

Proposed Carried Interest Regulations Leave Unanswered Questions

While the proposed carried interest regulations clarify key aspects, the proposed rules leave some ambiguity for investment fund managers.

Section 1061¹ is intended to limit long-term capital gain treatment attributable to “carried interest” arrangements issued to owners and employees of investment fund managers by imposing a three-year holding period requirement in lieu of a one-year holding period requirement to obtain favorable long-term capital gain rates. On July 31, 2020, the Treasury Department and Internal Revenue Service (together, Treasury) issued proposed regulations under Section 1061 (the Proposed Regulations).

Key Points:

- The Proposed Regulations broadly define an “applicable partnership interest” and provide detailed rules for the identification of taxpayers subject to the three-year holding period requirement for long-term capital gain treatment.
- The exception for “capital interests” is narrowly drafted and could cause gain from invested capital to be subject to the three-year holding period requirement.
- The relevant holding period for determining whether gain is reclassified as short-term capital gain is generally the holding period of the asset that is sold, which can provide planning opportunities.
- Section 1231 gains are excluded, which could cause sponsors to favor sales of assets of flow-through investments rather than sales of partnership interests or interests in blocker corporations.
- The preamble to the Proposed Regulations states that carry waivers can be subject to challenge under existing law, but further guidance is not provided.

Applicable Partnership Interests

In general, Section 1061(a) recharacterizes certain net long-term capital gain as short-term capital gain with respect to gain allocated to a taxpayer from an applicable partnership interest (API) by applying a three-year holding period instead of a one-year holding period to qualify for long-term capital gain treatment. An API is generally defined as any interest in a partnership which, directly or indirectly, is transferred to (or held 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).

Definition of Applicable Trade or Business

The Proposed Regulations provide that an ATB exists if the activities of the taxpayer (and all related persons²) of (1) raising or returning capital and (2) investing or developing “specified assets” are sufficient (when taken as a whole) to constitute a trade or business under Section 162. Specified assets include securities (*i.e.*, shares of a corporation, interests in publicly traded partnerships, and debt instruments), commodities, real estate held for rental or investment, options, derivative contracts, and partnership interests attributable to any of the foregoing. The Proposed Regulations aggregate the activities of the taxpayer and related persons, including any agents or delegates, to determine if an ATB exists. For example, the activities of a management company are attributed to the general partner if the management company is considered a related person to the general partner or if the management company provides management services on behalf of a general partner pursuant to a contractual arrangement.³ In addition, raising or returning capital do not need to occur in the same taxable year in which investing or developing activities are undertaken. If a taxpayer provides any services in an ATB and a profits interest is transferred in connection with those services, the services are presumed to be substantial.

Observation: The Proposed Regulations confirm that carried interest issued by private equity funds or hedge funds, as well as fee waiver profits interests, are treated as APIs.

API Exceptions

The Proposed Regulations provide for five exceptions to the definition of an API:

1. Partnership interest held by an employee of another entity not conducting an ATB

Consistent with the statute, an API does not include an interest transferred to a person that is only conducting services for, and employed by, one entity that is not engaged in an ATB.

2. Partnership interest held by a corporation (other than S corporations and qualifying electing funds)

An API does not include any interest held by a corporation. However, consistent with the IRS’s prior guidance,⁴ the Proposed Regulations provide that a corporation does not include an S corporation. The Proposed Regulations also exclude a passive foreign investment company (PFIC) for which a “qualified electing fund” (QEF) election has been made. These exclusions are intended to prevent taxpayers from avoiding the impact of Section 1061 by holding an interest in a partnership through a corporate entity in which the character of the income as short-term or long-term capital gain flows through to the taxpayer.

3. Capital interest gains and losses (with exclusion for borrowed amounts)

An API does not include a capital interest in a partnership that provides the taxpayer with a right to share in partnership capital commensurate with the capital contributed to the partnership. The Proposed Regulations narrowly interpret this exception in a number of respects.

The Proposed Regulations exclude from the capital contributed to a partnership any outstanding amounts a person borrows from — or that are guaranteed by — the management company, general partner, or another partner. This rule is only applicable while, and to the extent, amounts are borrowed.

Observation: Since the exclusion for borrowing is not in the Code, many taxpayers may be surprised by its incorporation in the Proposed Regulations, and the borrowing exception may be subject to challenge on the grounds that Treasury lacks the authority to implement this rule. As proposed, the capital interest exception would not be available for amounts borrowed under many common arrangements, such as if a management company loans money to an employee to invest in a fund or if an employee borrows from a third-party bank supported by a guarantee from the general partner or management company.

To qualify for the capital interest exemption in a typical fund structure in which the API holder receives a disproportionate share of profits as a result of its carried interest, an API holder's capital interest gains and losses must meet the following requirements:

- Allocations of capital gains and losses must be made by the underlying partnership in the same manner as third-party investors that are non-service partners. This requires that allocations with respect to the capital interest be made based on relative capital accounts and that the terms, priority, type and level of risk, rate of return, and rights to cash or property as current or liquidating distributions are the same for both API holders and non-service partners. The Proposed Regulations clarify that an API holder will not fail to satisfy this requirement solely because allocations to an API holder are not reduced by the cost of services (*e.g.*, a management fee).
- Third-party non-service partners must have a 5% or more aggregate capital account balance in the underlying partnership.
- Allocations to the API holder and third-party non-service partners in respect of their underlying capital interests must be clearly identified in both the partnership agreement and partnership's books and records as "separate and apart" from the allocations in respect of an API holder's underlying API.

Observation: Capital invested by the sponsor in many private equity funds may not meet the capital interest requirements, because funds allocate profit and losses on an investment-by-investment basis — which can differ from allocations based on relative capital accounts for a variety of reasons, including the admission of investors in separate closings at different times, investors being excused or excluded from specific investments, or other special allocations of expenses.

In addition, it is not clear whether a portion of the profit on the sponsor's own capital is treated as an API that does not satisfy the capital interest exception, even though sponsors do not typically charge carry on their own capital. An example in the Proposed Regulations suggests that the 20% "carried interest" percentage of profits earned on the sponsor's own capital is treated as an API subject to Section 1061.

The Proposed Regulations are also unclear regarding whether future allocations to a sponsor that are made on a pro rata basis with investors and are attributable to unrealized "book" gain in the sponsor's capital account will be subject to Section 1061. This scenario is common to many hedge funds that allocate unrealized appreciation to a sponsor's capital account through an incentive allocation (which is then able to participate in future gains and losses on a pro rata basis) or in joint ventures in which the sponsor's promote is "crystallized" into a partnership interest that participates ratably with the investors following a development period or other pre-defined event. Given the

importance of the capital interest exception and the uncertainty regarding its application in a number of common fact patterns, this exception is likely to be an area of significant focus during the comment process.

The Proposed Regulations further provide that capital interests in pass-through entities that either hold direct interests in assets, or hold interests in lower-tier partnerships that are attributable to allocations from investments made directly or indirectly by the pass-through entity (other than an API in the lower-tier partnership), may qualify for the capital interest exception, if the allocations are made in proportion to the capital account balances of all the partners in the pass-through entity.

Observation: This rule may permit fund managers to structure capital interests in underlying investments as coinvestment vehicles that participate alongside a main fund without having fund managers be issued capital interests indirectly through the main fund vehicle, thereby avoiding some of the additional requirements and ambiguity associated with holding APIs as a vehicle with third-party investors in which the partners do not have pro rata economic interests.

4. Partnership interests acquired by purchase by an unrelated taxpayer

Although not included in the Code, the Proposed Regulations contain an exception in the case of a purchase of an API for fair market value by an unrelated person. To qualify, the unrelated purchaser must not directly or indirectly provide, and is not anticipated to provide, services to the underlying partnership or any lower-tier partnership for which the target partnership holds an interest.

Observation: This exception is likely to be of particular relevance to financial institutions that acquire passive interests in general partners and management companies of private equity and hedge funds.

5. Family offices exception

Section 1061(b) authorizes Treasury to establish an exception to Section 1061 for gain attributable to any assets not held for portfolio investment on behalf of third-party investors. While the Proposed Regulations reserved on further rule making under this exception, the preamble to the Proposed Regulations states that this exception is already implemented in the capital interest exception rules with respect to allocations from capital interests in pass-through entities derived from direct investments by such pass-through entities other than APIs.

Observation: Comments likely will request explicit rules under Section 1061(b) for family offices, given that the existing capital interest exception in the Proposed Regulations generally would not provide relief from Section 1061, except in the case of partnership vehicles with pro rata economic interests among all the partners.

Calculation of the Recharacterization Amount

The Proposed Regulations contain a number of key clarifications for determining the amount of long-term capital gain subject to recharacterization under Section 1061:

Reference Holding Period

Identifying the level at which the relevant holding period is determined is critical to the application of Section 1061. The Proposed Regulations provide that the relevant holding period is the holding period of the person disposing of the asset, rather than the holding period of an API holder's respective API. As a result, so long as the entity disposing of the applicable asset has a holding period of greater than three years at the time of sale, Section 1061 would not apply even if carried interest recipients are issued APIs from an upper-tier partnership within the past three years. However, under a new look-through rule in the Proposed Regulations, if an API holder disposes of an API held for more than three years and 80% or more of the value of the assets held by the partnership at the time of such disposition are assets held for three years or less, a percentage of the gain or loss on the disposition of the API will be treated as not having more than a three-year holding period.

Observation: This rule (apart from the new look-through exceptions) is generally consistent with expectations of how Section 1061 should apply. This rule underscores the need for funds to consider the holding period of the asset being disposed of, as a different holding period can apply to different blocks of stock of a corporation or to the assets of a partnership versus the interests in a partnership. This consideration can also be important when making a follow-on investment in an existing portfolio company.

Excluded Gains and Income

The Proposed Regulations exclude the following types of gains and income from long-term capital gains subject to recharacterization under Section 1061:

- Gains and losses under Section 1231, which applies to gain on the sale of property used in an active trade or business, including real estate, oil and gas assets, and certain assets owned by operating partnerships
- Gains and losses from mark-to-market gains from certain futures and options contracts
- Qualified dividend income eligible for long-term capital gains rates
- Capital gains and losses characterized as short-term or long-term without regard to the underlying holding period of the asset
- Dividends attributable to the sale of capital assets from real estate investment trusts (REITs) and regulated investment companies (RICs), if the REIT or RIC discloses the amount of net capital gain from the disposition of assets with a holding period of more than three years

Observation: The exclusion of these items could cause sponsors to favor sales of assets that generate Section 1231 gains (as opposed to sales of partnership interests or interests in blocker corporations) and to favor leveraged recapitalizations that generate qualified dividend income over alternative transactions that generate short-term capital gain for the sponsor.

In-Kind Distributions

If a partnership distributes property in-kind to an API holder (Distributed API Property), the Proposed Regulations would taint the Distributed API Property and apply Section 1061 if the Distributed API Property is subsequently disposed of by the API holder or any intermediate pass-through entity. Once the Distributed API Property has a holding period of more than three years, Section 1061 would cease to apply.

Observation: The in-kind distribution rule is likely to be applicable if a private equity fund distributes marketable securities in-kind, as well as in certain general partner-led secondary transactions in which a general partner receives carry in-kind.

Transfers of APIs to Related Persons

Section 1061(d) generally triggers short-term capital gain on transfers to related persons. The Proposed Regulations clarify and apply Section 1061(d) to any direct or indirect transfer of an API or other Distributed API Property to a Section 1061(d) related person, which includes a member of the taxpayer's family or a pass-through entity in which the transferring taxpayer or person who performed services in the same ATB as the transferor is a partner. While the application of the statute was not entirely clear, the Proposed Regulations clarify that gain recognition is generally required even in the case of a transfer that would otherwise qualify for nonrecognition treatment. The term transfer includes, but is not limited to, any contribution, distribution, sale, exchange, or gift. These rules do not apply to a contribution to a partnership under Section 721(a) because the partnership would be required to allocate any unrealized gain and loss to the contributor under the principles of Section 704(c). However, the Proposed Regulations do not exclude other nonrecognition transactions to which Section 1061(d) should not apply based on similar policy reasons. Treasury requested comments on transfers other than Section 721(a) contributions that should be excluded from Section 1061(d).

Carried Interest Waivers

Of particular interest to fund sponsors, the Proposed Regulations do not explicitly address arrangements found in many fund agreements whereby a general partner may elect to waive or defer allocations and distributions of carried interest for capital gains that are subject to recharacterization under Section 1061 as a result of not meeting the three-year holding period requirement. Treasury, however, noted in the preamble to the Proposed Regulations that carried interest waivers and other similar arrangements may not be respected under existing US federal income tax law, either because such waiver arrangements create allocations that lack substantial economic effect or because they are subject to challenge under general economic substance doctrines.

Applicability Dates

The Proposed Regulations do not provide for retroactive applicability, other than in respect of the exception for APIs held through S corporations. Rather, the Proposed Regulations generally provide that final regulations will apply to taxable years beginning on or after the date final regulations are promulgated. Taxpayers may rely on the Proposed Regulations for taxable years beginning before the date final regulations are published, provided that taxpayers consistently apply the proposed rules.

Conclusion

Given the Proposed Regulations' complexity and narrow application in key aspects, they are likely to attract a number of comments from investment fund professionals. In particular, the capital interest exception to API treatment under the Proposed Regulations may be inapplicable to a number of common carried interest arrangements for private equity and hedge funds. Although Proposed Regulations are not final, investment fund sponsors should consider whether existing contractual language in governing fund documents permits amendments to key allocation and distribution provisions to address future regulatory changes.

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Endnotes

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- ¹ All references to "Section" refer to sections of the Internal Revenue Code of 1986, as amended (the Code), or the Treasury regulations promulgated thereunder.
 - ² The Proposed Regulations define "related persons" to include any person or entity that is related to the taxpayer under Sections 707(b) or 267(b).
 - ³ See Proposed Treasury Regulation Section 1.1061-2(a)(2), *Example 5*.
 - ⁴ Notice 2018-18, 2018-12 I.R.B. 443.