TAXATION ALERT

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Fund Managers and Family Offices Get Some Clarity on Carried Interests with Issuance of Proposed Treasury Regulations

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On August 14, 2020, the IRS published Proposed Treasury Regulations (the "Proposed Regulations") under Section 1061 of the Internal Revenue Code to close the "carried interest loop hole" through which managers of investment funds could treat certain gains allocated to them in exchange for advisory services (i.e., their "carry") as preferentially taxed long-term capital gains, rather than the higher rate applicable to compensation. Section 1061 limits fund managers' ability to qualify for the preferential rate to situations in which a fund holds the underlying investment for three years.

This alert first summarizes the Proposed Regulations, and then offers more-detailed insights into certain operational rules, limited exceptions, and mitigation strategies.

Summary

Any investment advisor receiving a carried interest in a private equity, VC, hedge, or other investment fund may be impacted by Section 1061 and the Proposed Regulations.

The Proposed Regulations clarify that the relevant holding period for determining whether gain will be taxed at a preferential rate is the fund's holding period in the underlying asset generating the gain, regardless of the length of the advisor's holding period of the carried interest in the fund. Because only allocations of long-term capital gains under Code Sections 1222(3) and (4) are subject to recharacterization to higher rates, limited opportunities may exist for fund managers to sell assets of fund portfolio investments to generate gains that do not require a three-year holding period or distribute assets in-kind. However, investments held through multiple tiers of "pass-through" entities are generally looked-through and may require burdensome reporting obligations.

Because Section 1061 and the Proposed Regulations are intended to target a narrow type of potentially abusive transaction, there are several limited exceptions available for (i) fund interests held by persons who are employed by an entity that is not providing services to the fund, (ii) fund interests held by C corporations (but not S corporations), (iii) gains that represent a return on invested capital, (iv) gains from assets that are not held for portfolio investment on behalf of third-party investors, and (v) gains allocated to persons who acquire their respective fund interests in arm's length transactions and who are neither related nor a fund service-provider.

In order to avoid certain common transactions designed to "work around" the three-year holding period, a "related party" provision has been included that accelerates the recognition of built-in gains when carried interests are sold to a broad list of "related parties" including family members and colleagues. Further, the Proposed Regulations strongly discourage fund managers from using carried interest "waivers" with threats of IRS scrutiny and challenges.

The remainder of this alert provides a more-detailed review of the technical provisions of the Proposed Regulations.

Background of Section 1061

Section 1061 was enacted as part of the 2017 Tax Cut and Jobs Act to counter perceived inequities in the rate of tax applicable to "carried interests" commonly held by fund managers. Generally, carried interests are partnership interests issued in exchange for services that entitle the recipients to a percentage of the partnership's net profits after third-party investors have earned enough to at least pay back their capital investment in the partnership (or that entitle the recipients to a percentage of the partnership's net profits with respect to a particular investment after third-party investors have earned enough to at least pay back their capital investment in such asset of the partnership). Because carried interests are structured as "profits interests" for U.S. federal income tax purposes, the service provider typically does not incur any tax on receipt or vesting of the interest. Instead, the recipient recognizes gain upon disposition of the interest or an underlying partnership asset, and such gain is generally taxed at the long-term capital gain rate rather than the ordinary income rates typically applied to compensation. Section 1061 recharacterizes certain long-term capital gains as short-term capital gains (taxed at ordinary income rates) by extending the holding period required to qualify for the preferential long-term rate from one year to three years for certain assets.

Operational Rules

Capital Gains Subject to Recharacterization

The Proposed Regulations provide guidance on the determination of the "Recharacterization Amount," which is the amount that will be recharacterized as short-term capital gain and subject to tax at ordinary income rates. The Recharacterization Amount is generally determined by comparing a taxpayer's distributive share of gains allocated from a partnership and gains from the disposition of partnership interests using one-year and three-years as the necessary holding period for long-term capital gain treatment, and recharacterizing any excess amount using the three-year holding period as short-term capital gain.

Only long-term capital gains under Sections 1222(3) and (4) of the Code are subject to recharacterization. Installment sale payments received after the effective date of Section 1061 are subject to recharacterization even if the sale occurred before the effective date. In addition, property that is distributed from a partnership to a partner remains subject to recharacterization in the hands of the distributee partner unless the distributee partner holds the property for more than three years (including the holding period of the distributing partnership).

Notably, by defining recharacterizable amounts by reference to Section 1222, (a) gains from depreciable or real property used in a trade or business under Section 1231, (b) gains from derivatives and other financial contracts that are marked-to-marked under Section 1256, (c) qualified dividends subject to the preferential 20-percent rate, and (d) mixed straddles under Section 1092 that are characterized as long-term or short-term without regard to the holding periods rules in Section 1222, would not be subject to recharacterization. Thus, under the right circumstances, it may be possible to limit the amount of gain subject to recharacterization by selling the assets of an underlying private equity portfolio business to generate Section 1231 gains, or by taking a distribution-in-kind of securities from a hedge or VC fund with the intention of holding the security for the three-year holding period.

Applicable Partnership Interests

Section 1061 targets only certain long-term gains, which may be viewed as similar to compensation for services, by limiting its applicability only to "applicable partnership interests" ("API"). An API is defined as an interest in a partnership that is (i) directly or indirectly transferred to or held by a taxpayer, (ii) in connection with the performance of "substantial services" by the taxpayer or any other related person, (iii) in any "applicable trade or business." In

determining whether there is an API, the actions of the taxpayer, all related persons and lower-tier partnership entities are all taken into consideration, and the applicability of IRS Rev. Proc. 93-27 to treat the receipt of a profits interest as other than a taxable event has no bearing. The Proposed Regulations presume services to be "substantial" if the interest is transferred in connection with any services.

The Proposed Regulations define an applicable trade or business ("ATB") as (i) any activity conducted on a regular, continuous, and substantial basis, (ii) which consists in whole or part of "specified actions" with respect to "specified assets." Specified Actions include: (a) raising or returning capital; and (b) either investing in or disposing of (or identifying for investment or disposition) specified assets, or developing specified assets. Recognizing that funds may have an initial investment of capital and no additional investments in future years, the Proposed Regulations do not require "Raising or Returning Capital Actions" and "Investing or Developing Actions" to occur in the same year in order for an ATB to exist, provided that both types of actions have occurred in the past or are anticipated in the future.

Holding Periods and the Lookthrough Rule

For purposes of the three-year holding period requirement, the holding period of the asset owner generally controls, such that the holding period of the interest holder would apply if the asset disposed of is the API itself, and the holding period of the partnership would apply if the asset disposed of is an underlying capital asset. Thus, gain from the sale of an underlying capital asset that has been held by a partnership for three years or less is treated as short-term capital gain even if it is allocated to a service provider who has held their carried interest for more than three years. In contrast, gain from the sale of an underlying capital asset that has been held by a partnership for more than three years is treated as long-term capital gain even if it is allocated to a service provider who has held their carried interest for less than one year.

In the case of a sale of a partnership interest, the Proposed Regulations create a limited exception to the general holding period rules. Under the "Lookthrough Rule," a partnership's holding period for the underlying assets is taken into consideration if "substantially all" (defined as eighty percent or more of the assets based on fair market value) would produce disqualifying capital gain or loss and have a holding period of three years or less. If the Lookthrough Rule applies, then a corresponding portion of the gain on the sale of the carried interest is treated as short-term capital gain regardless of the partner's holding period in the API.

Exceptions to API Treatment

The Proposed Regulations provide guidance on the four statutory exceptions to API treatment, and add a fifth regulatory exception.

The "Non-ATB Employee Exception" provides that an API does not include an interest held by a person who is employed by another entity that is conducting a non-ATB trade or business and provides services only to such other entity. Unfortunately, the exception is of limited use because it generally is not available to owners of investment management entities or to people who receive interests in a non-employee capacity such as directors and consultants.

The "Corporate Exception" provides that APIs do not include interests held by a "corporation." Certain fund managers have taken the position that carried interest held by an S corporation or a passive foreign investment company (a "PFIC") are thus exempt from API treatment based on the plain language of the statute. However, the Proposed Regulations rely on the statutory authority granted under Section 1061(f) and attempt to close this perceived "loop hole" by interpreting the Corporate Exception as not applying to interests held by S corporations or PFICs with respect to which a qualified electing fund election is in place.

The "Capital Interests Gains and Losses Exception" excludes capital interests in partnerships that provide taxpayers with a right to share in partnership capital commensurate with the capital contributed or the value of a profits interest upon receipt or vesting. In order to qualify for the exception: (A) allocations must be made (i) under the partnership agreement, (ii) to both "API Holders" and "Unrelated Non-Service Partners" with significant aggregate capital account balances (defined as five percent or more of the aggregate capital account balance at the time of allocation), and (iii) in the same manner; (B) the terms of the allocations must be identified in the partnership agreement; and (C) the partnership's books and records must clearly separate allocations made with respect to capital contributions and APIs. For an allocation to be made "in the same manner" to API Holders and Unrelated Non-Service Partners, the terms, priority, type and level of risk, rate of return, and rights to cash or property distributions during the partnership's operations and liquidation must be the same. The Proposed Regulations do not address the impact on the "in the same manner" requirement of differences in withdrawal rights and terms, tax distributions and other liquidity rights, and other special allocations. While the Proposed Regulations state that an allocation to an API Holder will not fail to qualify solely because it is subordinated to allocations made to unrelated non-service partners or is not reduced by the cost of services provided by the API holder, it is not certain whether a co-investment by the manager who is not obligated to pay any management fees or carry represents a qualifying capital interest.

Because of the mechanical and narrow application of the exception, many managers or family offices may find it difficult to qualify for the exception. As a threshold requirement, partnerships must have significant unrelated investors who are not service providers. Further, any capital that has been borrowed from, or guaranteed by, another partner, the partnership, or a related person is excluded from the capital account for purposes of the determination. Thus, loans provided by an asset manager to its employees for co-investments, or third party loans guaranteed by the asset manager, will result in limitation of the exception. In addition, if funds make allocations on an investment-by-investment basis, if there are admissions or withdrawals of partners, or if a manager's capital account reflects prior allocations of carried interest, allocations may not be in proportion to aggregate "book" capital accounts.

The "1061(b) Exception" applies to any income or gain attributable to any asset not held for portfolio investment on behalf of third-party investors. The Preamble notes that the exception is intended to apply to investors who do not hold an interest in the partnership and who do not provide substantial services and, thus, may apply in the family office context.

Finally, the Proposed Regulations create a "Bona Fide Unrelated Purchaser Exception." In order to limit Section 1061 to situations where an interest is received in exchange for services (as opposed to open market purchases), an interest holder who (i) has never provided, and does not anticipate providing, services, (ii) is unrelated to any service provider, and (iii) acquired the interest for fair market value, shall not be subject to recharacterization.

Special Transaction

Carry Waivers

The Proposed Regulations warn taxpayers about using so-called "carry waivers" or "carried interest waivers," under which managers waive their right to certain gains (with a three-year or less holding period), and either receive substitute gains (with a greater than three-year holding period) or a future fill-up allocation. Under these arrangements, other non-service-providing investors who are not subject to Section 1061 receive allocations of gain that would be subject to recharacterization and the fund managers are subsequently "made whole" for the amount that has been waived. The Proposed Regulations warn that the IRS is aware of such arrangements and may challenge them using various partnership rules, or substance-over-form or economic substance doctrines.

APIs Retain Their Status as APIs

Under the Proposed Regulations, once an interest is treated as an API, it retains its status as an API unless and until an exception applies, regardless of whether a taxpayer or related person continues to provide services. Thus, if a partner retires from the partnership or contributes the interest to a new partnership, or if the partnership ceases to engage in an ATB Activity, the interest continues to be treated as an API.

Related Party Transactions

In the case of a direct or indirect non-taxable transfer of an API to a related party, Section 1061 accelerates the recognition of any unrecognized net built-in capital gain with respect to any underlying assets held for three years or less. The Proposed Regulations define "related party" for this purpose to include family members, any person who performed services in the current year or preceding three years in any ATB in which the taxpayer also performed services (i.e., former or current colleagues), and passthrough entities to the extent that a member of the taxpayer's family or a colleague is an owner.

Because transfers include contributions, distributions, sales, exchanges, and gifts to related parties, the related party rule may have unexpected consequences. High net worth individuals, family offices, and estate planners should be aware that gifts of an API may cause immediate tax events, even though the gift recipient may not obtain stepped-up basis in the transferred assets and the interest may continue to be treated as an API. Similarly, a tax event may occur when recipients of profits interests forfeit their interest prior to vesting (such as when a service professional is terminated from employment), or when fund managers solicit additional investors or liquidate a portion of their holdings by offering to sell their interests.

Reporting

Under the authority of Section 1061(e), the Proposed Regulations create substantial reporting obligations. Specifically, passthrough entities are required to provide their owners with sufficient information to enable the owner to comply with Section 1061 and determine the Recharacterization Amount. This reporting obligation applies to intermediary passthrough entities in a fund structure, even if an interest in the intermediary entities are not APIs.

Because holders that do not receive sufficient information to determine their Recharacterization Amount are presumed not to meet the three-year holding requirement, there is a mechanism to request information and partnerships may be subject to penalties if they do not provide sufficient information to interest holders.

Finally, any owner that takes a position inconsistent with information that they have received from a partnership is required to notify the IRS on their federal income tax return.

Effective Date

The Proposed Regulations are generally effective for taxable years beginning after final regulations are published in the Federal Register, rather than retroactively to the enactment of Section 1061. However, with the exception of "Transition Amounts" (related to the treatment of assets held for more than three years as of the effective date of Section 1061), the Proposed Regulations may be relied upon provided that they are followed entirely and consistently. Taxpayers may rely upon the Proposed Regulations with respect to Transition Amounts without consistent application of the other Proposed Regulations. Finally, the exclusion of S corporations from the Corporate Exception will be retroactive to the applicability date of Section 1061, and the exclusion of PFICs with qualified electing fund elections is retroactive to taxable years beginning after August 14, 2020.

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If you have any questions regarding these proposed carried interest regulations, please contact Scott Bakal, Jeff Shamberg, Michael Gray, David Presser, Eric McLimore or your Neal Gerber Eisenberg attorney.

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