PROPOSED REGULATIONS ON CARRIED INTERESTS

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On July 31, 2020, the IRS issued proposed regulations ([REG-107213-18]) under Section 1061 of the Internal Revenue Code (the "Code") as required by Code Section 1061(f). The proposed regulations provide guidance on the application of Code Section 1061, and also include new regulations regarding the treatment of carried interests held by the partnership sponsor or through one or more tiered pass-through vehicles. Also, the proposed regulations contain new reporting rules.

Once the proposed regulations are finalized, they generally will apply to taxable years beginning on or after the date on which the final regulations are published, but taxpayers may rely on the proposed regulations, provided they follow the proposed regulations in their entirety and in a consistent manner. Penalties may apply to partnerships that fail to comply with the reporting rules set forth in the proposed regulations and as further required in forms, instructions, or other guidance.

SUMMARY Code Section 1061 contains special rules to recharacterize the capital gains derived by a partner with a carried interest as short-term capital gains, the result being that such capital gains are taxed as ordinary income. A carried interest is a disproportionate profit sharing of a partner in a partnership in exchange for his services. In the case of a partnership where the general partner has a carried interest and such partner is owned by an individual, that is bad news because of the gap between the individual income tax rate and the capital gain tax rate. If the partner who holds the carried interest is a partnership, it would be taxed at the rate of 37% rather than the capital gain tax rate of 20%. In order to avoid being taxed as ordinary income, the general partner or sponsor would be required to hold the carried interest for at least three years. Alternatively, if the general partner is a corporation, then there is no substantial problem as the tax rate for ordinary income of corporations is currently at 21%. There may be a problem if and when dividends are distributed because of the dividend tax applicable in the case of C corporations.

Code Section 1061 re-characterizes as short-term gain the difference between a taxpayer's net long-term capital gain with respect to one (or more) applicable profit interest ("API"), as well as the taxpayer's net long-term capital gain with respect to these APIs if Code Section 1222(3) and (4) regarding the definition of long-term capital gain or net long-term capital loss are applied using a three-year holding period instead of a one-year holding period. Under the proposed regulations, an API is defined as an interest in a partnership that is transferred or held in connection with the performance of services.

BACKGROUND

A private equity fund will typically incentivize its manager with the grant of a "carried interest" in the fund, whereby the manager (the "general partner") is allowed to participate in profits of the fund disproportionally to its invested capital. Historically, the general partner would be taxed in the same manner as taxable limited partners in a fund. Same kind of profits interests are created in hedge funds and other investment vehicles. In the case of a private equity fund, the fund's income allocable to the limited partners and the general partner would retain its fund-level character as either ordinary income or capital gain. Fund investments are typically structured so that the vast majority of the fund's income qualifies as long-term capital gain, provided such investments are held for more than one year as of the time of sale or other disposition. Accordingly, a general partner's distributive share of a fund's income has historically been comprised primarily of long-term capital gains.

Before the enactment of Code Section 1061, the tax treatment of a profits interest in s-partnership was generally governed by Revenue Procedure 93-27. Under Revenue Procedure 93-27, a "profits interest" is a partnership interest that does not entitle the holder to a share of the proceeds if partnership assets are sold for their fair market value and the net sale proceeds are distributed to the partners in liquidation. If the partnership interest qualifies as a profits interest, the service provider is not taxed upon receipt, the interest is treated as a capital asset in the hands of the service provider, and the service provider is considered a partner and as such is issued a K-1 Statement. The IRS detailed three exceptions to this general treatment. One of the exceptions required is for the service provider to hold the investment for a two-year period. From the standpoint of Code Section 1061, the two-year holding period only matters if the partnership interest is subject to vesting and no Code Section 83(b) election is made. The greatest risk of a disposition of an unvested profits interest within the two-year period is that the proceeds will be taxable as compensation under Code Section 83. In the pre-Code Section 1061 era, if the plan included the possible sale or redemption of the carried interest during the first 24 months, a reasonably safe approach would have been to have the service provider contribute, for example, $1,000 in connection with the issuance of the interest. The interest would then be a capital interest subject to immediate taxation under Code Section 83, but the service provider would take the position that the value of the interest at the time of issuance was only $1,000.

Code Section 1061 was added in 2017 by the Tax Cuts and Jobs Act to prevent partners in a partnership from recharacterizing income attributable to the performance of services as long-term capital gains. Under Code Section 1061, corporations holding carried interests are not subject to the Code Section 1061 three-year holding period requirement. The IRS also has clarified in Notice 2018-18 that S corporations are subject to Code Section 1061.

The capital interest portion of a partnership interest is not an API. For example, if a hedge fund professional is issued a capital interest, its pro rata share of profits based on invested capital is not an API. For purposes of Code Section 1061, a “capital interest” is defined to include “any capital interest in the partnership which provides the taxpayer with a right to share in partnership capital commensurate with (i) the amount of capital contributed (determined at the time of receipt of the partnership interest), or (ii) the value of such interest subject to tax under Code Section 83 upon the receipt or vesting of such interest. For example, if a hedge fund manager and four investors each contributes $1 million in exchange for 20% LLC interests, then the hedge fund professional’s interest would not be an API. However, if in addition to the $1 million, the hedge fund manager is issued an additional 20% carried interest in profits, this would be deemed a carried interest and would be subject to Code Section 1061.

The carried interest rule under Code Section 1061 increases the holding period required for long-term capital gains treatment (set forth in Code Section 1222) from more than one year to more than three years for an API. This rule mostly affects hedge fund managers and private equity fund general partners and real estate developers where the sponsor or manager has a carried interest. Code Section 1061 does not change the tax treatment of carried interests. Profits interests, including carried interests, continue to be nontaxable at the time of issuance. Subject to the new three-year holding period under Code Section 1061, the holder of a carried interest continues to enjoy long-term capital gains treatment (not subject to employment taxes) from the sale of partnership assets, or the sale or redemption of the carried interest.

WHAT IS A CARRIED INTEREST?

A carried interest is a typical way to compensate a sponsor or manager of a partnership (including an S corporation) for its entrepreneurial work for the company and allocate an additional profit to such person disproportionate to its capital investment upon the sale of the underlying asset.

Code Section 1061 potentially treats the portion of the interest that would otherwise be defined as a profits interest (using the Revenue Procedure 93-27 test) as an API subject to the three-year holding period requirement. It is worth keeping in mind that while not all profits interests are APIs for purposes of Code Section 1061, all APIs will have the economic features associated with a profits interest. A difference between a profits interest and an API is that Revenue Procedure 93-27 doesn't contemplate splitting an interest into separate "capital interest" and "profits interest" components.

TAX TREATMENT OF A CARRIED INTEREST

If an interest falls within the scope of an API, then gain on the sale of capital assets will be recharacterized as short-term capital gains unless the holder satisfies the more than three-year holding period requirement. This more-than-three-year holding period requirement potentially applies to both the sale of the capital assets by the partnership (i.e., with respect to gain passing through on a K-1 Statement) and the sale of the profits interest.

If an API is sold after being held for fewer than three years, Code Section 751 would apply to treat any gain on the partnership property as ordinary income (e.g., depreciation recapture, inventory or depreciable real estate held for less than a year) and the balance of the gain would be treated under Code Section 1061 as short-term capital gains.

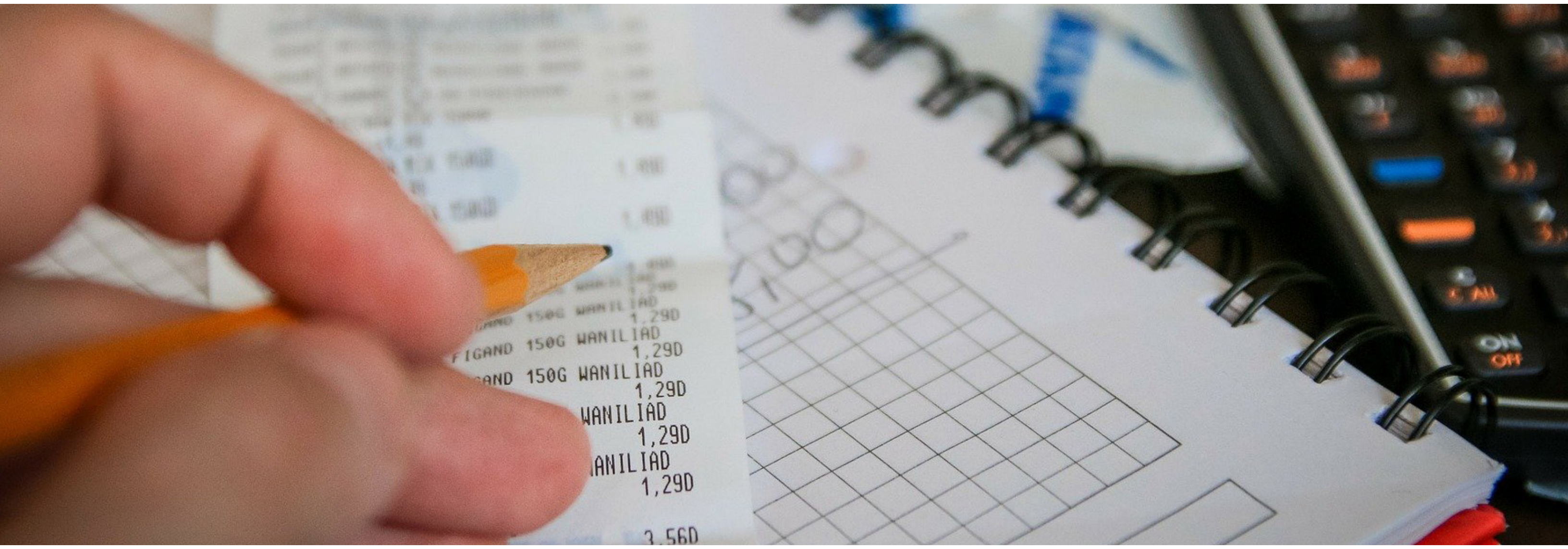
If a partnership sells a capital asset with a holding period of 24 months, partners would typically be entitled to long-term capital gains treatment on the income passing through on their K-1 statements. But if a partner is holding an API, this gain passing through would be short-term capital gains regardless of whether the holder's interest has satisfied the more-than-three-year holding period requirement.

HIGHLIGHTS OF THE PROPOSED REGULATIONS

The proposed regulations take some surprising positions in connection with profit interests of sponsors and managers, and create a new look-through approach for certain dispositions of partnership interests subject to these rules.

The following summarizes the key points of the Proposed Regulations.

- **Gains Excluded From Section 1061** - The proposed regulations provide that Section 1061 does not apply to any capital gain that is characterized as long-term or short-term without regard to the holding period rules of Code Section 1222. As a result, Code Section 1231 gains, Section 1256 gains and qualified dividends are not subject to the recharacterization rules of Section 1061.
- **Substantial Services Presumption** - A partnership interest is an API if it is transferred in connection with the performance of “substantial services.” The proposed regulations presume that services are substantial with respect to the partnership interest transferred in connection with those services. “This presumption is based on the assumption that the parties have economically equated the services performed with the potential value of the partnership interest transferred.”
- **Maintaining API Status** - The proposed regulations provide that once a partnership interest is characterized as an API, it remains an API and never loses that characteristic unless and until an exception applies. Thus, “even after a partner retires and provides no further services, if the retired partner continues to hold the partnership interest, it remains an API. Further, an API remains an API if it is contributed to another pass-through entity or a trust or is held by an estate.
- **Treatment of an S Corporation as a Partnership for Purposes of Code Section 1061** - The proposed regulations provide the same ruling of the IRS that a partnership interest held by an S corporation will be treated as an API if the interest otherwise meets the definition of an API.



- **Transfers to Related Persons** - According to Code Section 1061(d), if a taxpayer transfers an API to a related person in a transfer that would not otherwise be a taxable event, the taxpayer must include certain capital gain in gross income as short-term capital gain. A "related person" is defined as a member of the taxpayer's family (within the meaning of Code Section 318(a)(1)) or a person who performed a service within the current calendar year or the preceding three calendar years in any active trade or business in which or for which the taxpayer performed a service. In other words, a related person is a family member (i.e., parents, spouse, children, and grandchildren) or a colleague (or recent former colleague).

  The amount of gain required to be included in gross income as short-term capital gain is essentially equal to the partner's share of the net, built-in long-term capital gain in the partnership's assets that have been held for fewer than three years.

  The proposed regulations define the term "transfer" to include contributions, distributions, sales and exchanges, and gifts. However, a contribution to a partnership that qualifies for non-recognition treatment under Code Section 721(a) is not treated as a transfer for purposes of Code Section 1061, because any unrealized gains associated with the contributed API interest will be allocated to the contributing partner when they are actually recognized.

  The proposed regulations also provide that if the basis of the transferred API in the transferee's hands is determined in whole or in part by the basis of the API in the transferor's hands (before application of Code Section 1061), then the basis of the transferred API shall be increased by the capital gain included in gross income by the transferor solely by reason of Code Section 1061.

- **Sales of Fund Assets and In-Kind Distributions** - For purposes of calculating the sponsor's holding period of an API, the proposed regulations look to the holding period of the owner of the asset sold. Thus, where a fund sells an asset, regardless of the general partner's holding period in its fund interests, the fund's holding period in the asset will determine whether or not long-term capital gain treatment is available for the general partner.

- The proposed regulations also acknowledge that a distribution of property in-kind to a general partner in respect of its carried interest will not accelerate gain recognition under the three-year holding period rules. However, if the general partner subsequently disposes of such property when it has a holding period of less than three years, the three-year holding period rules will recharacterize any capital gain from the disposition of such property as short-term capital gain. Once the holding period in a distributed property exceeds three years, long-term capital gain treatment would be available to the general partner in respect of such distributed property.
- **Sales or Dispositions of an API** - Under the proposed regulations, unless certain look-through exceptions apply (described below), the three-year holding period rules are applied at the partner level in connection with the sale of a partnership interest. For example, if an individual holds an interest in a general partner and sells a portion of such interest, the general rule is that the individual's holding period in the general partner controls for purposes of applying the three-year holding period rules. If, however, 80 percent or more of the assets (based on fair market value) of a fund in which the general partner holds its carried interest are comprised of certain assets that have a holding period to such fund of three-years or less, then even if the individual held the interest in the general partner for more than three-years, and the general partner held its carried interest in the fund for more than three-years, all or a portion of the gain from the sale of such individual's interest in the general partner would be recharacterized as short-term capital gain.
- **Capital Interest Exception** - As discussed above, Section 1061 of the Code provides that capital interests in a partnership are not subject to the three-year holding period rules (the "Capital Interest Exception"). In determining what qualifies as a "capital interest" for the purposes of qualifying for the Capital Interest Exception, the proposed regulations look to capital account balances and allocations to determine whether an interest in a fund is eligible for the Capital Interest Exception by generally comparing sponsor interests to unrelated Limited Partner interests.
- **REIT and RIC Look-Through Rules** - The proposed regulations also include special rules for REIT and RIC capital gain dividends and require a REIT or a RIC to report whether the REIT's or RIC's holding period in the property that it sold to generate the capital gains dividend was less than three years. Any such capital gain dividend

allocable to the general partner would be subject to recharacterization as short-term capital gain.

- **Reporting Requirements** - A partnership in which a taxpayer holds an API is required to provide the taxpayer with the information necessary for the taxpayer to comply with Code Section 1061. The proposed regulations provide that this information includes:
  - The API one-year distributive share amount;
  - The three-year distributive share amount;
  - The long-term capital gains and losses allocated to the taxpayer that are excluded from Code Section 1061 under the proposed regulations;
  - The capital interest gains and losses allocated to the taxpayer;
  - The API holder transition amounts; and
  - In the case of a disposition by the API holder of an interest in the partnership during the taxable year, any information required by the taxpayer to properly take the disposition into account under Code Section 1061.

CONCLUSION

Any sponsor or manager of any asset-backed security partnership or S corporation should start applying the rules under Code Section 1061 and the proposed regulations with respect to the recharacterization of long-term gains or losses under Code Section 1222 as long-term gains or losses under Code Section 1065.

Therefore, if the proposed regulations are finalized as drafted, many sponsors may need to reevaluate how they structure their capital interests in respect of hedge funds, private equity partnerships and real estate investment conduits.

Although the proposed regulations do not specifically address the validity of carry deferral or waiver mechanisms that sponsors and manager commonly employ with a view toward meeting the three-year holding period rule, the preamble to the proposed regulations does note that taxpayers should be aware that such arrangements could be challenged under existing law and IRS guidance depending on the applicable facts and circumstances.

Sponsors and managers may need to review the holding of carried interest indirectly through pass-thru vehicles and be aware that these gains can be recharacterized as short-term gains. Same consideration should be given to the holding of carried interest through related parties. One alternative would be to explore how the tax treatment can be changed by interposing a blocker corporation between the final sponsor and the partnership.

Finally, partnerships subject to the proposed regulations should be aware of the new reporting requirements and seek compliance with these rules.

*For further information about the proposed regulations on carried interests, or to learn more about BurgherGray's experience with similar transactions and, thus, our ability to be a legal services partner in connection with the structuring or restructuring and relevant tax treatment of carried interests in hedge funds, private equity funds or other type of asset-backed investments and securities, please contact Augusto Egoavil (**aegoavil@burghergray.com**) or Gopal M. Burgher (**gburgher@burghergray.com**), each of whom can also be reached by telephone at (646) 513-3231.*