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Carried Interest – Proposed Regulations – Impact on Real Estate: The Good and the Bad

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On July 31, 2020, the IRS and Treasury released the long-awaited proposed regulations on the new carried interest rules in Section 1061 of the Internal Revenue Code (IRC) that became law as part of the Tax Cuts and Jobs Act (TCJA). A "carried interest" (also known as a "profits interest") is an interest in an entity treated as a partnership for federal income tax purposes (typically an LLC or partnership[1]) that is received for services and is disproportionate to the capital invested in the partnership by the holder of the carried interest. For example, assume a sponsor invests no money in an LLC intended to own and operate rental real estate and investors invest $1,000x in the LLC. The economic deal between the investors and the sponsor is: after the investors receive back their money back and a return, the sponsor would receive 20 percent of any excess proceeds and the investors would share in the remaining 80 percent. The sponsor's interest is a carried interest.

INTRODUCTION

The TCJA recharacterizes certain gain that otherwise would be long-term capital gain (1) allocable to the holder of a carried interest (defined as an "applicable partnership interest" or API) from the sale of a partnership asset or (2) from the sale of an API as short-term capital gain, unless something unspecified by the TCJA (the API, the partnerships assets, or both) was held for more than three years. Guidance was necessary to implement this most basic part of the TCJA carried interest provisions and to answer other important questions. The mechanism by which the TCJA accomplishes this recharacterization is by providing that, in the case of an API, the excess of the long-term capital gain determined under the normal more-than-one-year holding period over the long-term capital gain determined by applying a more-than-three-year holding period is treated as short-term capital gain. Net short-term capital gain is taxed at ordinary income tax rates, not the advantageous long-term capital gain rates.

The TCJA also provides that there are adverse tax consequences if the holder of a carried interest transfers that interest to a related person, which includes a family member and a person with whom the carried interest holder works or has worked. However, the language in the TCJA is so vague that it is not possible to figure out what those consequences might be.

Because the drafting is so imprecise, the TCJA provision addressing carried interests raised many questions. Among them:

1. Does this provision apply to a partnership's sale of real estate used in a trade or business held for more than one year?
2. Does the carried interest, the underlying partnership property, or both have to be held for more than three years in order to avoid short-term capital gain treatment for the holder of a carried interest?

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[1] This e-alert refers to all entities treated as partnerships for federal income tax purposes, including LLCs, as partnerships.

3. What are the tax consequences of transferring a carried interest to a related person?

WHAT IS AN API?

An API is a carried interest or profits interest in a partnership acquired by a taxpayer in connection with the performance of substantial services by the taxpayer or a related person in an applicable trade or business (ATB). An API does not include:

- a "capital interest" in a partnership that shares in partnership assets in proportion to the capital invested (determined at the time of the contribution);
- a partnership interest held by an employee of a different partnership not engaged in an ATB that the employee received in connection with the performance of substantial services as an employee of the other partnership;
- a partnership interest held by a corporation (according to the proposed regulations, other than an S corporation);
- a partnership interest acquired for its fair market value by an unrelated third party who does not provide services to the partnership; or
- the value of a partnership interest subject to tax on receipt or vesting.

A partnership interest is not a capital interest if the capital for the contribution is borrowed from or guaranteed—directly or indirectly—by any other partner, the partnership, or any person related to such other partner or the partnership.

An ATB is a regularly and actively conducted trade or business of raising or returning capital and either investing in, disposing of, or developing specified assets. Specified assets include real estate held for rental or investment and financial assets such as securities, commodities, cash, options, etc.

The proposed regulations include detailed rules for determining whether a partnership interest is a capital interest. Among other requirements, a capital interest must be entitled to allocations of long-term capital gain or loss that are (i) allocated "in the same manner" to persons holding APIs and to third-party investors, and (ii) allocated to third-party investors with a significant aggregate capital account balance (at least 5 percent of the partnership). Additionally, the partnership agreement and the partnership's books and records must segregate capital interest allocations from API allocations.

Allocations are " in the same manner" if they are based on the relative capital account balances of the partners and have the same terms, priority, type, and the level of risk, rate of return, and rights to cash or property distributions. The definition of capital interest in the proposed regulations is narrower than many commentators had hoped.

A partner may own both an API and a capital interest in the same partnership, and the more-than-three-year holding period is applicable only to the API. However, the proposed regulations rely on the general rule that a partner has a unitary basis for its partnership interests and provide that, although a partner may dispose of solely a capital interest or an API, the partner's basis and holding period nonetheless is apportioned between the interest retained and the interest transferred. As a result, even if a partnership has classes of interests and a partner disposes only of the class that is a capital interest at a gain, part of that gain could be attributed to the API and subject to recharacterization as short-term capital gain.

The unitary basis rule also applies to capital gain allocated to the partners from the sale of an asset by the partnership. A partner to whom capital gain is allocated determines the amount of gain that, in a hypothetical liquidation, would be allocable to the capital interest, as opposed to the API; the portion attributable to the API is subject to the more-than-three-year holding period rule and could be recharacterized as short-term capital gain.

WHAT MUST BE HELD FOR MORE THAN THREE YEARS?

The proposed regulations provide that the more-than-three-year holding period rule is applied to the asset sold. Thus, if an API is sold, the relevant holding period is the partner's holding period for the API, and it is not necessary for the partnership to have held its assets for more than three years—only that the asset sold produce long-term capital gain without regard to the new carried interest rules, subject to an exception for the look-through rule described below. If the partnership sells an asset, the relevant holding period is the partnership's holding period for the asset sold, and it is irrelevant how long the API is held.

WIN FOR REAL ESTATE

As a general rule, the TCJA's carried interest provisions do not apply to a sale of real estate by a real estate partnership. The proposed regulations arrive at this result through a technical analysis.

The TCJA recharacterizes long-term capital gain as short-term capital gain from the sale of a capital asset held for more than a year, but not more than three years, by cross-referencing Section 1222 of the IRC, which in turn references the definition of capital asset in Section 1221 of the IRC. Explicitly excluded from the definition of capital asset in IRC Section 1221 is depreciable property used in the taxpayer's trade or business or real property used in the taxpayer's trade or business. The reason that some sales of real property (other than dealer property) are afforded long-term capital gain treatment is that IRC Section 1231 provides long-term capital gain treatment for such sales.

Under IRC Section 1231, gain on the sale of, among other assets, real property (other than inventory) used in a trade or business held for more than one year is long-term capital gain. Losses on the sale of such real property are ordinary losses, and there can be a recapture of the ordinary losses by converting certain IRC Section 1231 gains into ordinary income.

Because IRC Section 1231 treats gains from the sale of real estate used in a trade or business held for more than one year the same as long-term capital gain, as opposed to providing that such gain actually is long-term capital gain under IRC Section 1221 and IRC Section 1222, the IRS and Treasury concluded that the TCJA's carried interest provisions do not recharacterize IRC Section 1231 gain as short-term capital gain.

However, this does not mean that all carried interests in real estate partnerships automatically avoid recharacterization if held for more than one year but not more than three years. Some real estate partnerships own real estate that is not used in a trade or business, and a carried interest in such a partnership would be subject to the TCJA carried interest rules.

For example, some vacant land may be held for investment, not for use in a trade or business. Moreover, some triple net-leased real estate may not be considered to be held for use in a trade or business. Although there is some support in older case law for treating the rental of property as a trade or business for purposes of IRC Section 1231 even when the owner's activities with respect to the property are negligible, more recent cases and IRS rulings look to whether the owner provides at least some services to the property. These rulings take into consideration whether the taxpayer's activities—personally or through agents—are sufficient to rise to the level of a trade or business and go beyond merely collecting rent.

Therefore, it would appear—although it is not certain—that a partnership owning triple net-leased real estate in which the landlord provides services and is compensated for them by the tenant would qualify as a trade or business under IRC Section 1231. Conversely, a triple net lease where the landlord provides no services and simply collects rent may not qualify.

It should be noted, however, that the IRS and Treasury recently have been resistant to treating triple net-leased real estate as a trade or business. Consider, for example, the regulations under IRC Section 199A (the 20 percent business income

deduction), the regulations under IRC Section 1400Z-2 (qualified opportunity zones), and the regulations under IRC Section 163(j) (the interest deduction limitation).

WHAT HAPPENS IF THE HOLDER OF AN API SELLS ITS API?

As noted above, the proposed regulations look to the asset that is sold to determine whether and how the carried interest rules apply. As a result, if the holder of an API sells its API, it is the API that is relevant. If the API was held for three years or less, the gain will be recharacterized as short-term capital gain. Moreover, the proposed regulations include a look-through rule that works to the disadvantage of the holder of an API. If the partnership has a holding period of three years or less for substantially all of its assets (defined as 80 percent of the fair market value of its assets[2]) and if the holder of the API has a more-than-three-year holding period for the API, any gain on the sale of the API is recharacterized as short-term capital gain. The proposed rules also apply this rule to APIs held through tiered pass-through entities.

WHAT HAPPENS IF THE HOLDER OF AN API TRANSFERS THE API TO A RELATED PERSON?

If the holder of an API, directly or indirectly, transfers an API to a related person, the API holder recognizes short-term capital gain equal to the API holder's share of the net built-in gain attributable to the partnership's assets held for three years or less. Moreover, this acceleration rule seemingly applies even to APIs in partnerships that hold Section 1231 property. For this purpose, a transfer includes not only a sale or exchange, but also a tax-free transfer to an entity other than a partnership and a gift. A related person for this purpose includes a person's spouse, children, grandparents, parents, or a person who performed a service within the current or prior three calendar years in any ATB in which, or for which, the API holder owned an interest. As a result, careful consideration of income tax consequences must be considered when gifts are made pursuant to estate and gift plans.

SPECIAL RULE FOR INSTALLMENT SALES

Installment gain recognized in tax years beginning after December 31, 2017, are subject to these rules. Thus, if a partnership that is an ATB sold a capital asset (other than IRC Section 1231 property) prior to 2018, and installment gain is allocable to the holder of an API, that holder's gain could be subject to recharacterization as long-term capital gain, notwithstanding that the sale occurred before enactment of the TCJA.

REPORTING REQUIREMENTS

The proposed regulations also allow the IRS to require the owner of an API to report information about the API. To facilitate such reporting, a partnership will be required to provide the API owner with the adjustment information necessary to determine the amount, if any, to which the recharacterization rules apply. A partnership that fails to comply with these reporting requirements will be subject to penalties. Additionally, if an API owner does not obtain the required information, the IRS will presume that all gain attributable to an API has a holding period of three years or less.

EFFECTIVE DATE

The regulations under the TCJA carried interest provision will be effective after publication in the Federal Register, other than the provision that an API is an API if held by an S corporation that is effective for tax years beginning after December 31, 2017. Until they are finalized, the proposed regulations generally may be relied upon, provided that the proposed

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[2] Excluding, among other assets, IRC Section 1231 property.

regulations are followed in their entirety.

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