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Newly Issued Proposed Treasury Regulations Provide Clarity on the Tax Treatment for Carried Interest and Promotes

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On July 31, 2020, the U.S. Department of Treasury published proposed regulations providing guidance under Section 1061 of the Internal Revenue Code of 1986 ("Code"), relating to taxation of so-called "carried interest" or "promote." Code Section 1061 was added by the 2017 Tax Cuts and Jobs Act (the "TCJA") and sets forth special three-year holding period rules that apply to certain types of carried interest and profits interests. The new holding period means that these interests must be held for three years (rather than the usual one year) before they can receive long-term capital gains tax treatment. While it was clear that Code Section 1061 applied to some, but not all, interests issued in limited liability companies and limited partnerships that were issued in exchange for something other than in connection with the contribution of cash or other property, the exact scope of the new law was unclear.

Overall, the proposed regulations are consistent with taxpayer and practitioner expectations. However, certain aspects of these proposed regulations set forth rules for applying Code Section 1061 that are more stringent than anticipated.

The following is intended to be only a high-level summary of the proposed regulations and a discussion regarding the types of taxpayers these proposed regulations and could affect how carried interest and profits interests may be structured in the future. While the proposed regulations might cause certain managers of real estate and certain real estate-related funds to breathe a sigh of relief, the proposed regulations do no favors to hedge fund managers and managers of funds with short-lived assets and might alter how private equity managers allocate their gains and losses.

Section 1061 Background

The legislative history of Code Section 1061 indicates that this Code Section was included in the TCJA to address the perceived "carried interest loophole" which allowed capital gain treatment on payments that arguably were being made in connection with the performance of services. However, Code Section 1061 casts a narrow reach and applies only to limited liability company and limited partnership interests that are "applicable partnership interests" ("API") in an "applicable trade or business" ("ATB"). Thus, if an interest in a limited liability company or a limited partnership is not an API, or if it is an API but the underlying entity is not an ATB, the special three-year holding period would not apply.

Definition of an "Applicable Partnership Interest"

Code Section 1061 defines an API as any interest in a partnership which, directly or indirectly, is transferred to (or is held by) the taxpayer in connection with the performance of substantial services by the taxpayer, or any other related person, in any ATB. Code Section 1061 also provides that an interest in a partnership held by a corporation (directly or indirectly) is not treated as an API. Similarly, a capital interest in a partnership which provides the taxpayer with a right to share in partnership capital commensurate with either (i) the amount of capital contributed (determined at the time the interest is received), or (ii) the value of the interest subject to tax under Code Section 83 upon the receipt or vesting of that interest, is not treated as an API for purposes of Code Section 1061.

The proposed regulations refine the definition of an API in a manner that, among other things, accounts for interim pass-through entities and related persons. The proposed regulations also provide a few exceptions to the API (see various API Exceptions below). The proposed regulations provide that an API remains an API unless and until one of the exceptions applies.

An Overview of the Various Clarifications to the API Definition Set Forth in the Proposed Regulations

1. *Section 1231 and Section 1256 Exclusions.*

The proposed regulations confirm the general (but not universal) expectation that Section 1061 does not apply to various types of income that otherwise qualify for long-term capital gain tax rates without reference to holding period rules. These include Section 1231 gains from depreciable or real property used in a trade or business, gains on derivatives and other financial instruments that are marked to market under Section 1256, qualified dividend income and capital gain characterized under the identified mixed straddle rules.

This exclusion from Section 1061 treatment for Section 1231 gains will apply to most, but not all real estate activities. As a result, the clarification of how Code Section 1061 applies to Section 1231 gain should not be read as a blanket exclusion of all real estate partnerships from Code Section 1061 treatment.

2. *Narrowing the API Exception for Interests Held by Corporations for Interests Held by S Corporations and certain Passive Foreign Investment Corporations ("PFICs").*

Code Section 1061 provides that a carried interest held by a corporation will not be treated as an API. Nevertheless, consistent with prior guidance in Notice 2018-18, the proposed regulations provide that Section 1061 applies to an API held by an S corporation. Similarly, the proposed regulations provide that Section 1061 cannot be avoided by holding a carried interest through a PFIC that that has a

qualified electing fund (QEF) election in effect. While these rules can be viewed as being in conflict with the plan language of Code Section 1061, the U.S. Department of Treasury claims that it has the legal authority to issue these rules. Moreover, these rules are effective as of the effective date of Code Section 1061, so taxpayers who tried to avoid the application of Section 1061 by using an S corporation or PFIC are in for a rude surprise.

3. *Capital Interests.*

Section 1061 does not apply to gain attributable to a "capital interest" which provides the taxpayer with a right to share in partnership capital "commensurate" with the amount of capital contributed (or amount included in income by the taxpayer upon receipt or vesting of such capital interest). This rule is narrow and seems to provide that capital interest allocations will generally only be respected if they "fit" the capital economics among the partners (e.g., accounting for relative capital accounts, priority, level of risk, rate of return, etc.)

4. *API Exception for Partnership Interest Held by an Employee of Another Entity that is not Conducting an ATB.*

The proposed regulations provide that a partnership interest transferred to an employee of another entity will not constitute an API if the entity does not conduct an ATB and the employee provides services only to the employer entity.

5. *API Exception for Partnership Interests Acquired by Purchase by an Unrelated Taxpayer.*

A taxpayer will not be treated as acquiring an API when purchasing a partnership interest for fair market value if the buyer has not and will not provide, services to the partnership or relevant ATB.

6. *API Exception for Family Offices.*

The proposed regulations reserve for later guidance rules implementing Section 1061(b) (which provides that gain re-characterization shall not apply to gain attributable to any asset not held for portfolio investment on behalf of third-party investors) but does seem to endorse that this exception is intended to apply to family offices.

Definition of an "Applicable Trade or Business"

An ATB is defined in Code Section 1061 as any activity conducted on a regular, continuous and substantial basis which, regardless of whether the activity is conducted in one or more entities, consists (in whole or part) of raising or returning capital and either investing in or disposing of specified assets (or identifying specified assets for such investing or disposition) or developing specified assets.

For purposes of determining whether an activity is an ATB, Code Section 1061 defines the term "Specified Assets" as one of the following:

(A) a security which is a: (i) share of corporate stock, (ii) partnership interest (or beneficial ownership interest) in a widely held or publicly traded partnership or trust, (iii) note, bond, debenture, or other evidence of indebtedness, (iv) interest rate, currency, or equity notional principal contract, (v) interest in, or derivative financial instrument in, any such security or any currency (regardless of whether Code Section 1256 applies to the contract) and (vi) position that is not such a security and is a hedge

with respect to such a security and is clearly identified, (B) a commodity which is: (i) actively traded, (ii) a notional principal contract with respect to such a commodity, (iii) an interest in, or derivative financial instrument in, such a commodity or notional principal contract, or (iv) position that is not such a commodity and is a hedge with respect to such a commodity, (C) cash or cash equivalents, (D) options or derivative contracts with respect to any of the foregoing and (E) an interest in a partnership to the extent of the partnership's proportionate interest in any of the foregoing.

The proposed regulations provide additional guidance on what activities will be treated as an ATB by including an “ATB Activity Test.” The “ATB Activity Test” is satisfied if Specified Actions are conducted with respect to Specified Assets in a manner which would constitute a “trade or business” under Code Section 162. For purposes of the “ATB Activity Test,” the proposed regulations define a “Specified Action” as the raising or returning capital and investing in (or disposing of), or developing, certain Specified Assets.

The Proposed Regulations Provide Guidance on the Dispositions of an Asset

The proposed regulations confirm that the relevant holding period is generally measured based on the time the seller has held the API. However, the proposed regulations provide two “lookthrough” rules. The first rule applies where 80% or more of the fair market value of the assets of the applicable partnership consists of capital assets with a holding period of three years or less. The second applies when testing against tiered partnership structures. In each case, the taxpayer may be denied long term capital gain treatment even though it has held its interest for three years.

The proposed regulations also subject certain related party transfers to a special gain recognition rule whereby the seller would recognize short-term capital gain equal to the aggregate appreciation in assets with a holding period of less than three years, even if the transfer would not otherwise be taxable. Notably, though, the related party transfer rules do not apply in a Section 721 contribution to a partnership.

Additional Issues Addressed in the Proposed Regulations

Installment Sale Gain.

The proposed regulations provide that Section 1061 cannot be avoided through the use of the installment method for deferring gain. This is consistent with the ‘normal’ rules applicable to the sale of capital assets that have not been held for more than one year, where the character of the income is set at the time of the original sale.

Allocation Waivers.

The proposed regulations do not address the implications of waiving or deferring allocations that would otherwise be treated as short-term capital gain due to Code Section 1061. That said, the preamble signals that some such arrangements are subject to challenge under Code Section 702, the substance over form doctrine and the economic substance doctrine.

Reporting Obligations.

The proposed regulations establish heightened reporting requirements on taxpayers who directly or indirectly hold APIs as well as on the partnerships that issue APIs, with noncompliance possibly resulting in penalties and gain recharacterization.

Conclusion

The proposed regulations provide long-anticipated guidance regarding the application of Code Section 1061. In many ways, the proposed regulations confirm expectations regarding how the rules of Code Section 1061 would be applied. Unfortunately, there are many unresolved issues related to how Code Section 1061 applies in various situations and, in certain instances, the proposed regulations are more restrictive than anticipated.

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