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CLIENT ALERT

Treasury and IRS Release Proposed Carried Interest Regulations

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On Friday, July 31, the U.S. Department of the Treasury (the "Treasury Department") and the Internal Revenue Service (the "IRS") released proposed regulations (the "Proposed Regulations") related to Section 1061 of the Internal Revenue Code of 1986, as amended. Section 1061 was added as part of the Tax Cuts and Jobs Act of 2017 in order to alter the taxation of carried interest – that is, a special allocation of partnership gains to a partner who provides services to the partnership, such as the general partner of an investment fund. Prior to the enactment of Section 1061, if a taxpayer was allocated gains from the sale of partnership property held for more than one year with respect to its carried interest, it (or, if the taxpayer is itself a partnership, its partners) would pay taxes on these gains at preferential long-term capital gains rates. However, after the enactment of Section 1061, taxpayers (or their equity owners) are entitled to preferential long-term capital gains rates only if the partnership property that generated the capital gain was held for more than three years.

The Proposed Regulations address a number of open questions relating to Section 1061, and provide detailed rules regarding computations and new Schedule K-1 reporting requirements.

General Background

Section 1061 requires the recharacterization of certain long-term capital gains to short-term capital gains when allocated to a service provider that holds, directly or indirectly, an applicable partnership interest (an "API"). Generally, long-term capital gains with respect to an API are subject to recharacterization to short-term capital gains when sourced from assets with a holding period of not more than three years.

To qualify as an API, the partnership interest must be transferred to, or held by, the taxpayer in connection with the performance of substantial services by the taxpayer (or a related person) in any applicable trade or business (an "ATB"). An ATB is an activity that is conducted on a regular, continuous, and substantial basis and that consists (in whole or in part) of (i) raising or returning capital and (ii) investing in, or disposing of, "specified assets" (or identifying such specified assets for investing or disposition), or developing specified assets. "Specified assets" include securities, commodities, real estate held for rental or investment, cash or cash equivalents, options or derivative contracts with respect to the foregoing assets, or an interest in a partnership to the extent of the partnership's interest in the foregoing assets.

Carried Interest Waiver

The Proposed Regulations do not address structures where a general partner forgoes carried interest on the sale of assets held for three years or less, and receives a "make up" allocation of carried interest on assets held for more than three years (a so-called "Carried Interest Waiver" provision). The Preamble to the Proposed Regulations acknowledges that these structures exist, and cautions taxpayers that these structures may be challenged with existing legal doctrines, such as the partnership anti-abuse rules, the substance over form doctrine, and the sham transaction doctrine. Accordingly, it appears that a Carried Interest Waiver that is drafted to ensure meaningful risk and economic substance would continue to be respected. However, the IRS is clearly skeptical of Carried Interest Waivers, and therefore due consideration should be given to being certain that any such structure cannot be successfully attacked under these legal doctrines.

Holding Periods Used for Applying Section 1061

The Proposed Regulations look to the partner's or partnership's holding period in the capital asset sold (i.e., the API or a capital asset owned by a partnership in which the taxpayer holds an API) when determining which gains or losses are subject to recharacterization. As a result, if a partnership disposes of an asset, the holding period is generally applied at the partnership level. For example, if a partner holds an interest in a partnership for three years or less, but the partnership sells an asset it held for more than three years, the partner will benefit from the holding period of the partnership.

Lookthrough Rule on Sale of APIs

Generally, the Proposed Regulations do not look through a partnership to its assets on the sale of a partnership interest. However, the Proposed Regulations include a limited "lookthrough" rule (the "Lookthrough Rule") that may apply to the sale of an API or a lower-tier API with a holding period of more than three years. In the case of a disposition of an API with a holding period of more than three years, the Lookthrough Rule applies if substantially all (80 percent or more) of the underlying assets taken into account under Section 1061 have a holding period of three years or less. Therefore, if more

than 20 percent of the underlying assets taken into account under Section 1061 have a holding period of more than three years, the Lookthrough Rule will not apply to the sale of an API.

Distributed API Property

Generally, distributions of property with respect to an API will not accelerate the recognition of gain under Section 1061. However, the property distributed retains its character as API property and the holding period continues in the hands of the distributee-partner. For example, if a partner receives a distribution of securities that were held by the partnership for two years, the securities retain their character as an API subject to the recharacterization rules. The distributee-partner would need to hold the securities for more than one year (i.e., a total of more than three years) in order to receive the preferential capital gains rates.

Corporate Exception

Section 1061(c)(4)(A) provides that the term API does not include a partnership interest directly or indirectly held by a corporation. On March 19, 2018, the Treasury Department and the IRS issued Notice 2018-18, notifying taxpayers that they intend to issue regulations providing that a corporation does not include an S corporation for this purpose. The Proposed Regulations adopt Notice 2018-18 and confirm that S corporations that hold APIs are subject to the recharacterization rules. This rule is applied to taxable years beginning after December 31, 2017.

Additionally, the Treasury Department and the IRS have concluded that a partnership interest held by a passive foreign investment company (a “PFIC”) with respect to which a taxpayer has a qualified electing fund (a “QEF”) election in effect is treated as an API. Therefore, the Proposed Regulations provide that a PFIC with respect to which the shareholder has a QEF election in effect is not treated as a corporation. This rule applies to all taxable years beginning after the date the Proposed Regulations are published.

Calculation Considerations

The Proposed Regulations clarify that certain items of income are not taken into account when determining gain or loss subject to the recharacterization rules since they do not depend on the holding period under Section 1222. These items include long-term capital gains determined under Sections 1231 and 1256 and qualified dividends described in Section 1(h)(11)(B). Capital gain dividends from regulated investment companies and real estate investment trusts are also excluded from the recharacterization rules to the extent attributable to capital assets held for more than three years or assets that are not subject to Section 1061, provided that the regulated investment company or real estate investment trust discloses information about the components of its capital gain dividends.

Related Party Transfer

Certain transfers of an API that would have otherwise been nontaxable (for example, transfers resulting from a gift) are no longer tax-free under the Proposed Regulations. Instead, if an API is transferred to a related party, the taxpayer looks to the hypothetical gain the taxpayer would be allocated if the partnership were to sell all of its assets in a hypothetical sale at fair market value. If any of this hypothetical gain is related to assets held for three years or less, the portion of that gain is included in gross income, as short-term capital gain.

Capital Interest Exception

The Proposed Regulations include an exception for gains derived by a taxpayer with respect to its capital interest in the partnership. However, for an interest to be treated as a capital interest rather than an API, the taxpayer must follow the Proposed Regulations' detailed requirements. These include that (1) allocations must be made in the same manner to all partners, subject to carve outs for preferred returns made to unrelated non-service partners and cost of services provided (e.g., management fees), (2) the allocations are made to unrelated non-service partners with a significant aggregate capital account balance (5 percent or more of the aggregate capital account balance of the partnership), and (3) the partnership agreement and the partnership's books and records clearly segregate the capital interest allocations from allocations with respect to APIs. Given the manner in which many private investment funds operate, the framework for determining this amount set forth in the Proposed Regulations may cause gain attributable to capital contributions to be subject to Section 1061(a). We expect that this provision will be the subject of taxpayers' comments because it does not appear to be consistent with the intent of the statute.

Other Guidance

The Proposed Regulations provide additional guidance, including, but not limited to, the following items:

- General computational rules for implementing the provision of Section 1061.
- Transition rules for pre-2018 gains, including pre-2018 installment sale gains.
- Rules regarding the definition of an applicable trade or business, including a requirement to consider all relevant business activities in the aggregate.
- Partnership reporting requirements for various Section 1061 items when a partner holds an API.

Applicability Date

The Proposed Regulations generally will apply to taxable years beginning on or after the date final regulations are published in the Federal Register. Taxpayers may rely on the Proposed Regulations for taxable years beginning before the date final regulations are published in the Federal Register, provided that they follow the Proposed Regulations in their entirety and in a consistent manner. Taxpayers may, however, rely on a transition rule for assets held for more than three years as of December 31, 2017 without having to follow the entirety of the Proposed Regulations.

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