IRS Releases Carried Interest Proposed Regulations

Alert
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On July 31, the IRS issued proposed regulations under Section 1061 of the Internal Revenue Code further clarifying the tax treatment of carried interest and other "applicable partnership interests" (APIs). Congress added Section 1061 in 2017 establishing that certain carried interest arrangements could be taxed at the 20% preferential capital gains rate if a three-year holding period with respect to underlying assets sold is met, despite the fact that that these profits interests were granted as compensation for services, which would normally be taxed as ordinary income.

Section 1061 governs the treatment of APIs held by, or transferred to, a taxpayer, directly or indirectly, in connection with the performance of substantial services by the taxpayer, or by any other related person, in any applicable trade or business (ATB). An API is an interest in a partnership's profits that is transferred or held in connection with the performance of services and may be held through one or more pass-through entities. An ATB is one conducted on a regular, continuous and substantial basis whose activities consist of (i) raising or returning capital, and (ii) either investing in or developing specified types of assets (securities, commodities, real estate, cash or cash equivalents, partnership interests to the extent such assets are held by the partnership, and options or derivative contracts with respect to such assets).

There are exceptions from classification as API under Section 1061. These exceptions include:

- Any interest in a partnership directly or indirectly held by a corporation
- Certain capital interests
- An API that is acquired by a bona fide purchaser who (i) does not provide services, (ii) is unrelated to any service provider, and (iii) acquired the interest for fair market value
- Certain partnership interests held by employees of entities that are not engaged in an ATB
- Gain attributable to any assets not held for portfolio investment on behalf of third party investors (this potential exception is reserved for regulatory authority and remains reserved under the proposed

regulations)

The proposed regulations address, among other things, these first three exceptions. This alert covers the following topics addressed in the proposed regulations:

- Types of partnership interests and businesses subject to Section 1061
- Computation of the amounts that may be recharacterized as short-term capital gain, subject to tax at ordinary income rates, if Section 1061 applies
- Transfers of APIs to related persons
- Reporting requirements

TYPES OF PARTNERSHIP INTERESTS AND BUSINESSES SUBJECT TO SECTION 1061

The proposed regulations in part broaden the definition of API and in part limit the exceptions from API status.

1. Pass-through entity: The proposed regulations define a pass-through entity for purposes of holding an API interest as a partnership, an S corporation, or a passive foreign investment company (PFIC) with respect to which the shareholder has a qualified electing fund election in effect. Pass-through entities are treated as the API holder under the proposed regulations. This means an API interest held by an S corporation, PFIC or other pass-through entity will not meet the "held by a corporation" exception and will be subject to Section 1061.

2. Performance of substantial service: Part of the API definition requires that the API be acquired in exchange for the performance of "substantial" services. The proposed regulations add the presumption that services are substantial with respect to the partnership interest transferred in connection with those services, essentially negating any separate test for substantiality. The proposed regulations base the presumption on the assumption that the parties have economically equated the services performed with the potential value of the partnership interest transferred.

3. Capital interests: The proposed regulations address the capital interest exception by excepting long-term capital gains and losses that represent a return on an API partner's invested capital in a pass-through entity from recharacterization under Section 1061. However, the proposed regulations exclude from the API partner's invested capital any amounts borrowed from (or guaranteed by) another partner, the partnership, or persons related to such other partner or the partnership. Under the proposed regulations a partner who disposes of an interest that is composed of a capital interest and an API has a mechanism to determine the portion of long-term capital gain or loss recognized on the disposition that is treated as a capital interest disposition amount, which is treated as a capital interest gain or loss.

4. ATB: Under Section 1061, for an interest in a partnership to be an API, the interest must be held or transferred in connection with the performance of services in an ATB. An ATB is defined as any activity conducted on a regular, continuous and substantial basis which consists, in whole or in part, of raising or returning capital, and either (i) investing in (or disposing of) specified assets (or identifying specified assets for such investing or disposition), or (ii) developing specified assets. The proposed regulations refer to these actions, respectively, as raising or returning capital actions and investing or developing actions (referred to as specified actions in the aggregate).

The proposed regulations provide that an activity is conducted on a regular, continuous and substantial basis if it meets the ATB Activity Test: the total level of activity meets the level of activity required to establish a trade or business for purposes of Code Section 162. In applying the ATB Activity Test, the proposed regulations provide that, in some cases, it is not necessary for both Raising or Returning Capital Actions and Investing or Developing Actions to occur in a single year for an ATB to exist in that year. Further, specified actions of related persons are aggregated together to determine if the ATB Activity Test is met.

5. **Bona fide purchaser:** The proposed regulations add an exception for an API that is acquired by a bona fide purchaser who (i) does not provide services, (ii) is unrelated to any service provider, and (iii) acquired the interest for fair market value.

COMPUTATION OF AMOUNT RECHARACTERIZED AS SHORT-TERM CAPITAL GAIN

1. **The general rule.** Once it is determined that an individual taxpayer (referred to in the proposed regulations as an owner taxpayer) holds an API (or APIs), then Section 1061 recharacterizes certain net long-term capital gain (LTCG) with respect to the owner taxpayer's APIs as short-term capital gain (STCG), thereby depriving the owner taxpayer of the favorable 20% LTCG tax rates with respect to the recharacterized amount. The recharacterized amount (referred to as the recharacterization amount in the proposed regulations) is calculated as follows for each tax year: The excess, if any, of the owner taxpayer's "One Year Gain Amount" over the owner taxpayer's "Three Year Gain Amount."

Very generally, the owner taxpayer's "One Year Gain Amount" is the amount of net long-term capital gain recognized by the owner taxpayer that (i) either (a) is recognized with respect to the disposition of an API ("disposition gain") or (b) is allocated to the API as a result of the disposition of an asset held by the underlying "fund" ("distributive share gain") and (ii) meets a one-year holding period requirement. Similarly, the owner taxpayer's "Three Year Gain Amount" is the amount of net long-term capital gain recognized by the owner taxpayer that (i) either (a) is "disposition gain" or (b) is "distributive share gain" and (ii) meets a three-year holding period requirement.

For example, if—with respect to a particular API—the owner taxpayer has $1,000,000 of LTCG that meets the one-year holding period requirement, but only $300,000 of such LTCG meets the three-year holding period requirement, then $700,000 of such LTCG is recharacterized as STCG. (As used in this summary, the term ″fund″ refers generally to the partnership--including its lower tier subsidiaries--in which the owner taxpayer holds an API.)

2. Specific applications under the Proposed Regulations.

A. Which holding period applies? Under the proposed regulations, a critical issue in determining the recharacterization amount is whether the owner taxpayer has met the one-year and three-year holding period requirements with respect to the disposition of an API (and with respect to the fund's disposition of an asset that causes gain to be allocated to the owner taxpayer's API). Subject to certain narrow exceptions discussed in the following paragraph, the relevant holding period is generally the holding period of the entity that sells the underlying asset. For example, if the fund sells an investment that it has held for more than three years, the gain from the sale (as allocated to the API) will meet the three-year holding period requirement, even if the owner taxpayer has held the API for less than three years.

Likewise, if the owner taxpayer sells an API that he/she has held for more than three years, the gain from the sale will meet the three-year holding period requirement, even if the underlying fund has held a substantial portion of its assets for less than three years.

> Planning Note: Depending on the relative lengths of (i) the holding period of the owner taxpayer's API and (ii) the holding period of the assets held by the fund, it may be possible to achieve a better tax result under the proposed regulations by selling the item (i.e., either the API or, alternatively, the fund assets) that has the longest holding period.

The general rule stated in the preceding paragraph, however, is subject to the following exceptions:

1. If (a) the owner taxpayer sells an interest in an upper-tier partnership that holds an API in a lower-tier partnership, (b) the owner taxpayer has a holding period of more than three years in the upper-tier partnership, and (c) the upper-tier partnership has a holding period of less than three years in the lower-tier partnership, then the shorter holding period of the lower-tier partnership controls for purposes of determining whether the owner taxpayer has met the three-year holding period requirement with respect to gain recognized by the owner taxpayer with respect to the sale of the interest in the upper-tier partnership.
2. Very generally, if the owner taxpayer sells an API that he/she has held for more than three years, but 80% or more (based on FMV) of the assets held by the underlying fund have a holding period of three years or less, the owner taxpayer will be treated as having failed the three-year holding period requirement with respect to a portion of the gain recognized by the owner taxpayer on the sale of the API.

B. Calculation of recharacterization amount is performed at the level of the owner taxpayer. The proposed regulations recognize and clarify that although the sale transaction (or transactions) giving rise to the ultimate allocation of LTCG to the owner taxpayer may occur at a level below the owner taxpayer (for example, through tiers of partnerships or other pass-through entities), the calculation of the recharacterization amount is always performed at the level of the owner taxpayer. This is true even though the character of the gain from the particular sale transaction (for example, characterization of the gain as capital gain), and the holding period for the particular sale transaction, may be determined at the level of the selling lower tier entity.

C. Certain items excluded from calculation of recharacterization amount. The proposed regulations confirm that the following items are excluded from the calculation of the owner taxpayer's recharacterization amount: qualified dividend income, long-term capital gain determined under Code Section 1231, and mark-to-market gains from Section 1256 contracts. This is true even if these items are allocated to the API held by the owner taxpayer and, as such, may be taxed at favorable long-term capital gain rates in the hands of the owner taxpayer.

> Planning Note: If (i) the holding period of the owner taxpayer's API is less than three years and (ii) the fund holds assets that—if sold—would qualify for long-term capital gain treatment under Section 1231, it may be possible to achieve a better tax result under a sale of assets by the fund, as opposed to a sale of the API by the owner taxpayer.

D. In kind distributions made with respect to an API. Ordinarily, if the owner taxpayer sells an asset other than an API, any gain recognized by the owner taxpayer as result of such sale would not be taken into in computing the Owner taxpayer's recharacterization amount. Under the proposed regulations, however, if (i) the owner taxpayer receives a distribution of property (from the fund) with respect to their API, (ii) the owner taxpayer subsequently sells the distributed property and (iii) the cumulative holding period of the fund and owner taxpayer with respect to the distributed property, at the time of the sale, is three years or less, then the gain recognized by the owner taxpayer with respect to such sale is included in computing the owner taxpayer's recharacterization amount.

E. Installment sale gain. If a fund with respect to which the owner taxpayer holds an API sells an asset on the installment basis, the holding period for this sale—for purposes of determining whether the owner taxpayer has met the one-year and three-year holding period requirements discussed above—is based on the holding period of the fund at the time of the sale. Thus, for example, if (i) the fund sells an asset (on the installment basis) in 2015 and has a two-year holding period at that time and (ii) the owner taxpayer receives an allocation of installment sale gain in 2020 with respect to their API in the fund, the gain allocated to the Owner taxpayer will be included in the calculation of the Owner taxpayer's recharacterization amount and will not be treated as having met the three-year holding period requirement (due to the fund's two-year holding period at the time of the sale). This is true even though the fund's sale

occurred before the enactment of Section 1061.

F. RIC and REIT capital gain dividends. The proposed regulations provide special rules with respect to capital gain dividends received from regulated investment companies (RICs) and real estate investment trusts (REITs). Specifically, if a fund receives a capital gain dividend from a RIC or a REIT, the RIC or REIT may provide the fund with statements referred to in the proposed regulations as "one year amounts disclosure" and "three year amounts disclosure" (relating to the capital gain dividends).

Very generally, the purpose of the such statements is to advise the fund which of the capital gain dividends meet only the one-year holding period requirement (one year amounts disclosure) and which of the capital gain dividends also meet the three-year holding period requirement (three year amounts disclosure). The owner taxpayer may then use the statements for purposes of computing their recharacterization amount. If the RIC or REIT pays capital gain dividends to the fund and does not provide both the one tear amounts disclosure and the three year amounts disclosure, the entire capital gain dividend received by the fund (and allocated to the owner taxpayer with respect to their API) generally must treated as having satisfied the one-year holding period requirement, but not the three-year holding period requirement.

G. Carried interest waivers. Since the enactment of Section 1061, fund sponsors have speculated as to whether it would be possible to avoid Section 1061 gain recharacterization (as described above) by waiving distributions, and related gain allocations, to the holder of an API, if such allocations would not meet the three-year holding period requirement (referred to as a carry waiver). Under this strategy, the waived amounts would be replaced by subsequent distributions and allocations to the owner taxpayer that would not be subject to Section 1061. The proposed regulations do not address carry waivers specifically, but the preamble warns that an attempt to use carry waivers to circumvent Section 1061 may be challenged on audit. Fund sponsors should perhaps pay heed to this warning.

SPECIAL ACCELERATION RULE FOR TRANSFERS TO RELATED PERSONS

Section 1061(d) requires the acceleration of the recognition of gain upon the transfer of an API to a "related person," regardless of whether the transfer is a taxable event. Under the proposed regulations, the transferor of the API is required to recognize STCG on the excess, if any, of (i) all of the LTCG from assets in which the partnership that granted the API had a holding period of three years or less that the transferor would have been allocated had the partnership sold all of its assets over (ii) the amount recharacterized as STCG under Section 1061(a).

Under the proposed regulations, a "transfer" is broadly defined for these purposes to include contributions, distributions, sales and exchanges, and gifts. A "related person" is defined for these purposes to include not only certain family members and colleagues (as well as former colleagues), but also pass-through entities to the extent a family member or colleague (or former colleague) directly or indirectly owns an interest. However, the proposed regulations contain an exception for contributions of APIs to partnerships

governed by Code Section 721(a). Under the proposed regulations, such a contribution to a partnership is not a transfer to a related person because the proposed regulations require that under the principles of Code Section 704(c) all unrealized API gains that would be directly or indirectly allocated to the API holder at the time of contribution be allocated to that API holder when they are recognized.

REPORTING OBLIGATIONS

The proposed regulations impose significant reporting obligations on partnerships that have issued APIs. A partnership that has issued an API is required to provide the API holder with additional information to enable the API holder to comply with Section 1061 and to determine the recharacterization mount. The proposed regulations contemplate that this information will generally be provided as an attachment to the Schedule K-1 furnished to the API holder for the taxable year. The partnership is also required to file this information with the IRS. To satisfy their reporting obligations, investment funds that have issued APIs will have to implement mechanisms to track gains attributable to assets held for more than three years, gains attributable to assets held less than three years and other items. The failure to properly report these items is subject to penalties.

The proposed regulations impose additional reporting obligations in the case of tiered partnership structures. A partnership that has issued an API and that holds an interest in a lower-tier partnership may need information from that lower-tier entity to meet its reporting obligations. The Proposed Regulations generally provide a mechanism by which an upper-tier partnership can request information from any lower-tier entities in which it owns an interest and require the lower-tier entities to respond to those requests. Notably, a partnership that itself has not issued an API may have to comply with these reporting obligations if it has a direct or indirect partner that is an upper-tier partnership that has issued an API.

APPLICABILITY

The proposed regulations generally apply for taxable years beginning on or after the date final regulations are published. However, taxpayers generally can rely upon the proposed regulations until publication of final regulations so long as they are applied consistently and in their entirety.

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