

What do the Proposed Carried Interest Regulations Mean for You?

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On July 31, 2020, the Internal Revenue Service (IRS) released proposed regulations (the Proposed Regulations) relating to the scope and applicability of Internal Revenue Code Section 1061. This alert will provide an overview of the Proposed Regulations and how they may affect hedge, private equity and other investment funds.

Background

A carried interest (also referred to as a profits interest, a performance allocation or a promote) is a partnership interest that is generally received for services to a partnership that allows the holder to share in future profits with no (or minimal) required capital contribution. As a general rule, carried interest recipients are not required to treat the receipt of the carried interest as a taxable income event upon grant and instead are taxed upon receipt of a distributive share of future profits (including long-term capital gains) of the partnership.

In December 2017, the Tax Cuts and Jobs Act (TCJA) was signed into law and included new Section 1061 with the intention of limiting the perceived tax benefits associated with carried interests received by investment fund managers. Under Section 1061, gains attributable to an applicable partnership interest (API) are recharacterized as short-term capital gains unless the holding period of the assets giving rise to the gains is at least three years. If the three-year holding period is met, the gains are taxed as long-term capital gains.

An API is a partnership interest that is held by, or transferred to, a taxpayer in connection with the performance of substantial services in any applicable trade or business (ATB) of the partnership that issued the partnership interest. An ATB generally includes any activity conducted on a regular, consistent and substantial basis that consists, in whole or in part, of: (i) raising or returning capital, and (ii) either investing in or developing securities, commodities, real estate, cash or cash

equivalents, options or derivatives with respect to any of the foregoing; that is, any investment fund activities.

Section 1061 carved out two exceptions from the definition of an API:

(1) Corporate Exception - for partnership interests held directly or indirectly by a corporation and

(2) Capital Interest Exception - does not include a partnership interest that provides a right to share in partnership capital commensurate with the amount of capital contributed by the partner.

Both the Corporation Exception and the Capital Interest Exception are discussed further below.

Although the goal of Section 1061 was relatively straightforward, there is significant ambiguity in the statutory language. The Proposed Regulations generally clarify and elaborate on the applicability and operation of Section 1061 while also focusing on transactions that taxpayers may have considered to avoid its application.

Gains Excluded from Section 1061

The Proposed Regulations provide clarity on certain types of income such as Section 1231 gains, Section 1256 gains and qualified dividend income stating that these items are not subject to recharacterization under Section 1061 since they do not rely on the greater than one year holding period for capital gains under Section 1222.

Section 1231 property includes real and depreciable property used in a trade or business and held over one year.

Section 1256 contracts, such as regulated futures contracts, foreign currency contracts and non-equity options, that are held at the end of a tax year, are marked-to-market (treated for tax purposes as if they were sold at their fair market value), with any gain or loss treated as 60% long-term capital gain or loss and 40% short-term capital gain or loss, irrespective of how long the contract has been held.

Qualified dividend income includes dividends from U.S. corporations and certain

foreign corporations with respect to shares that meet certain holding period requirements.

Anchin Observation: This is welcome news for private investment funds that invest in commodities or other financial instruments subject to Section 1256, that have significant qualified dividend income or that generate Section 1231 gains on property used in a trade or business.

In addition, installment sale gains may be subject to Section 1061, even when the sale took place prior to Section 1061's effective date (January 1, 2018).

Under the Proposed Regulations, to the extent a fund receives capital gain dividends from a regulated investment company (RIC) or real estate investment trust (REIT), such capital gains dividends will not be subject to recharacterization under Section 1061 if they are attributable to capital assets of the RIC or REIT that have been held for more than three years or to assets not subject to Section 1061.

Anchin Observation: RICs and REITs may, but are currently not required to, designate the portion of the capital gain dividend that is from three-year property. If, however, the RIC or REIT does not provide this information, the entire amount of the capital gain dividend is presumed to be from one-year property. Funds that invest in RICs or REITs should consider contractually obligating them to provide the relevant Section 1061 information.

Corporate Exception

Since Section 1061 explicitly excludes carried interests held by corporations, advisors quickly noted the possibility that a carried interest held by an S corporation might be outside the scope of Section 1061. Responding to the chatter, the IRS quickly issued Notice 2018-18 (Notice) a few months after the TCJA became law and indicated that they would issue regulations that explicitly limit this Corporate Exception to C corporations. The Notice also indicated that the regulations would be effective for taxable years beginning after December 31, 2017 (the effective date of Section 1061 under the TCJA).

The Proposed Regulations are consistent with the Notice and provide that

partnership interests held by S corporations are treated as APIs if the interest meets the API definition. Also, consistent with the Notice, this rule is effective as of the effective date of Section 1061.

The Proposed Regulations also state that Passive Foreign Investment Companies (PFICs), where the shareholder has made a Qualified Electing Fund (QEF) election, are **not** corporations for purposes of the Corporate Exception under Section 1061. A QEF election generally allows the income (and loss) of the PFIC to pass through to the electing shareholder. This rule is effective for taxable years beginning after the date of publication of the Proposed Regulations in the Federal Register.

Anchin Observations: The industry continues to question and debate whether the IRS has the authority to interpret “corporation” to exclude S corporations and PFICs or whether Section 1061 would need to be amended.

Certain investment funds, such as credit funds or other funds that generate significant ordinary income, may hold their carried interests in C corporations. Such interests would not be treated as APIs under Section 1061.

Capital Interest Exception

The exception was somewhat unclear when addressing a general partner interest and whether that interest could be bifurcated as an API with respect to the carried interest allocation and eligible under the contributed capital exception for capital contributed by the general partner to the partnership. This uncertainty has serious ramifications for general partners that reinvested their carried interest allocation in their funds through their general partner entities.

Rather than clarify or define what a capital interest means under Section 1061, the Proposed Regulations include criteria that must be met for an interest to be treated as a capital interest rather than an API. These requirements include the following:

1. Allocations must be based on the partners’ respective capital account balances and made in the same manner to all partners, subject to preferred returns and cost allocation differences (e.g. management fee breaks) and
2. There must be at least one unrelated non-service partner (i.e. third-party

investor) with a “significant” aggregate capital account balance. Significant for this purpose is defined as 5% or more of the aggregate capital account balance of the partnership.

3. The partnership agreement and the partnership’s books and records must clearly segregate capital interest allocations from allocations with respect to APIs.

Anchin Observations: The Proposed Regulations are not explicit on whether allocations based on respective capital account balances also means that a general partner’s share of later year profits earned on prior year allocations of carried interest to the general partner’s capital account could be treated as a capital interest allocation. This was one of the most challenging questions for, in particular, hedge fund managers that reinvest their carried interest allocations in the fund.

The Proposed Regulations, however, provide that an interest will not fail to qualify for the Capital Interest Exception solely because the allocations in respect of such interest are not reduced by the cost of services provided by the API holder or a related person. Therefore, the fact that the service provider may not be charged a management fee in respect of their partnership interest should not cause the interest to fail to qualify as a capital interest.

The Proposed Regulations do not require capital accounts to be maintained under the Section 704(b) regulations – which are generally applied for such partnership allocations – but appear to state that it is enough for partnerships to maintain capital accounts using principals similar to those regulations. The preamble to the Proposed Regulations requests comments on other allocation arrangements, which seems to indicate the IRS’s recognition that certain investment funds (e.g., private equity funds) follow a distribution/waterfall driven model while most hedge funds follow a realized and unrealized gains and losses aggregation or layering model, none of which are included under the Section 704(b) regulations.

The Proposed Regulations add complexity and greatly expand the requirements under the Section 1061 statute. The IRS appears to acknowledge this and has requested additional comments about whether a more simplified regime would be more appropriate for smaller investment funds.

Carried Interest Waivers

The preamble to the Proposed Regulations notes that the Treasury Department and the IRS are aware of, and may challenge, carried interest waiver arrangements where an API holder may seek to allocate themselves gains generated from capital assets held for more than three years in lieu of capital gains held for less than three years, by waiving the rights to be allocated the shorter period capital gains. While the Proposed Regulations do not include specific provisions regarding these sorts of arrangements, they do acknowledge that the IRS is aware of carried interest waivers and may challenge them on audit under existing anti-abuse rules and previously proposed, but not finalized, regulations regarding management fee waivers.

Anchin Observation: There are several versions of carried interest waivers in the marketplace and the warning in the preamble to the Proposed Regulations, while pertinent, doesn't do much to stop that practice.

Once an API, Always an API

The Proposed Regulations clarify and emphasize that once a partnership interest qualifies as an API, it remains an API, regardless of transfers, gifts or other dispositions, unless and until an API exception applies. A partnership interest will continue to be an API even after the substantial service provider retires or stops providing services, the partnership no longer meets the ATB test (discussed earlier) or the API is contributed to another pass through entity or trust or is held by an estate.

A new exception in the Proposed Regulations allows for interests to be treated as non-API interests in the hands of a bona fide third-party purchaser. Specifically, if a third-party purchaser (1) acquires what was an API in a taxable transaction at fair market value, (2) has not, does not, and does not anticipate providing services to the partnership or any related entities, and is not related to anyone who provides such services and (3) Section 1061(d) does not apply, then the interest will not be an API in the hands of the third-party buyer.

Section 1061(d) provides a special rule for taxpayers who transfer (in a non-taxable

event) an API directly or indirectly to certain members of their family or to a person who in the current year, or the prior three years, performed services in any ATB in which or for which the taxpayer performed a service. In addition, the Proposed Regulations indicate that a related person or family member will include a pass through entity in which an interest is held by those individuals. Such a taxpayer will include short-term capital gain equal to the excess of the net built-in long-term capital gain in assets held for three years or less attributable to the transferred interest over the amount of long-term capital gain recognized on the transfer that is treated as short-term capital gain under the Section 1061(a) recharacterization rules.

Anchin Observations: Understandably, there has been significant uncertainty regarding this provision with concern that this provision would trigger gain for transfers that would normally be non-recognition events (e.g. gifts). The Proposed Regulations confirm that this provision will apply to treat a transfer of an API in an otherwise nontaxable transaction as a gain recognition event. The thought here is that this will generate some significant commentary and will most likely be modified prior to these Proposed Regulations being issued as final. If not changed, this trap for the unwary may adversely impact carried interest gift planning and may require additional and careful structuring to avoid its reach.

In the normal course of business, many managers move a portion or all of their general partner capital to new or existing limited partner accounts in their respective funds. In light of the broad interpretation of Section 1061(d) discussed above, which could result in gain upon certain transfers to related parties, managers should revisit their strategy to ensure that this does not unintentionally trigger gain.

A transfer of an API to a partnership that qualifies as a nontaxable event (under Section 721) will generally not require current gain recognition under Section 1061(d) because the Section 704(c) rules would allocate such built-in gains existing at the time of the transfer. However, the Proposed Regulations do not clearly address the tax treatment of the additional appreciation to an API after it is contributed to another partnership. The hope is that this will be addressed before these Proposed Regulations are issued as final.

Transition Rules

The Proposed Regulations also include some provisions that are meant to simplify the application of Section 1061 to certain partnerships that were in existence on January 1, 2018. Such partnerships, with a mix of contributed capital, carried interest and reinvested carry prior to the enactment of Section 1061 (January 1, 2018), can irrevocably elect to treat all long-term capital gains and losses from the sale of assets held by the partnership for more than three years as of December 31, 2017 as not subject to Section 1061. However, the amount excluded is capped for each partner at what they would have been allocated with respect to their partnership interest under the partnership agreement in effect on March 15, 2018 and with respect to the calendar year ending December 31, 2017.

Holding Periods - Lookthrough Rule - Distributions of Property to API Holders

The Proposed Regulations generally provide that the holding period of the owner of the asset sold is the applicable holding period. Accordingly, if a partnership disposes of an asset, the partnership's holding period controls. For example, if an investment partnership sells a security that it has held for more than three years, the gain from that sale will satisfy the three-year holding period requirement under Section 1061 for all API holders allocated a portion of the gain from the sale, including an API holder who has held an interest in the general partner of the investment partnership for less than three years. Conversely, if the API holder has held its interest for more than three years, but the investment partnership has held an asset for less than three years, Section 1061 can apply to the distributive share of the gain allocated to the API holder if and when the investment partnership sells that asset.

Anchin Observations: The taxpayer's holding period in the API is relevant only if the API is the asset being sold.

Under the Proposed Regulations, a profits interest issued by a fund to an employee of another entity will not be subject to Section 1061 if the other entity does not conduct an investment business, either on its own or together with related persons, and the employee provides services only to the other entity. Accordingly, it appears that the grant by a private equity fund of a carried interest in the fund to an

employee of a portfolio company that it owns and that is engaged in an operating business should not be subject to Section 1061.

The Proposed Regulations include a rule that, in substance, basically requires a selling partner to look to the partnership's holding period in its assets (the Lookthrough Rule) rather than at the partner's holding period in the partnership interest for purposes of applying Section 1061. The Lookthrough Rule does not apply to the related party transfers under Section 1061(d) described above.

Under the Lookthrough Rule, there are two situations in which some or all of the capital gain is subject to recharacterization under Section 1061(a):

- ***Substantially All Test (or 80% Test).*** Applies to the direct sale of an API if the API holder held the API for more than three years, recognized capital gain, and 80% or more of the underlying assets of the partnership are assets that would produce capital gain or loss if sold by the partnership and have a holding period to the partnership of three years or less. In this situation, a portion of the API holder's capital gain will be subject to recharacterization from long-term to short-term capital gain. For example, if the API holder (where API has been held for more than three years) sells the interest in the API at a time when 85% of the partnership's assets have been held for less than three years, then the Lookthrough Rule will apply and 85% of the API holder's gain will be recharacterized as short-term capital gain.
- ***Sale of Interest in Tiered Partnerships.*** If the taxpayer holds the API through other affiliated or intermediate entities (e.g. an S corporation or other LLC), and if any of those entities have a holding period in the API of three years or less, then all of the capital gain will be recharacterized from long-term to short-term. For example, if an API holder in the upper-tier partnership has held the API for over three years, but the upper-tier partnership was issued a carried interest in an underlying partnership within the last three years, then a sale of the API by the holder will be recharacterized under Section 1061.

Anchin Observation: Given the holding period rules laid out in the Proposed Regulations, API holders disposing of a partnership interest should analyze whether

it is more tax efficient for the partnership to sell its assets or for the API holder to sell their partnership interest.

The Proposed Regulations also confirm that it is not possible to avoid Section 1061 by distributing partnership property to the API holder. The property distributed by a partnership to an API holder retains its character as “Distributed API Property” with any gain on its disposition included in the recharacterization under Section 1061(a). The Proposed Regulations do not change the default rule which provides that a partner takes on the carryover or tacked-on holding period in the asset distributed by the partnership.

For example, if a fund is considering disposing of a stock that has been held for less than three years, the fund may distribute the API holders’ pro rata portion of the stock directly to the API holder rather than selling it. The API holder would then need to hold the stock until the three-year holding period is met to avoid recharacterization under Section 1061. On the other hand, if the API holder sells the shares before attaining the requisite three-year holding period, then the gain will be recharacterized as short-term capital gain under Section 1061.

Anchin Observation: The distributed property rule is only relevant if the partnership distributes to the API holder a capital asset that it held for less than three years. The Proposed Regulations also do not prohibit the API holder from keeping and aging the Distributed API Property so as to attain the required three-year holding period and therefore avoid Section 1061 recharacterization.

Reporting Changes

The Proposed Regulations create additional reporting requirements with more detailed information to be reported and attached to all partner Schedules K-1, including:

- Each partner’s share of (i) long-term capital gains and long-term capital losses from assets held more than one year and (ii) long-term capital gains and long-term capital losses for assets held for more than three years
- Long-term capital gains and long term capital losses allocated to the API holder that are excluded from Section 1061, such as from Section 1256 and

Section 1231 transactions.

- Long-term capital gains and long-term capital losses allocated to the API holder qualifying for the Capital Interest Exception
- API Holder Transition Amounts – allocations to the API holder of long-term capital gain or long-term-capital loss recognized on the disposition of assets held by the partnership for more than three years as of January 1, 2018 (if the partnership has elected to treat these amounts as API Holder Transition Amounts).

Anchin Observation: The Proposed Regulations have implications for investment funds, fund managers and the general partners of such funds. Along with the applicability of penalties for failing to timely comply and the additional administrative requirements, the quest for information will be substantially more challenging and costly. Without such information, the partners will not have adequate information to treat capital gain as gain from three-year property and, under the Proposed Regulations, amounts from three-year property will be presumed to be zero.

Effective Date

With limited exceptions, the Proposed Regulations will be effective on or after the date the final regulations are published in the Federal Register. Taxpayers may rely on the Proposed Regulations for taxable years beginning before the date final regulations are published provided they follow the Proposed Regulations in their entirety and in a consistent manner.

Please contact [E. George Teixeira](#) or any member of Anchin's Financial Services Practice at your earliest convenience if you have any questions or would like more information. We stand ready to help you plan effectively and to navigate through these new rules and reporting requirements. In the meantime, we will continue to update you as more information becomes available.