Carried Interests and Investment Management Fees: Certain Tax Reform Changes for Fund Managers

Related Attorneys

Victor J. Ferguson

John F. Furniss III

David A. Groenke

Dan L. Jaffe

Joseph B. Mann

Emily S. Pan

Michael G. Schwartz

Lauren N. Fromme

Mark E. Vannatta

Suzanne R. Galyardt

Karen M. Moore

Related Services

Trusts, Estates and Wealth Transfer

AUTHORED ARTICLE | 4.16.2018

The following article was featured in the April 2018 edition of *Legacy*, the Vorys newsletter focused on wealth planning.

—

Family office investment vehicles often are organized as limited partnerships or LLCs treated as partnerships for federal income tax purposes. Typically, the manager of such a partnership receives an interest in the partnership's profits (a carried interest) in connection with the management services, in addition to management fees paid by the partnership. The following discusses the tax treatment of such carried interests and management fees, as modified by the Tax Cuts and Jobs Act (the act).

Treatment of Carried Interests

A carried interest generally provides the holder with the benefit of capital gain treatment on a significant portion of the holder's income from the carried interest (resulting from either a sale of the partnership's assets, or a sale of the carried interest itself). Prior to the act, so long as such capital gain satisfied a 1-year holding period requirement, the gain would be taxed at favorable long-term capital gain rates. Although the act does not eliminate the ability of carried interests to generate long-term capital gain, beginning in 2018 the act does impose more stringent requirements in order to obtain long-term capital gain treatment.

The new requirements of the act generally apply to carried interests that are transferred to a holder in connection with services provided by the holder (or a related person) in the business of (i) raising and returning capital, or (ii) investment or development activities with respect to securities, commodities, real estate held for rental or investment, and cash or cash equivalents (including options or derivative contracts with respect to, and interests in partnerships relating to, any of these assets).

For carried interests subject to the new requirements, capital gain resulting from the sale of assets by the partnership will qualify as long-term capital gain *only if* the partnership has held the sold assets for more than *3 years* (rather than more than 1 year) as of the time of the sale. Where the asset has been held for 3 years or less, the capital gain will be treated as short-term capital gain and therefore taxed at ordinary income rates.

If a holder sells a carried interest that is subject to the new limitations, the 3-year holding period requirement generally is applied to the period that the holder has held the carried interest itself (as opposed to the period that the partnership has held the underlying assets). However, where the carried interest is transferred (directly or indirectly) to a related person, the transferor will recognize short-term capital gain on the portion of the gain for the taxable year attributable to the sale of any asset held by the partnership for not more than 3 years (to the extent not already recognized).

Potential Planning Opportunities for Carried Interests

If your family office uses carried interests, particular consideration to certain aspects of the new limitations may be warranted. First, as currently drafted, the new 3-year holding period requirement appears to apply only to capital gain resulting from the sale of non-business assets of a partnership, but not to capital gain resulting from the sale of property used in a trade or business (i.e. “Section 1231 gain”), such as certain rental real estate. It is not clear that the omission of “Section 1231 gain” from the new holding period requirement was deliberate, and it will not be surprising if the omission is addressed in a future technical corrections bill or other guidance.

Second, the new 3-year holding period requirement does not apply to carried interests held directly or indirectly by a “corporation.” Based upon this exception, many fund managers have transferred their carried interests to wholly-owned corporations treated as “S corporations.” However, on March 1 of this year, the Treasury Department issued a notice stating that despite the language of the enacted law, S corporations *are* subject to the new 3-year holding period requirements and announced that regulations to that effect will be issued soon, with retroactive effect. We expect that there would be legal challenges to such a regulation. This issue also could be addressed by a future technical corrections bill. It is unclear how this issue ultimately will be resolved.

The uncertainty surrounding these issues may present planning opportunities, though any such planning should be undertaken only with the assistance of qualified tax counsel, and with full appreciation of associated risks.

Deductibility of Management Fees

The act also suspends the deductibility of certain “investment expenses” formerly deductible as miscellaneous itemized expenses (subject to a 2% adjusted gross income floor). Thus, until 2026, a non-corporate partner is unable to deduct his or her share of management fees paid to a manager by a partnership. Vorys has assisted family offices with the development of an alternative management compensation structure that does not face these same restrictions. If your family office is facing these new restrictions, you should immediately contact qualified tax counsel to explore planning opportunities.