2018-18, 2018-12 I.R.B. 443

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subject to Section 1061 with respect to the portion of his or her partnership interest that is a "capital interest." It is apparent from the Carried Interest Regulations that the IRS and Treasury were concerned that taxpayers would attempt to use this exception to disguise a profits interest as a capital interest. Accordingly, the Carried Interest Regulations apply the capital interest exception in a mechanical and narrow manner and, as a result, many capital interests may not qualify for the exception under the Carried Interest Regulations. Further, the Carried Interest Regulations exclude from a partner's share of capital any amounts borrowed from (or guaranteed by) another partner, the partnership or persons related to such other partner or the partnership.

- *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.
- *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. In the preamble to the Carried Interest Regulations, in response to comments that this exception is intended to apply to family offices, Treasury and the IRS stated that they believe that they had effectively implemented an exception for family offices under a different provision relating to direct investment allocations.

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 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) and mark-to-market gains from "Section 1256 contracts" (generally applying to certain futures and options contracts).
- *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.

Capital Interest Gains and Losses Not Subject to Section 1061

As discussed above, Section 1061 does not apply to gain derived by the taxpayer with respect to its capital interest in the partnership. The Carried Interest Regulations implement this exception through a complex set of computations to determine the taxpayer's "Capital Interest Gains and Losses," which are not subject to the three-year holding period requirement. Unfortunately, given the manner in which many private investment funds operate, the framework for determining this amount set forth in the Carried Interest Regulations may cause a significant amount of gain attributable to capital contributions[2] to be subject to the three-year holding period requirement.

Under the Carried Interest Regulations, an API holder's "Capital Interest Gains and Losses" are gains and losses attributable to "Capital Interest Allocations," or allocations of long-term capital gain and loss from the underlying partnership (or tiers of partnerships) meeting the following requirements:

- The allocations are made in the same manner to persons holding APIs and unrelated non-service partners (i.e., third party investors),
- The allocations are made to unrelated non-service partners with a significant aggregate capital account balance (at least 5% or more of the aggregate capital account balance of the partnership), and
- The partnership agreement and the partnership's books and records clearly segregate such Capital Interest Allocations from allocations with respect to APIs.

Allocations are considered to be made in the same manner if the allocations are based on the relative "book" capital accounts of the partners and 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 the same. However, there are many common situations where capital-based allocations will not meet the requirements set forth in the Carried Interest Regulations. For example:

- If a fund allocates profit and loss on an investment-by-investment basis (as is the case in many PE funds), capital-based allocations from a particular investment will be made in proportion to the partners' capital contributions for such investment but this often will not be in proportion to the partners' aggregate "book" capital accounts (which reflect all investments).
- Even where a fund makes allocations on a "whole fund" basis, it is not clear that the allocations will always be made in proportion to capital accounts, particularly where there are admissions and withdrawals of different partners at different times and/or the sponsor's capital account includes amounts that had previously been allocated in respect of carried interest.

The Carried Interest Regulations clarify that an allocation to an API holder will not fail to qualify solely because the allocation is subordinated to allocations made to unrelated non-service partners or it is not reduced by the cost of services provided by the API holder (e.g., management fees). However, the Carried Interest Regulations do not address the effect of other common differences between the capital interests of API holders and the capital interests of non-service partners, such as withdrawal rights and terms, liquidity terms, rights to tax distributions, special allocations of expenses other than management

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[2] As discussed above, under the Carried Interest Regulations, capital interests would not include interests attributable to capital contributions that were funded with amounts borrowed from or guaranteed by another partner, the partnership or related parties.

fees and the fact that API holders' capital allocations are not subject to carried interest or incentive allocations.

The Carried Interest Regulations also provide that unrealized gains in respect of an API cannot be converted into gains attributable to a "capital interest" through a recapitalization or contribution. However, although not entirely clear on this point, the Carried Interest Regulations appear to exclude from the scope of Section 1061 any allocations of gain that are attributable to appreciation of the fund's investments arising after such a recapitalization, so long as the gain is allocated in accordance with the rules for Capital Interest Allocations described above.

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 two situations where gain otherwise meeting the three-year holding period requirement must be tested by looking at a different holding period:

- *Lower-Tier API has Holding Period of Three Years or Less.* If (i) a taxpayer sells at a gain an interest in an upper-tier partnership (e.g. the GP of a PE fund) that holds an API in a lower-tier partnership (e.g, the 20% carried interest in the PE fund), (ii) the taxpayer has a more-than-three-year holding period in the upper-tier partnership, and (iii) the upper-tier partnership has a holding period of three years or less in the lower-tier partnership, then the holding period of the lower-tier partnership controls for purposes of determining whether the partner's gain attributable to the lower-tier partnership interest is long-term or short-term under Section 1061. This rule could apply, for example, to the sale of an interest in the GP of a PE fund that holds a carried interest in the fund, an "alternative investment vehicle," or a "splitter" partnership.
- *80% or More of Underlying Assets have Holding Period of Three Years or Less.* A special "look-through" rule applies to recharacterize long-term gain as short-term gain if 80% or more of the underlying partnership assets have a holding period of three years or less.

Acceleration of Short-Term Gain in Sales to Family Members or Colleagues

Section 1061(d) generally triggers 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 of 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 liquidation of the partnership, over (2) any amount treated as short-term capital gain under Section 1061. The Carried Interest Regulations would require gain to be recognized on such a transfer even if the transaction is not otherwise taxable, but clarify that this special rule does not apply upon a contribution of the API to another partnership.

Carried Interest Waivers and Deferrals

Many fund sponsors include provisions in their funds' partnership agreements that permit the general partner 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. Although the Carried Interest Regulations do not address carried interest waivers, the preamble to the Carried Interest Regulations states 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. Because the "owner taxpayers" must comply with Section 1061 on their individual returns, private investment funds will 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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