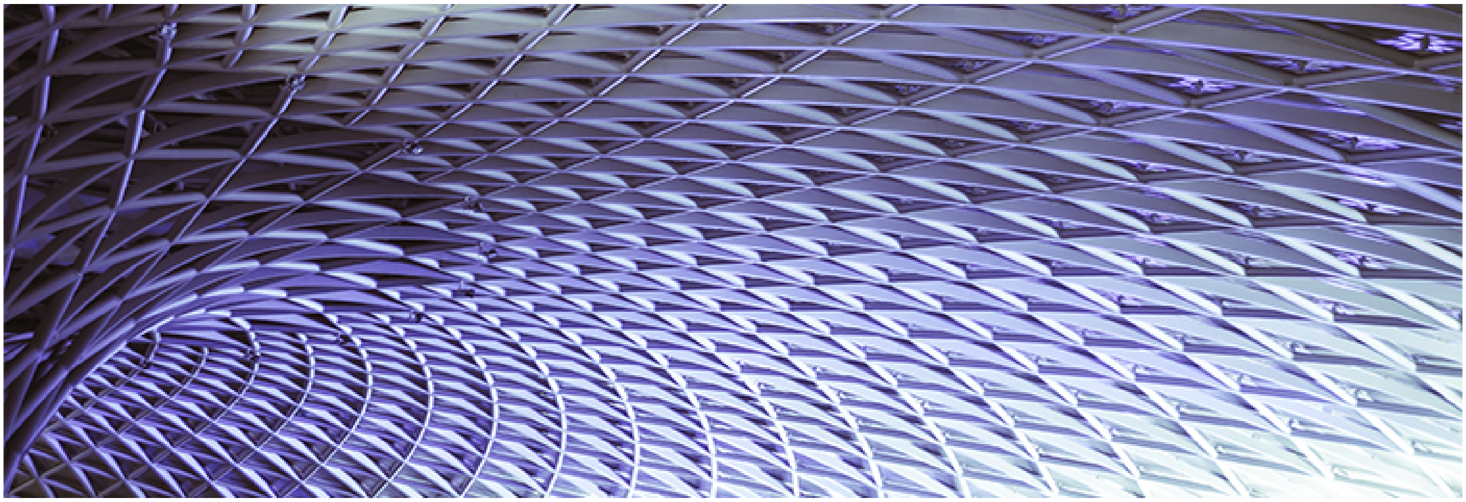

Proposed carried interest regulations contain some good news, but many more traps for the unwary

US Tax Alert

31 August 2020
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On July 31, 2020, the Treasury Department and Internal Revenue Service issued proposed regulations (the Proposed Carried Interest Regs) under Section 1061 of the Internal Revenue Code of 1986, as amended (the Code). Section 1061, added to the Code by Tax Cuts and Jobs Act of 2017 (the TCJA), limits the ability of individuals who organize and manage investment partnerships (including hedge funds and venture capital funds) to use Carried Interests (ie, an ownership interest in a partnership that gives the partner a share of profits without having to make a proportionate capital contribution) to convert what the partner might otherwise receive as fee income (taxed at ordinary income rates) into allocations of long-term capital gain realized by the partnership. Where it applies, Section 1061 replaces the one-year holding period for favorable long-term capital gain treatment with a three-year holding period.

The Proposed Carried Interest Regs provide much-needed guidance on interpreting and applying Section 1061. Following are our basic takeaways and initial impressions of the Proposed Carried Interest Regs.

Background

1. Section 1061 is the culmination of various legislative attempts over the past 10 years to change the taxation of “carried interests.”Like prior legislative efforts, Section 1061 limits the ability of individuals who

organize and manage investment partnerships (including hedge funds and venture capital funds) to use Carried Interests (ie, an ownership interest in a partnership that gives the partner a share of profits without having to make a proportionate capital contribution) to convert what the partner would otherwise receive as fee income (taxed at ordinary income rates) into allocations of long-term capital gain realized by the partnership.

2. The basic pattern of Section 1061 is clear:where a taxpayer/partner holds an "applicable partnership interest," Section 1061 replaces the one-year holding period for favorable long-term capital gain treatment with a three-year holding period.Capital gain caught by the Section 1061 recharacterization rule is treated as short-term capital gain taxable at ordinary income rates.

3. While the basic pattern of Section 1061 is clear, the provision appears to have been written in haste and contains several drafting glitches and ambiguities.The Proposed Carried Interest Regs provide much-needed remedial help to an otherwise opaque statute.

Executive summary/basic takeaways

Following are high-level takeaways on how the three-year holding period requirement of Section 1061 works under the Proposed Carried Interest Regs (together, the Carried Interest Rules).

i. **Carried Interest Rules are retroactive and extremely broad**. Section 1061 is effective for tax years beginning after December 31, 2017.However, there was no "grandfathering," so that the Carried Interest Rules apply to partnership interests issued at any time before or after 2018.Also, the Proposed Carried Interest Regs cast a broad net, and apply to almost any partnership interest issued to a partner in exchange for services to the partnership, even (it appears) a typical 90/10 real estate joint venture arrangement between an investor and real estate developer in which the developer is entitled to a Carried Interest.

ii. **Carried Interest Rules generally extend holding period for long-term capital gain from one year to three years.** However, the devil is in the details, and the holding period may be different depending on exactly what asset is sold (eg, the service partner's LP interest in the General Partner, the General Partner's interest in the Fund LP or the Fund LP's ownership interest in a real estate project).

iii. **The Proposed Carried Interest Regs confirm (surprisingly) that the three-year holding period requirement does not apply to the sale of depreciable real property (or other Section 1231 Property).** This result follows from a literal interpretation of Section 1061(a), which many tax advisors believed was a drafting glitch that was "too good to be true."The Proposed Carried Interest Regs confirm the literal reading – *but only if the depreciable real estate or other Section 1231 property is sold directly* (rather than indirectly through the sale of an intermediate partnership interest).

iv. **Exceptions and exclusions are narrow**. The text of Section 1061 provides several exceptions and exclusions which the IRS has interpreted very narrowly (other than the exclusion for Section 1231 Property above).It will be difficult for fund sponsors to qualify for one of the most significant exceptions – for capital interests (ie, partnership interests that service partners pay for) – because of the hyper-technical conditions required under the Proposed Carried Interest Regs.

v. **Transfers of Carried Interests are hazardous**. A transfer of a Carried Interest by a service partner to a family member or other related party (using a special definition) will accelerate gain on partnership capital assets held for less than three years, even if the transfer is a gift or other transaction that generally is not taxable.Transfers to a partnership or grantor trust escape this draconian result.

vi. **The Carried Interest Rules have many traps for the unwary.** The Proposed Carried Interest Regs are very complicated and contain special rules to avoid abuse that will certainly create unexpected results for taxpayers.

Initial impressions of Proposed Carried Interest Regs

1. **Broad application to partnership interests received for services.** A gating issue in applying Section 1061 is whether a taxpayer holds an "applicable partnership interest" (API).The statute defines an API as "any interest in a partnership which, directly or indirectly, is transferred to (or is held by) the taxpayer in connection with the performance of substantial services by the taxpayer, or any other related person, in any applicable trade or business".An applicable trade or business is designed to capture common investment partnerships, and is defined by the statute as an activity (conducted in one or more entities) that consists in whole or in part of (A) raising or returning capital, and (B) either (i) investing in or disposing of securities, commodities or real estate held for rental or investment or (ii) developing securities, commodities or real estate held for rental or investment.

   Although the statutory definition of an API is full of ambiguities, the Proposed Carried Interest Regs leave little room for doubt: an interest issued by a hedge fund, venture capital fund or real estate investment partnership to a partner for performing services – whether the partner is an individual or an intermediate General Partner/Managing Member LLC or other entity – will presumptively be treated as an API. The Proposed Carried Interest Regs:

   - Apply a broad test of what is an "applicable trade or business" (ATB), in which the activities of related entities are aggregated and activities conducted before and after the investment partnership is formed are taken into account.
   - Confirm that Section 1061 does not apply to partnership interests issued to corporations, but repeat and reinforce the position previously announced by the IRS that – for this purpose – an S corporation will not be treated as a "corporation." There are fairly strong reasons to believe that IRS' position that S corporations do not qualify for the corporate partner exception goes too far.
   - Recognize certain other exceptions to Section 1061 recharacterization, including (i) profits interests issued to employees of operating businesses and (ii) certain capital interests issued in exchange for the contribution of money or property (discussed below).
   - Emphasize that Section 1061 applies to a partnership interest issued for services regardless of whether the partnership interest technically is a "profits interests" under established rules (Revenue Procedure 93-27); for example, a partnership interest acquired by a General Partner LLC from an Investment Partnership for which the GP LLC serves as General Partner, makes a cash capital contribution and is entitled to (i) a pro rata share of economic returns based on its cash capital contribution and (ii) a 20% Carried Interest.
   - Provide rules for applying Section 1061 to tiered ownership arrangements.

2. **Surprisingly, Proposed Carried Interest Regs confirm that Section 1231 gains from sales of real estate assets *are not* subject to recharacterization.** The heart of Section 1061 is its recharacterization rule.In general, a taxpayer treats gain on capital assets held for one year or more as long-term capital gain; Section 1061 changes this result by recharacterizing long-term capital gain that is allocated by a partnership to a partner who holds an API into short-term capital gain if the partnership did not hold the asset it sold for more than three years (rather than one year).

   The recharacterization rule in Section 1061 refers to net long-term capital gain "applying paragraphs (3) and (4) of sections (sic) 1222". Section 1222 provides key operational and computation rules for taxing gain on sale of capital assets, as defined in Section 1221. Importantly, depreciable property used in a trade or business and real estate used in a trade or business are specifically excluded from Section 1221, and are taxed instead under the favorable rules of Section 1231 (under which net gains are taxed as capital gain and net losses as ordinary losses). Accordingly, gains from the sale of "section 1231 property" should not be – under a literal reading of the statute – subject to recharacterization under Section 1061. Many – if not most – tax advisors believed that the failure of the statute to refer to Section 1231 was a drafting glitch, that was "too good to be true" and would be corrected either by Treasury Regulations or technical corrections/amendment to Section 1061.

   In something of a surprise, the IRS agreed with the literal reading of the statute and confirmed in the Proposed Carried Interest Regs that gains from the direct sale of commercial real estate and other Section 1231 Property are not subject to the three-year holding period requirement of Section 1061. This is good news to sponsors of real estate investment partnerships.

Note that, however, this is something of a Pyrrhic victory. The exclusion for gains determined under Section 1231 applies *only to a direct sale* of real property or other depreciable property – and not to an ownership interest in the partnership that owns the property. Accordingly, what is sold – the asset itself or an interest in a partnership that owns the asset – matters here. The net result is that – as things stand today – (i) well-advised sponsors of real estate investment partnerships can avoid the three-year holding period requirement by careful timing and structuring of dispositions but (ii) inevitably the difference between an asset sale and a sale of ownership interests will be a trap for the unwary.

3. **Other taxpayer-friendly/helpful aspects**

    i. **Holding period applies (most of the time) to asset sold.** One of the many ambiguities in interpreting/applying Section 1061 is discerning whose holding period the statute is referring to – the taxpayer/service partner or the partnership/owner of asset sold? For example, assume Partnership X purchased a capital asset on January 1, 2018, and issued individual A a profits interest on January 1, 2020. If Partnership X sells the capital asset at a gain on January 2, 2021, does A escape recharacterization of his share of the gain because Partnership X held the capital asset for more than three years?Or does A need to apply Section 1061 using the holding period for his profits interest?

    The Proposed Carried Interest Regs confirm/clarify that (most of the time) Section 1061 is applied by analyzing the tax consequences – holding period, character of gain, etc. – of the asset that is actually sold. While this had been the view of most tax advisors, it is helpful that the Proposed Carried Interest Regs confirm this interpretation.

    Example #1 – Sale of Carried Interest held for more than three years: A receives a 10% profits interest in Partnership X on Jan. 1, 2018. Partnership X purchases Property 1 on Jan 1, 2018 and Property 2 on January 1, 2020. On Jan. 2, 2021, the FMV of Property 1 is $50 and FMV of Property 2 is $50, and A sells her profits interest for $10. A's $10 gain <u>is not</u> subject to Section 1061 recharacterization even though X did not own Property 2 for more than three years at the time of the sale.

    Unfortunately, the clarity of this favorable rule is largely undone by the anti-abuse Lookthrough Rule summarized below.

    ii. **Sound conceptual (although complex) framework for analysis.** The Proposed Carried Interest Regs provide a much-needed framework for applying the Section 1061 rules to complex ownership structures/tiers of ownership. While these rules are complex and will take many hours for tax advisors to master, they appear to provide a sound framework for applying a confusing statute.

4. **Challenges and disappointments.** Following are some of the more challenging and disappointing aspects of the Proposed Carried Interest Regs:

    1. **Transfer of APIs to related party.** Section 1061(e) provides that if a taxpayer transfers an API to a related person, the taxpayer recognizes as short-term capital gain the unrealized gain on the API attributable to capital assets held for three years or less. For this purpose, a "related party" of a partner is (i) a member of his/her family or (ii) someone who worked with the taxpayer in the partnership business.

        The Proposed Carried Interest Regs take the position that the Section 1061(e) gain recognition rule overrides other nonrecognition rules in the Code, and causes transfers that would not otherwise be taxable events – such as a gift or contribution to a family corporation – to be taxable. It is not at all clear that this result is required by the statute or was intended by Congress. Fortunately, a transfer of a Carried Interest to a partnership or grantor trust escapes the gain acceleration rule.

    2. **Capital interest exception.** The statute provides an exception from the Section 1061 for gains from a capital interest that "provides the taxpayer with a right to share in partnership capital commensurate with … the amount of capital contributed."This sensible rule differentiates between Carried Interests issued to sponsors/GPs (APIs) and partnership

interests issued to investors in exchange for making capital contributions.

The Proposed Carried Interest Regs provide a complex set of rules for applying this exception. Essentially, the partnership interest of a partner who is a service provider is excluded as a "Capital Interest" only if the partnership has third-party investors holding at least a 5% interest in the partnership and the economic terms of the service partner's Capital Interest – priority, type and level of risk, rate of return and rights to distributions -- are the same as for interests held by third-party investors. Further, for allocations of long-term capital gain to qualify for the Capital Interest exclusion, the allocations must be made to all partners in accordance with their respective capital accounts.

The requirements needed to comply with the Capital Interest exclusion are so demanding as to be overbroad in many instances. Compliance with the exclusion will likely require many existing partnerships to amend the allocation provisions of their partnership agreements.

3. **Lookthrough Rule.** The Proposed Carried Interest Regs include a special rule that requires a service partner who holds a Carried Interest for more than three years to apply the Section 1061 recharacterization rule by "looking through" the Carried Interest to the assets of the underlying partnership.This Lookthrough Rule applies in two situations – (i) where 80% or more of the assets the underlying partnership are capital assets that it has held for less than three years and (ii) where the underlying partnership holds a Carried Interest in a subsidiary partnership for less than three years.

    Example 2 – Lookthrough Rule and 80% Test: Same facts as in *Example #1*, above, except that Partnership X's only asset that it purchases on January 1, 2020. On Jan. 2, 2021, when the FMV of Property 2 is $100, A sells her profits interest for $10. Even though A held her profits interest for three years, A's $10 gain *is subject* to Section 1061 recharacterization under the Lookthrough Rule because Property 2 is X's only asset and X's holding period for Property 2 is less than three years at the time of the sale.

    Example 3 – Lookthrough Rule in tiered partnership structure: On Jan. 1, 2018, GP is formed and purchases Property I for $50, and B acquires a 10% interest GP for $5. On Jan. 1, 2019, GP forms Fund as an investment partnership and receives a 20% profits interest in Fund for acting as Fund's general partner. On Jan. 2, 2021, when the FMV of Property I is still $50 and the FMV of GP's interest in Fund is $50, B sells his 10% interest in GP for $10 (a gain of $5). Even though B held his 10% interest in GP for more than three years, his $5 gain *is subject*to Section 1061 recharacterization because GP did not hold its 20% profits interest in Fund for more than three years at the time of the sale.

    If adopted in the form proposed, the Lookthrough Rule will be a trap for many unsuspecting partners who hold Carried Interests in tiered ownership structures.

4. **Exclusion for assets not held for portfolio investment.** Section 1061(b) provides the Treasury Department with authority to issue regulations under which the recharacterization rule will not apply to "gain attributable to any asset not held for portfolio investment on behalf of third party investors." Neither the statutory language or the legislative history sheds insight into what Congress intended would be excluded under this provision.

    The Proposed Carried Interest Regs do not address the Section 1061(b) exclusion, with the Treasury Department expressly reserving on its authority to issue regulations. This is disappointing because the Proposed Carried Interest Regs are so broad that they may – in the absence of Treasury Regulations that activate the exclusion – apply to arrangements like (i) a typical 90/10 real estate joint venture arrangement between an investor and real estate developer in which the developer is entitled to a Carried Interest and (ii) family office partnerships, in which the GP entity receives a Carried Interest in respect of administering the family office but all the partners are related.

5. **Carried Interest waivers.** In the preamble to the Proposed Carried Interest Regs, the IRS/Treasury Department went out of their way to caution taxpayers that “carried interest waivers” and special allocations to avoid application of Section 1061 may be challenged under anti-abuse rules and/or the substance over form or economic substance doctrines.

6. **Property distributions.** The Proposed Carried Interest Regs contain yet another anti-abuse rule to prevent taxpayer/partners from avoiding Section 1061 recharacterization by receiving a distribution of built-in-gain property, rather than having the partnership sell the property. The Proposed Carried Interest Regs confirm that gain is not accelerated/triggered to a partner holding a Carried Interest by receiving a distribution of property from his partnership. However, if a partner receives a distribution of property and the partner later sells property when his holding period (which includes the partnership’s holding period) is three years or less, the partner’s gain from selling the property is subject to the Section 1061 recharacterization rule. This rule for distributed property no longer applies when the partner’s holding period for the distributed property is more than three years.

5. **Effective date.** The Proposed Carried Interest Regs generally apply in taxable years beginning on or after final regulations are issued. Taxpayers are permitted to rely on the Proposed Carried Interest Regs prior to their being finalized, provided that they follow the Proposed Carried Interest Regs in their entirety and consistently.

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