

IRS Issues Final Carried Interest Regulations

Alert

01.26.2021

The tax treatment of carried interests was changed with the enactment of Section 1061 of the Internal Revenue Code as part of the 2017 Tax Cuts and Jobs Act. After issuing proposed regulations last summer, the Internal Revenue Service (IRS) and the Department of the Treasury issued final regulations under Section 1061 on January 7, 2021. For a description of the proposed regulations, see [IRS Releases Carried Interest Proposed Regulations](#).

While a one-year holding period is generally required for long-term capital gains, Section 1061 generally imposes a three-year holding period requirement in order to receive long-term capital gain treatment for gains allocated (or otherwise recognized) with respect to an “applicable partnership interest” (API). An API is defined as any interest in a partnership that, directly or indirectly, is transferred to (or is 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” is generally a trade or business that consists, in whole or in part, of raising or returning capital, and either investing in (or disposing of) certain investment assets—such as securities, commodities and real estate. Section 1061 provides for several exclusions from the definition of an API, including for capital interests in partnerships that are commensurate with contributed capital (Capital Interest Exception) and for partnership interests that are held by corporations (Corporate Holder Exception).

Thus, an API generally includes a carried interest held by the sponsor (or manager) of an investment fund (such as a private equity fund or hedge fund) that entitles the sponsor (or manager) to a share of the fund’s future profits. An API would also include a partnership interest in a carry vehicle or a general partner entity issued to individuals in exchange for their performance of investment management services.

While the final regulations largely follow the approach taken by the proposed regulations, the final regulations include several important changes.

IRS Issues Final Carried Interest Regulations

- The final regulations change how a capital interest is defined for purposes of the Capital Interest Exception. Whereas the proposed regulations provided that the Capital Interest Exception only applied to the extent gain was allocated in proportion to the relative value of the holder's capital account balance (as determined under Section 704(b)), the final regulations look to whether allocations are made in a manner commensurate with allocations to other significant partners with respect to their capital contributions. The final regulations also provide that typical differences between a general partner's capital interest and a fund investor's capital interest (such as a general partner's right to tax distributions and the general partner not being subject to certain expenses, such as charges for management fees) will not cause a general partner's capital interest to fail to qualify for the Capital Interest Exception.
- The final regulations loosen restrictions in the proposed regulations that applied to capital interests acquired with loan proceeds. Under the proposed regulations, capital interests financed by loans from the partnership, another partner or related person could not qualify for the Capital Interest Exception—thereby severely restricting the ability of individual members of the general partner from borrowing in order to fund a capital interest. The final regulations allow a capital interest that is financed with a loan from a partner or related person (but not the partnership) to qualify for the Capital Interest Exception if (1) the loan is fully recourse to the individual service provider, (2) the service provider has no right to reimbursement from another person and (3) the loan is not guaranteed by another person.
- The final regulations limit the application of the look-through rule that can recharacterize long-term capital gain recognized in a taxable disposition of an API (such as an interest in the general partner) that is held for more than three years as short-term gain by looking through to the underlying assets. Whereas the proposed regulations used a mechanical "substantially all" test in applying the look-through rule, the final regulations limit the look-through rule to situations involving a sale of an API held for more than three years if, at the time of the sale (1) the three-year holding period requirement would not be satisfied if the holding period of such API were determined by disregarding the period prior to the date on which unrelated investors are obligated to fund their capital commitments or (2) there is a principal purpose of avoiding recharacterization under Section 1061.
- The final regulations limit the acceleration of gain on certain transfers of APIs to related persons. Under the proposed regulations, recognition of gain was accelerated upon all transfers of an API, even non-taxable transfers. The final regulations narrow the application of the acceleration rule so that it generally only applies to a taxable transfer of an API.
- The final regulations also did not specifically address how the IRS will treat carried interest deferral or waiver arrangements. The proposed regulations did not prohibit carry waivers under Section 1061, but the preamble to the proposed regulations warned that the IRS could challenge them under other provisions of the code or under general tax principles.

IRS Issues Final Carried Interest Regulations

The final regulations also maintained many features of the proposed regulations.

- The final regulations confirmed that the three-year holding period under Section 1061 applies only to gains that are characterized as either long-term or short-term under Section 1222 and do not apply to gain determined under Sections 1231 and 1256.
- The final regulations also retain (with only minor modification) the additional reporting requirements on taxpayers who directly or indirectly hold APIs, as well as partnerships that issue APIs, that were imposed by the proposed regulations. Failure to adhere to these reporting requirements can result in penalties and recharacterization of gain recognized with respect to an API.
- The final regulations also continue to require that capital interest allocations be clearly identified under the partnership agreement and in the partnership's books and records (reflected contemporaneously) as separate and apart from allocations made to holders of APIs.
- The final regulations, consistent with the proposed regulations, provide that partnership interests held by subchapter S corporations or PFICs with QEF elections do not qualify under the Corporate Holder Exception.

The final regulations were published in the Federal Register on January 19, 2021, and are generally applicable to tax years beginning on or after that date. Thus, the final regulations will apply immediately to new funds formed thereafter. For already existing funds, the final regulations generally will therefore not apply until 2022, but existing funds, however, can choose to apply the final regulations in their entirety to a tax year beginning after December 31, 2017, so long as they are applied consistently and entirely to such year and all subsequent years. Fund sponsors will want to make sure that their funds' partnership agreements (as well as the partnership agreements for carry vehicles and general partner entities) satisfy the requirements of the final regulations—particularly with respect to the Capital Interest Exception.

In an apparent attempt to avoid the freeze on new regulations by the Biden Administration, the Treasury Department and the IRS determined that, for purposes of the Congressional Review Act, the 60-day delay in the effective date of the final regulations was impracticable, unnecessary and contrary to the public interest.

RELATED CAPABILITIES

Corporate Finance

Private Business

Tax, Trusts & Estates

STINSON

STINSON LLP \ STINSON.COM