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Treasury and IRS Release Final Regulations Under the "Carried Interest" Rules of Section 1061

Final Regulations Largely Conform to Proposed Regulations, but with Taxpayer-Friendly Modifications

SUMMARY

On January 7, 2021, the Internal Revenue Service ("IRS") and the Treasury Department released final regulations (the "Final Regulations") under Section 1061 of the Internal Revenue Code (the "Code"),[1] a section which extends the holding period required for long-term capital gain treatment for holders of certain partnership interests from one year to three years. This rule is particularly important to the hedge fund and private equity industries.

The Final Regulations largely conform to the proposed regulations that were published on July 31, 2020 (the "Proposed Regulations") but make significant taxpayer-friendly modifications. These modifications focus on expanding the capital interest exception to Section 1061, limiting application of a lookthrough rule for dispositions of profits interests, and revising the rules for transfers of profits interests to related persons.

The Final Regulations generally apply to taxable years beginning on or after the date the Final Regulations are published in the *Federal Register*. Taxpayers may choose to apply the Final Regulations to taxable years beginning after December 31, 2017, provided they consistently apply the regulations in their entirety to that year and all subsequent years.

BACKGROUND

A taxpayer who is paid for services is generally taxed at ordinary income rates on the compensation received. In the case of a typical hedge fund or private equity fund structured as a partnership, the manager usually receives an interest in the profits of the fund (commonly referred to as "carried interest") in exchange for services. Under general principles of partnership taxation, the character of the fund's gains flow through to these partners. As a result, historically, when a fund recognized long-term capital gain, a portion of that gain was allocated to the manager and subject to tax at preferential long-term capital gains rates. In response to criticism of the "carried interest" treatment common in these industries, Congress enacted Section 1061 as part of the Tax Cuts and Jobs Act in 2017.

Section 1061 extends the holding period requirement for long-term capital gain treatment on specified assets—generally securities, certain real estate, and cash—from one year to three years, and operates by recharacterizing net gains recognized with respect to capital assets held for more than one year but not more than three years as short-term capital gains (the "Recharacterization Amount"). The rule applies to gain in respect of applicable partnership interests ("APIs") received in connection with the performance of substantial services by the taxpayer or a "Related Person" in an applicable trade or business (an "ATB"). A Related Person is any person or entity treated as related to the taxpayer under Section 707(b) or 267(b), while an ATB is any activity conducted on a regular, continuous, and substantial basis which consists of (i) raising or returning of capital, and (ii) either (x) investing in (or disposing of) specified assets (or identifying specified assets for such investing or disposition) or (y) developing specified assets.

Section 1061 applies both to APIs held directly by the taxpayer and to APIs held indirectly through one or more tiers of passthrough entities. The rule also applies to certain transfers of an API.

THE FINAL REGULATIONS

A. GENERAL FRAMEWORK

The Final Regulations adopt the general framework of the Proposed Regulations, the main aspects of which are addressed in this section.[2]

1. Applicable Partnership Interests

The definition of an API continues to track the statutory language, and the Final Regulations retain the rule that an interest in a partnership also includes any financial instrument or contract the value of which is determined in whole or in part by reference to the partnership. While an API must be received in respect of substantial services in an ATB, the Final Regulations also retain the proposed presumption that services are substantial with respect to the partnership interest transferred in exchange for such services. Additionally, once an interest is determined to be an API, it remains an API unless and until an exception to API treatment applies

Section 1061 itself provides for four statutory exceptions from the application of these rules, and the Proposed Regulations added a fifth exception, which is retained in the Final Regulations. Under these exceptions, Section 1061 generally will not apply to: (i) certain partnership interests held by employees of entities that are not engaged in an ATB; (ii) any partnership interest held directly or indirectly by a corporation;[3] (iii) certain capital interests in a partnership; (iv) to the extent provided in regulations, any income or gain attributable to an asset not held for portfolio investment on behalf of third-party investors;[4] or (v) certain partnership interests purchased by unrelated buyers for fair market value.[5] The Final Regulations significantly alter the capital interest exception as proposed, which we address below.

2. Recharacterization Amount

While the existence of an API is determined at the entity level, the Recharacterization Amount is determined at the level of the "Owner Taxpayer," or the person ultimately subject to federal income tax on net gain with respect to the API. In contrast, for purposes of determining whether a partnership interest is an API at all, the Final Regulations look to the entity or person receiving the partnership interest (the "API Holder"), which may be a lower-tier partnership.

The Recharacterization Amount—the amount the Owner Taxpayer must treat as short-term capital gain as a result of these rules—is equal to the excess of the Owner Taxpayer's "One Year Gain Amount" over the Owner Taxpayer's "Three Year Gain Amount." The One Year Gain Amount and Three Year Gain Amount each consist of the sum of the net amounts taken into account as distributive shares of partnership income and amounts recognized on the disposition of an API. Because these amounts are determined on a net basis, losses in respect of property held for more than one year but not more than three years can offset gains on such property from other entities.

a. Distributive Share Amounts

Each passthrough entity must calculate an "API One Year Distributive Share Amount" for each API Holder that owns a direct interest in such entity. The API One Year Distributive Share Amount is generally equal to the API Holder's distributive share of net long-term capital gain from the partnership, but excludes items of income taxed at long-term capital gains rates under special rules (rather than under the general holding period rule of Section 1222). Consistent with the Proposed Regulations, the API One Year Distributive Share Amount is calculated under the Final Regulations without regard to: (i) long-term capital gains and losses computed under Sections 1231 and 1256; (ii) qualified dividends; (iii) any other capital gain that is characterized as long-term or short-term without regard to the holding period rules of Section 1222; and (iv) capital interest gains and losses (as discussed in Section B.1 below).

The "API Three Year Distributive Share Amount" is then calculated by subtracting from the API One Year Distributive Share Amount amounts that would not have been treated as long-term capital gains and losses if a three-year holding period had been required for long-term treatment.

b. Disposition Amounts

Calculation of the "API One Year Disposition Amount" and the "API Three Year Disposition Amount" takes into account not only gains and losses from the disposition of an API, but also gains and losses from the disposition of certain property distributed with respect to an API. The Final Regulations clarify that, like the API One Year Distributive Share Amount, the API One Year Disposition Amount does not take into account any capital gain that would be characterized as long-term or short-term without regard to the holding period rules in Section 1222 if the partnership had sold such Distributed API Property.

The API One Year Disposition Amount is generally the combined net amount of long-term capital gains and losses recognized by the Owner Taxpayer upon the disposition of (i) all or part of an API (including gain or loss recognized in respect of distributions in excess of basis[6] or a reduction in the partner's liabilities)[7] held for more than one year and (ii) "Distributed API Property" that has a holding period of more than one year but not more than three years. Distributed API Property is any property distributed by a passthrough entity to an API Holder with respect to an API if the holding period of the asset in the API Holder's hands is three years or less at the time the API Holder disposes of the asset. However, Distributed API Property loses its character as such and is no longer subject to Section 1061 once the aggregate holding period of the asset exceeds three years.

The API Three Year Disposition Amount generally includes the long-term capital gain or loss from an Owner Taxpayer's disposition of an API (including gain or loss recognized in respect of distributions in excess of basis or a reduction in the partner's liabilities) held for more than three years.

3. Holding Period

The relevant holding period under the Final Regulations is the owner's holding period in the disposed-of asset. Therefore, where a partnership disposes of an asset (including an API), the relevant holding period is the partnership's. If the partnership held the relevant property for more than three years, gain on the disposition of that property allocated to an Owner Taxpayer can be long-term capital gain, even if the Owner Taxpayer has held its partnership interest for less than one year. Conversely, if the partnership disposes of property held for three years or less, gain allocated to an Owner Taxpayer will be short-term capital gain regardless of the Owner Taxpayer's holding period in its partnership interest. These results also apply to distributions of capital gain property because the holding period of an Owner Taxpayer in Distributed API Property includes the holding period of the distributing partnership. In contrast, where a partner disposes of an API, the relevant holding period is the partner's. Therefore, the entire gain on a partner's sale of an API is generally subject to recharacterization as short-term capital gain if the partner has held the API for three years or less.

B. MODIFICATIONS

The Final Regulations modify the Proposed Regulations in several important taxpayer-friendly respects. Specifically, the Final Regulations expand the capital interest exception, restrict application of a lookthrough rule for dispositions of APIs, and limit potential recharacterization with respect to transfers of APIs to related persons.

1. Capital Interests

The statute provides that certain capital interests are not APIs, and thus gains and losses in respect of such capital interests are excluded from the Recharacterization Amount calculations.

a. Capital Interest Allocations

Under the Proposed Regulations, the exception for allocations in respect of capital interests ("Capital Interest Allocations") required that: (i) allocations in respect of capital interests be made in the "same manner" to API Holders and "Unrelated Non-Service Partners" based on the relative capital accounts of the partners, and (ii) allocations be made to Unrelated Non-Service Partners with an aggregate capital account balance of five percent or more of the aggregate capital account balance of the partnership. For these purposes, an Unrelated Non-Service Partner is a partner that has never (i) provided services in the relevant ATB nor (ii) been related to any API Holder in the partnership or any person who has ever provided services in the relevant ATB.

The preamble to the Final Regulations (the "Preamble") acknowledges that the requirement that Capital Interest Allocations be made in accordance with partners' overall capital accounts does not properly reflect the commercial reality of how many funds make allocations and would thus prevent many API Holders from taking advantage of the capital interest exception. For example, many private equity and hedge funds use targeted allocations rather than allocations based on capital accounts. The IRS also acknowledged that the "same manner" requirement is inconsistent with typical arrangements in which fund managers and limited partners have different economic rights with respect to their respective capital interests, such as varying rights regarding tax distributions, allocations of expenses (e.g., managers typically are not required to pay any fees or carried interest), and/or liquidity rights.

In response, the Final Regulations eliminate the requirement that Capital Interest Allocations be made to all partners in the same manner based on respective capital accounts; instead, a Capital Interest Allocation will qualify for the capital interest exception if such allocation is made to an API Holder in a "similar manner" as Capital Interest Allocations are made to Unrelated Non-Service Partners[8] that represent five percent or more of the aggregate capital contributed to the partnership at the time the allocations are made. Both the "similar manner" test and the Unrelated Non-Service Partner requirement may be applied on either an investment-by-investment basis or on the basis of allocations made to a particular class of interests. Relevant factors for determining whether allocations among partners are made in a similar manner include:

(i) the amount and timing of capital contributed; (ii) the rate of return on capital contributed; (iii) the terms, priority, type and level of risk associated with capital contributed; and (iv) the rights to cash or property distributions during the partnership's operations and on liquidation.

In addition, the Final Regulations simplify the application of the capital interest exception to tiered partnership structures by eliminating the concepts of "Passthrough Interest Capital Allocations," "Passthrough Capital Allocations," and "Passthrough Interest Direct Investment Allocations." The Final Regulations provide that an allocation made to a passthrough entity that holds an API in a lower-tier passthrough entity will be eligible for capital interest treatment if made in accordance with the "similar manner" principles described above. For these purposes, a Capital Interest Allocation will be respected as such if it is properly allocated to the upper-tier entity's partners with respect to their capital interests in the upper-tier entity in a manner that is respected under Section 704(b) (taking into account the principles of Section 704(c)).

The Final Regulations also allow reinvested gains to qualify for capital interest treatment. If an API Holder is allocated long-term capital gain with respect to its API ("API Gain," and together with long-term capital loss so allocated, "API Gains and Losses"), to the extent that an amount equal to the API Gain is reinvested in the relevant passthrough entity by the API Holder—either by actual payment and re-contribution, or by retention at the passthrough entity level—that amount will be treated as a contribution to the passthrough entity in exchange for a capital interest that is generally eligible for the capital interest exception.

b. Unrealized API Gains and Losses

Like the Proposed Regulations, the Final Regulations preserve the character of any unrealized gains allocated to an API Holder, thereby preventing taxpayers from circumventing Section 1061 by converting an API to a capital interest. As such, any unrealized capital gains and losses that would be allocated to an API Holder with respect to its API if all relevant assets of the partnership were disposed of for fair market value in a taxable transaction ("Unrealized API Gains and Losses") are treated as API Gains and Losses subject to Section 1061 when recognized.

However, in order to determine Unrealized API Gains and Losses, the Proposed Regulations would have required mandatory revaluations of partnership property (solely for purposes of Section 1061) at each relevant passthrough entity in a tiered structure upon the occurrence of a revaluation or contribution. The Final Regulations eliminate this revaluation requirement in response to concerns that an upper-tier passthrough entity would not be able to require every uncontrolled lower-tier entity to revalue its assets. Instead, the Final Regulations require Unrealized API Gains and Losses to be determined according to the existing rules governing unrealized gains and losses, including Section 704(c) principles.

c. Capital Contributions Made with Loan Proceeds

Under the Proposed Regulations, the capital interest exception would not have applied to contributions that were attributable to a loan made or guaranteed by another partner, the partnership, or a Related Person with respect to any partner or the partnership. The Preamble notes concerns that this rule was overly restrictive and adverse to many business arrangements, such as the common practice of fund managers making loans to employees to enable them to invest in the manager's own investment funds. The Final Regulations relax this rule by allowing the capital interest exception to apply to individual service providers who remain personally liable for the repayment of a loan the proceeds of which are used to make a capital contribution. An individual service provider is treated as personally liable for these purposes only if (i) the loan is fully recourse to the individual; (ii) the individual has no right to reimbursement from any other person; and (iii) the loan is not guaranteed by any other person.

2. Lookthrough Rule

Under a special "Lookthrough Rule," gain from the sale of an API (or an interest in a lower-tier partnership) may be recharacterized as short-term gain to the extent attributable to assets of the partnership held for three years or less, even if the API is held for more than three years. The Proposed Regulations would have applied the Lookthrough Rule to two situations. First, in the case of an Owner Taxpayer that directly disposes of an API held for more than three years, the proposed Lookthrough Rule applied if at least 80 percent of the assets (by value) of the partnership have a holding period of three years or less (the "Substantially All Test"). Second, the proposed Lookthrough Rule applied to the disposition of an interest in a lower-tier passthrough entity if such interest was held for more than three years, and either (i) the passthrough entity has a holding period in an API of three years or less or (ii) the passthrough entity has a holding period in the API of more than three years but the assets of the entity in which the API is held meet the Substantially All Test.

In response to concerns about the compliance burden of this requirement in tiered partnership structures, the Final Regulations significantly limit application of the Lookthrough Rule. Under the Final Regulations, this rule applies only where, at the time of disposition of an API held for more than three years, (i) the API would have a holding period of three years or less if such holding period did not begin until the date that Unrelated Non-Service Partners are legally obligated to contribute substantial capital or property to the relevant partnership, or (ii) a transaction or series of transactions has occurred with a principal purpose of avoiding application of Section 1061. The Preamble explains that clause (i) is intended to prevent fund managers from circumventing Section 1061 by establishing partnerships and leaving them inactive for three years.

3. Transfers to Related Persons

Section 1061(d) requires recognition of gain upon the transfer of an API to a related person. Like the Proposed Regulations, the Final Regulations define a related person for these purposes as: (i) a member of the taxpayer's family (as defined in Section 318(a)); (ii) a person that performed services for the ATB within the current calendar year or the preceding three calendar year; or (iii) a passthrough entity to the extent that a person described in clause (i) or (ii) owns, directly or indirectly, an interest in such entity (in each case, a "Section 1061(d) Related Person").

The Proposed Regulations would have required gain recognition upon a transfer that otherwise qualifies for nonrecognition treatment. The Final Regulations narrow the rule to exclude transfers (including gifts) where gain is not otherwise recognized. The Preamble notes that in the absence of statutory language to the contrary, Section 1061(d) should be interpreted only as a recharacterization provision and not as a provision that accelerates gain recognition. As a result, and in a departure from the Proposed Regulations, a partnership's Section 731 distribution of an API to a Section 1061(d) Related Person no longer results in gain recognition.

The Final Regulations also provide that the amount of gain recharacterized under Section 1061(d) (the "Section 1061(d) Recharacterization Amount") is equal to the Owner Taxpayer's share of net long-term capital gain from assets held for three years or less that would be allocated to the Owner Taxpayer with respect to the transferred API if the partnership sold all of its assets for fair market value immediately prior to the transfer of the API. Additionally, the Final Regulations treat an Owner Taxpayer as transferring its share of an indirectly held API or Distributed API Property if such API or Distributed API Property is transferred by the API Holder to a Section 1061(d) Related Person.

C. APPLICABILITY DATE AND REQUEST FOR COMMENTS

The Final Regulations generally apply to taxable years beginning on or after the date the Final Regulations are published in the *Federal Register*. Taxpayers may choose to apply the Final Regulations to taxable years beginning after December 31, 2017, provided they consistently apply the regulations in their entirety to that year and all subsequent years.

The IRS and Treasury Department specifically invite comments on numerous aspects of the Final Regulations, including: application of the capital interest exception generally, to S-corporations, and to co-invest vehicles; application of the exception for any income or gain attributable to an asset not held for portfolio investment on behalf of third-party investors; whether a simplified method for calculating API Gains and Losses should apply for small partnerships; and the information collection requirements for Owner Taxpayers.

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ENDNOTES

[1] References herein to a "Section" are to sections of the Code and the Treasury regulations ("Treasury Regulations" or "Treas. Reg.") promulgated thereunder.

[2] For a more complete analysis of the Proposed Regulations, see our prior memorandum by clicking here.

[3] S-corporations and PFICs with respect to which a taxpayer has a qualified electing fund election in effect are not treated as corporations for this purpose and can thus hold APIs subject to Section 1061.

[4] The preamble to the Proposed Regulations explained that this exception was addressed by the proposed capital interest exception rules, and therefore the Proposed Regulations reserved with respect to the application of this exception. While the Final Regulations eliminate those rules and continue to reserve on this matter, the preamble to the Final Regulations notes that the Lookthrough Rule (discussed below) will not apply to the extent that gain recognized on the disposition of an API is attributable to assets not held for portfolio investment on behalf of third-party investors.

[5] This exception applies only if the buyer (i) has never provided services in the relevant ATB, (ii) does not expect to provide services in the future, and (iii) is not a Related Person with respect to someone who has ever provided services.

[6] *See* Section 731(a).

[7] *See* Section 752(b).

[8] The Final Regulations retain the Proposed Regulations' definition of Unrelated Non-Service Partners.

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