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Carried Interest – Proposed Regulations and the Impact on Private Equity

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Treasury and the IRS released proposed regulations (the Proposed Regulations) under Section 1061 of the Internal Revenue Code (the Code) on July 31, 2020, that require certain taxpayers to satisfy a three-year holding period, rather than a one-year holding period, to qualify for the preferential long-term capital gains rates with respect to "applicable partnership interests" (or API). These rules apply to taxpayers—typically general partners or managers of private equity funds—who receive, in exchange for services rendered, a carried interest (also known as a "profits interest"). The three-year holding period applies not only to gain on the sale of an API but also to gains realized by a partnership from the sale of a portfolio company or other capital asset held for three years or less and allocated to partners holding API, directly or indirectly, in the partnership.

INTRODUCTION

Enacted as part of the 2017 Tax Cuts and Jobs Act, Section 1061 recharacterizes as short-term capital gains certain gains that would otherwise be long-term capital gains if such gains are either (1) from the sale of an API held for three years or less, or (2) allocable to the holder of a an API from the sale of a partnership asset held for three years or less. Thus, when Section 1061 applies, gains attributable to certain carried interests from investments held for three years or less will be taxed as short-term capital gains at ordinary rates while gains attributable to investments held for more than three years will continue to be taxed at long-term capital gain rates. The language of Section 1061 as enacted left many unanswered questions, and the Proposed Regulations provide much needed guidance as to its applicability and operation.

WHAT IS AN API?

An API is an interest in an entity taxed as a partnership, including a profits interest, issued to a taxpayer in connection with the performance by the taxpayer of "substantial services" to the partnership engaged in an "applicable trade or business" (or ATB). Such an interest is an API whether the taxpayer holds the interest directly or indirectly through a pass-through entity. The Proposed Regulations presume the taxpayer's services are substantial based on the assumption that the parties have economically equated the services performed with the potential value of the partnership interest transferred.

An interest classified as an API when issued generally retains that classification (with the exceptions discussed below). For example, an API remains an API if the holder retires, if the API is contributed to or distributed from another partnership, or if the API is subject to a recapitalization or division.

An ATB is a regularly and actively conducted trade or business of (1) raising or returning capital and (2) either investing in (or disposing of) "specified assets" or developing "specified assets." The Proposed Regulations require that the total level of

activity (conducted in one or more related persons or entities, such as those of a management company or general partner) meet the level of activity required to establish a trade or business. Specified assets are defined generally as securities, commodities, real estate, cash and cash equivalents, any partnership interest (to the extent it holds any of the foregoing) and an option or derivative contract with respect to any of the foregoing.

Based on the foregoing, the carried interest in a private equity fund would commonly constitute an API.

WHOSE HOLDING PERIOD?

The holding period for purposes of determining whether Section 1061 converts long-term capital gain to short-term capital gain is generally that of the seller of the asset that generates the gain. Thus, on the sale by a private equity partnership of a portfolio company, the partnership's holding period in the portfolio company is the relevant holding period. For example, if a private equity partnership sells its investment in a portfolio company that it has held for two years, gain allocated to the holder of an API in the partnership will be characterized as short-term capital gain even if the holder has held the API for more than three years. On the other hand, if the API is sold, the Proposed Regulations look to the partner's holding period in the API (subject to the look-through rules discussed next).

The Proposed Regulations include look-through rules that recharacterize gain as short-term capital gain from the sale of an API even when the API sold otherwise meets the three-year holding period. For example, in the case of a sale of an API held for more than three years, if 80 percent or more of the fair market value of the assets of the partnership consist of capital assets with a holding period of three years or less (the Substantially All Test), the Proposed Regulations recharacterize a portion of the gain from the sale of the API as short term based on the gain with respect to the underlying assets. There is a similar look-through rule for the sale of an interest in a partnership that holds an API if the partnership meets the Substantially All Test. The Proposed Regulations also look through certain tiered partnership arrangements where an underlying API has been held for less than three years, even if the holder of a carried interest has a greater than three-year holding period in an upper-tier partnership. The look-through rules generally prevent taxpayers from avoiding recharacterization of gain under Section 1061 by setting up a partnership and holding interests in the partnership in advance of investing in underlying assets.

EXCLUDED GAIN

The Proposed Regulations provide that Section 1061 applies only to capital gains that would be treated as long-term capital gains with respect to a sale or exchange of capital assets (pursuant to Section 1222 of the Code). As a consequence, other items or long-term capital gains that are not dependent on Section 1222 are excluded from recharacterization under the Proposed Regulations. These include qualified dividend income, gain on property used in trade or business under Section 1231, and mark-to-market capital gains under Section 1256. Since many intangible gains come within Section 1231, including gain from acquired goodwill held for more than one year, the Proposed Regulations exclusion of Section 1231 capital gains will likely be advantageous for the carried interest in a private equity partnership.

DISTRIBUTIONS OF PROPERTY TO AN API HOLDER

If a partnership distributes property to an API holder, the API holder generally determines its holding period for the property by taking into account the partnership's holding period for the distributed property. For example, if a partnership distributes property that had been held by the partnership for two years to the holder of an API, the API holder takes that property with a two-year holding period for purposes of Section 1061, regardless of the API holder's holding period in its partnership interest. As a result, if the API holder were to immediately sell the property, the sale would generate short-

term capital gain under Section 1061. In contrast, if the API holder were to hold the distributed property for more than an additional year (for an aggregate holding period of more than three years), the sale of the property would generate long-term capital gain.

CARRIED INTEREST WAIVERS

In some cases, carried interest holders may waive allocations of short-term capital gain in exchange for a larger share of future gain. The Proposed Regulations do not address waivers of allocations of gains that would otherwise be treated as short-term capital gain under Section 1061. The preamble to the Proposed Regulations, however, makes clear such waivers must be carefully structured to avoid IRS challenge under existing law. In particular, it states that taxpayers should be aware that carried interest waivers may not be respected and may be challenged under pre-existing law, such as substance over form and economic substance doctrines.

EXCEPTIONS TO THE SCOPE OF SECTION 1061

1. Services Exclusively Provided to One Entity

   An API does not include an interest held by a person who is employed by another entity that is conducting a trade or business (other than an ATB) and who only provides services to that other entity. For example, this exception should apply to an employee of a portfolio company who receives a profits interest in the fund. This exception would not encompass an API issued to a fund management company since the fund engages in an ATB.

2. Corporations

   An API does not include any partnership interest held directly or indirectly "by a corporation." The wording of the statute left unclear whether this exception would apply to S corporations. The Proposed Regulations, however, specifically exclude S corporations from the definition of a corporation for this purpose, which is consistent with Notice 2018-18. The effective date for this particular rule is for tax years beginning after December 31, 2017.

   In addition, the Proposed Regulations provide that passive foreign investment companies (PFICs) with qualified electing fund (QEF) elections, which are treated as pass-through entities for federal income tax purposes, are not treated as corporations for purposes of Section 1061.

3. Capital Interests

   Section 1061 does not apply to gain attributable to a capital interest in a partnership. To qualify as a capital interest under the state, the interest must provide the taxpayer with a right to share in partnership capital "commensurate" with the amount of capital contributed or the value recognized as taxable income by the taxpayer upon receipt or vesting under Section 83.

   The Proposed Regulations apply a restrictive approach to the capital interest exception. In general, a partnership interest will be a capital interest for purposes of Section 1061 only if (1) allocations or profits and losses to such partnership interest are based on relative capital accounts and are made in the same manner to the API holder as they are to another significant (5 percent or more), unrelated, and non-service providing partner, and (2) the terms, priority, type and level of risk, rate of return, and rights to cash or property distributions of such partnership interest are the same during the partnership's operations and on liquidation. In addition, the capital interest allocations must be clearly identified in the partnership agreement and the partnership's books and records as separate and apart from the

non-capital interest allocations. Funds may need to amend their documents to comply with the Proposed Regulations once they are finalized.

Further, the capital interest exception does not apply to a partnership interest attributable to any loan or other advance made or guaranteed, directly or indirectly, by any other partner, the partnership or any of their related persons.

4. Unrelated Purchaser

The recharacterization rules in the Proposed Regulations do not apply to an unrelated purchaser who purchases an API in a bona fide sale and who has not provided, and has no intention of providing, services to or for the benefit the partnership or any lower tier partnership. This exception allows for an API to shed its taint as an API upon such a sale of the interest. The acquisition by the unrelated taxpayer must constitute a taxable purchase. Thus, the exception does not apply to a contribution of cash in exchange for issuance of an interest in a partnership that holds an API, regardless of whether the new contributing partner is unrelated and does not provide any services.

RELATED PARTY TRANSFERS

If a taxpayer transfers an API directly or indirectly to a related person, the taxpayer must recognize short-term capital gain in general equal to the aggregate appreciation in assets with a holding period of less than three years, even where the transfer is not otherwise taxable. Under the Proposed Regulations, a "transfer" includes contributions, distributions, sales and exchanges, and gifts. There is an exception to the related party rule for a contribution of an API to a partnership.

EFFECTIVE DATES

The Proposed Regulations generally are not effective until final regulations are published in the Federal Register. As noted above, however, S corporations will not be treated as a corporation for purposes of Section 1061 for taxable years beginning after December 31, 2017. Taxpayers may generally rely on the Proposed Regulations so long as they are followed in their entirety.

There are many additional complications and nuances in the Proposed Regulations. If you have questions about how the regulations impact carried interests, please contact Wendi Kotzen, Jonathan Flora, Jeffrey Davine or Christopher Jones.