IRS Issues Proposed Carried Interest Regulations for Recharacterizing Certain Capital Gains from Investment Partnerships

On July 31, 2020, the US Internal Revenue Service (the "IRS") issued long-awaited proposed regulations (the "Proposed Regulations") providing guidance under Section 1061 of the Internal Revenue Code of 1986, as amended (the "Code"). The Proposed Regulations are of interest to taxpayers that engage in investment activity through private investment fund partnerships and other joint venture arrangements.

Background

A carried interest generally refers to a profits interest in a partnership that is issued in connection with the performance of services, typically representing a fund sponsor or other service provider's incentive compensation for meeting targeted performance goals. For carried interest received from certain investment partnerships, the 2017 Tax Cuts and Jobs Act introduced a three-year holding period requirement in order to qualify for long-term capital gain treatment. Capital gain received as carried interest that does not satisfy the three year holding period requirement is treated as short-term capital gain and taxed at higher ordinary income tax rates.

The Proposed Regulations provide guidance for identifying the types of partnership interests and underlying trades or businesses that are subject to the three-year holding period requirement. The Proposed Regulations also outline various exceptions and provide detailed operational rules for calculating the amount of gain that is recharacterized as short-term capital gain. In addition, the Proposed Regulations establish rules for accelerating and recharacterizing built-in gain inherent in carried interests that are transferred to related parties, even for certain transfers that would not otherwise be taxable events. Finally, the Proposed Regulations include rules for providing reporting information necessary for taxpayers to comply with Section 1061.

Key Definitions

Applicable Partnership Interests. Section 1061 applies to any applicable partnership interest ("API"), which is an interest in a partnership that, directly or indirectly, is transferred to (or held by) a taxpayer in connection with the performance of substantial services by the taxpayer, or by any other related person, in any applicable trade or business ("ATB").[1] An API may be held indirectly through one or more tiers of pass-through entities, including partnerships, S corporations, or any passive foreign investment company with respect to which a qualified electing fund election is in effect. For this purpose, 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. Once a partnership interest qualifies as an API, the interest remains an API unless and until an exception applies. For example, if a general partner holding a carried interest in an investment partnership retires and retains its carried interest but ceases providing services to the partnership, the interest remains an API even after the general partner retires.[2]

Applicable Trades or Businesses. For a partnership interest to be an API, the interest must be held or transferred in connection with the performance of services in an ATB. An ATB is any activity that meets the "ATB Activity Test" with respect to "Specified Actions."

ATB Activity Test. The ATB Activity Test is met if Specified Actions are conducted by one or more related persons and the total level of combined activities is sufficient to establish a trade or business under Section 162. The Proposed Regulations bifurcate activities that constitute Specified Actions into two broad categories: (1) raising or returning capital actions and (2) investing or developing actions. Investing or developing actions must be conducted with respect to "Specified Assets," which include commodities, real estate held for rental or investment, cash or cash equivalents, or interests in partnerships to the extent the partnership holds Specified Assets. However, management of working capital assets is not taken into account for purposes of the ATB Activity Test. It is not necessary to conduct both categories of actions each year in order to satisfy the ATB Activity Test. For example, taking a small number of actions to raise capital for new investments combined with taking numerous actions to make or manage new or existing investments are both taken into account and may be sufficient to satisfy the ATB Activity Test.[3] The Proposed Regulations also provide that actions of related persons (including recent former colleagues) and of agents or delegates are taken into account. Consequently, where a fund general partner contracts with a management company to provide services to the fund on the general partner's behalf, the actions of the management company will be attributed to the general partner.[4]

API Gains and Losses. API Gains and Losses refer to any long-term capital gains and losses with respect to an API and are the amounts that factor into the calculation of how much of a taxpayer's long-term capital gain will be recharacterized as short-term capital gain (i.e., the Recharacterization Amount). All long-term capital gains and losses with respect to a taxpayer's APIs are aggregated for this purpose, including the taxpayer's distributive shares of gain or loss from all APIs and the taxpayer's gain or loss from the disposition of APIs held during the year. Certain types of capital gains are excluded from a taxpayer's API Gains and Losses, perhaps most notably Section 1231 gains earned by many real estate partnerships and Section 1256 gains earned by many hedge fund partnerships. Other exclusions apply for gains and losses that are attributable to assets held for more than three years as of January 1, 2018 if the applicable partnership has elected to apply a transition rule. As noted below, a capital interest in a partnership is excluded from the definition of an API, and thus gains and losses received with respect to capital interests in partnerships are not API Gains and Losses.

Interaction with Revenue Procedures 93-27 and 2001-43

Revenue Procedure 93-27 defines a profits interest and provides a safe harbor pursuant to which the receipt of a profits interest is not treated as a taxable event. Revenue Procedure 2001-43 clarifies Revenue Procedure 93-27 and provides guidance on the treatment of grants of profits interests that are substantially nonvested at the time of issuance. The Proposed Regulations state that Section 1061 applies to all partnership interests that meet the definition of an API, regardless of whether the receipt of the issuance is a taxable event under Revenue Procedure 93-27. The Proposed Regulations also state that no inference should be drawn as to the application of Revenue Procedure 93-27 to arrangements where one party provides services and another party receives a an associated carried interest allocation. It appears the intention of this statement is to decouple the application of the Proposed Regulations to a carried interest from the IRS's 2015 proposal to modify the safe harbor set forth in Revenue Procedure 93-27 such that the safe harbor would not apply to fee waivers that benefit a related party.

Exceptions to the Definition of an API

Section 1061 provides four statutory exceptions to its application. The Proposed Regulations provide an additional exception.

Interests Held by Employees of Other Entities. The statute provides that an API does not include any interest transferred to or held by a person who is employed by another entity that is conducting a trade or business (other than an ATB) and only provides services to such other entity.[5] The Proposed Regulations track the statutory language.

Interests Held by Corporations. The statute provides that an API does not include any interest directly or indirectly held by a corporation.[6] Consistent with Notice 2018-18, the Proposed Regulations take the position that the corporate exception does not include S corporations and a taxpayer may not avoid the application of Section 1061 through the use of an S corporation.[7] This position is controversial and is likely to be challenged.

Additionally, under the Proposed Regulations, a partnership interest held by a passive foreign investment company ("PFIC") with respect to which the taxpayer has a qualified election fund ("QEF") election is treated as an API if the interest meets the API definition.[8] Generally, a US shareholder of a PFIC is subject to interest charges with respect to certain PFIC distributions and dispositions of PFIC shares. However, if the US shareholder makes an election to treat the PFIC as a QEF, the shareholder generally will not be subject to the interest charge regime and will instead include in income each taxable year its pro rata share of the ordinary income and long-term capital gain of the QEF.

To prevent taxpayers from using PFICs with respect to which QEF elections have been made to avoid the application of Section 1061, the Proposed Regulations take the position that a PFIC with respect to which the shareholder has a QEF election in effect is not treated as corporation for purposes of the corporate holder exception. As a result, the regulations treat a partnership interest held by a PFIC with respect to which the shareholder has a QEF election in effect as an API if the partnership interest otherwise meets the API definition.

Capital Interests. An API does not include a capital interest in the partnership that provides a right to share in partnership capital commensurate with (i) the amount of capital contributed (determined at the time of receipt of such partnership interest), or (ii) the value of such interest subject to tax under Section 83 upon the receipt or vesting of such interest.[9] The Proposed Regulations provide rules in determining (i) whether capital gains and losses allocated to the holder of an API are treated as allocations with respect to its capital investment, and (ii) the amount of gains or losses recognized upon disposition of an interest allocable to a capital interest. Generally, an allocation must be made in proportion to the relative value of the API holder's capital account in the partnership in order to be an allocation with respect to a capital investment.

The Proposed Regulations specify that an allocation will not fail the capital interest exception solely because the allocation is subordinate to allocations made to a non-service provider (such as in the case of preferred interests). An allocation will also not fail the capital interest exception because it is not reduced by the cost of services provided by the API holder or a related person; however, there is some uncertainty as to how this rule will apply in all cases.

Gain from Non-Portfolio Assets. Recharacterization does not apply to income or gain attributable to any asset not held for portfolio investment on behalf of third party investors.[10] A third party investor is a person who holds an interest in the partnership which does not constitute property held in connection with an applicable ATB, and who does not provide substantial services for such partnership or for any ATB.[11] The Treasury Department and the IRS state in the preamble to the Proposed Regulations that they generally agree that this exception is intended to apply to family offices, however the Proposed Regulations do not address this exception.

Interests Held by Unrelated Purchasers. The Proposed Regulations add an exception for a partnership interest that is acquired by a bona fide purchaser who (i) does not currently provide, has never provided and does not contemplate in the future providing services in the relevant ATB, (ii) is unrelated to any service provider, and (iii) acquired the interest in a taxable purchase for fair market value.[12] It should be noted that this exception does not apply to an unrelated non-service provider who becomes a partner by making a contribution to a pass-through entity that holds an API and in exchange receives an indirect interest in such API. In this case, allocations to the unrelated non-service provider with respect to the API are API Gains and Losses and retain their character as API Gains and Losses.

Section 1061 Computations

Recharacterization Amount. The amount of long-term capital gains that a taxpayer must treat as short-term capital gains under Section 1061(a) is referred as the "Recharacterization Amount." The Recharacterization Amount will be determined through multiple steps of calculations in order to weave through capital gains generated at different levels in a tiered ownership structure, but essentially, such an amount is the taxpayer's regular net long-term capital gains ("One Year Gain Amount") reduced by the taxpayer's net long-term capital gains that satisfy the three year holding period requirement ("Three Year Gain Amount"). For purposes of this calculation, the following items should be excluded: (i) income that is treated as long-term capital gain under Section 1231 and Section 1256, (ii) any gain that is treated as long term or short term without regard to an actual holding period, such as capital gains characterized under the identified mixed straddle rules, (iii) qualified dividend income, (iv) certain transition amounts that are grandfathered, and (v) any long-term capital gains or losses with respect to the taxpayer's capital interest in the applicable partnership.

One Year Gain Amount is defined as the sum of (x) the taxpayer's "API One Year Disposition Amount" (any long term capital gains with respect to any disposition of APIs) plus (y) the taxpayer's net "API One Year Distributive Share Amount" (distributive shares of long-term capital gains from all APIs held during the tax year). Three Year Gain Amount is the sum of (i) the taxpayer's "API Three Year Disposition Amount" (recomputed long term capital gains that satisfy the three-year holding period requirement with respect to any disposition of APIs) and (ii) the taxpayer's combined net "API Three Year Distributive Share Amount" (recomputed distributive shares of long term capital gains that satisfy the three year holding period requirement with respect to all APIs held during the taxable year). The amount of API Three Year Disposition Amount or API Three Year Distributive Share Amount may be further reduced by the adjustment required under certain look-through rules (discussed below).

Installment Sale. The Proposed Regulations clarify that any gain on an installment sale should be taken into account in the year of accrual regardless of whether the underlying sale occurred before the effective date of Section 1061, but the holding period of the associated asset will still be determined based on the date of its disposition. For example, if an API was sold prior to 2018 and at that time, the holding period of such an API was two years, any installment gain recognized during or after 2018 may be subject to Section 1061 recharacterization.

Distributed API Property. If a property is distributed in respect of an API ("Distributed API Property"), gain from a subsequent sale of such distributed property may be recharacterized as short-term capital gain. Such property will retain its character as Distributed API Property as it is passed from one tier to the next. However, once a Distributed API Property has been held for more than three years, it will no longer be treated as Distributed API Property.

Holding Period. For purposes of determining a holding period, the Proposed Regulations look to the holding period of the asset that is sold. So if a partnership disposes of an asset, the applicable holding period for Section 1061 purposes will be such partnership's holding period in the asset. If the holder of an API disposes of such API, the applicable holding period will be such holder's holding period in such API. In other words, a partner's share of a partnership's gain from the sale of an asset will not be subject to recharacterization if the partnership has held the property for more than three years, even if the partner has held an interest in the that partnership for less than three years. Similarly, subject to the look-through rules described below, a partner's gain from the sale of a partnership interest that has been held for more than three years will not be subject to recharacterization, even if the partnership has assets that have been held for less than three years. The Proposed Regulations also provide additional guidance as to how the holding period is determined if the holder's partnership interest is comprised in part of one or more APIs.

Look-through Rules. The Proposed Regulations include limited look-through rules pursuant to which certain gains recognized in respect of an API with a holding period of more than three years are not treated as API Three Year Distributive Share Amount or API Three Year Disposition Amount, if 80% or more (based on fair market value) of the underlying assets (other than cash and certain other excluded assets) are capital assets that have a holding period of three years or less.

REIT and RIC Capital Gain Dividends. Many taxpayers have been concerned that capital gain dividends paid by a real estate investment trust (a "REIT") or a regulated investment company (a "RIC") to a partnership could never satisfy the three-year holding period requirement because these dividends are specifically described as gains from the sale or exchange of capital assets held for more than one year.13 The Proposed Regulations alleviate this concern by confirming that long-term capital gain treatment is available for REIT and RIC capital gain dividends attributable to underlying sales of assets that either meet the holding period requirement or are not otherwise excluded from the application of Section 1061. The Proposed Regulations achieve this result by allowing a REIT or RIC to disclose two additional amounts: (1) the amount of capital gain dividends exclusive of amounts not taken into account for purposes of Section 1061 and (2) the amount of capital gain dividends attributable to non-excluded assets held for more than three years. These amounts are then included in the determination of a taxpayer's Recharacterization Amount. An unfavorable presumption rule provides that if a shareholder does not receive this additional reporting information, all REIT and RIC capital gain dividends are subject to recharacterization.

Acceleration of Short-Term Capital Gains upon Transfers to Certain Related Parties

Section 1061(d) generally triggers the recognition of short-term capital gain by a taxpayer who either directly or indirectly transfers an API to (i) a family member (as determined under certain attribution rules), (ii) a person who has performed services to the relevant trade or business within the current calendar year or the preceding three calendar years, or (iii) a pass-through entity to the extent a person described in (i) or (ii) directly or indirectly owns an interest therein.[14] The amount of short-term capital gain is equal to the excess of (1) the net built-in long-term capital gain in assets with a holding period of three years or less that would have been allocated to the transferor partner upon a hypothetical sale of the partnership, over (2) the amount treated as short-term capital gain under Section 1061 on the transfer.[15]

The Proposed Regulations require gain to be recognized on such a transfer even if the transaction is not otherwise taxable.[16] If the transfer is otherwise taxable, Section 1061(d) recharacterizes all or a portion of the capital gain otherwise recognized on the transfer as short-term capital gain.[17] If the amount of capital gain otherwise recognized by the taxpayer on a taxable transfer is less than the amount required to be included under Section 1061(d), the taxpayer must include the difference as short-term capital gain under Section 1061(d).[18] Under the Proposed Regulations, the term "transfer" includes, but is not limited to, contributions, distributions, sales and exchanges, and gifts.[19] However, the Proposed Regulations clarify that a contribution of an API to a partnership under Section 721(a) is not treated as a transfer to a related person under Section 1061(d).[20]

Carry Waivers Will Be Scrutinized

The preamble to the Proposed Regulations warns that Treasury and the IRS are aware that taxpayers may seek to circumvent the application of Section 1061 by engaging in "carry waiver" arrangements, which may adopt various forms but generally seek to cause a carried interest recipient to receive allocations of capital gain from the sale of assets that either (1) meet the required holding period or (2) are not subject to recharacterization. The preamble states that such arrangements may be challenged as disguised payments for services and/or by other means, including partnership anti-abuse rules and substance over form or economic substance doctrines. Until further guidance is issued, the proposed regulations issued in 2015 addressing disguised payments for services may be indicative of the factors that Treasury and the IRS would consider relevant in determining whether carry waiver arrangements should be respected.

Reporting Requirements

Pass-through Entity Reporting. Under the Proposed Regulations, a pass-through entity that has issued an API must provide the API Holder with additional information needed for the API Holder to comply with Section 1061 and to determine its Recharacterization Amount.[21] The Proposed Regulations contemplate that this information, which must be filed with the IRS, will generally be provided as an attachment to the Schedule K-1 furnished to the API Holder for the taxable year.[22]

Additional reporting is required in a tiered structure, and in certain cases an upper-tier entity must request, and a lower-tier entity must provide, additional information.[23] Consequently, a lower-tier partnership with a direct or indirect partner that is an upper-tier partnership that has issued an API may be required to comply with the Section 1061 reporting requirements, even if such lower-tier partnership itself has not issued an API. In this case, the pass-through entity must request information from any lower-tier entities in which it owns an interest by the later of the 30th day of the close of the calendar year or within 14 days after having received a request for information from an API Holder.[24]

If a taxpayer is not furnished the information described above and is not otherwise able to substantiate all or part of these amounts, then items that would otherwise be excluded from the application of Section 1061(a) will not be excluded from such taxpayer's API One Year Distributive Share Amount, and items that would otherwise be included in such taxpayer's API Three Year Distributive Share Amount will not be included.[25] The failure to report the required information will be subject to penalties.[26]

REIT and RIC Reporting. In order to facilitate a taxpayer's calculation of its Recharacterization Amount, REITs and RICs are permitted to provide additional reporting to shareholders with respect to capital gain dividends.[27] As noted above, this reporting consists of information that would be used by an API Holder in calculating the amount of any capital gain dividends that are subject to recharacterization. The Proposed Regulations provide that the additional disclosed amounts would be provided to shareholders in writing as part of normal REIT and RIC capital gain designation reporting, and the amounts must be proportionate to the share of capital gain dividends reported or designated to that shareholder for the taxable year. Importantly, the additional reporting is permissive and not required. Consequently, taxpayers who receive carried interest partnership allocations that are attributable to REIT or RIC capital gain dividends will want to ensure the partnership receives this additional reporting information.

Effective Date

Section 1061 applies to taxable years beginning after December 31, 2017. The regulations would generally apply beginning on or after the date final regulations are published in the *Federal Register*. Taxpayers may generally rely on the Proposed Regulations prior to final publication, provided they follow the Proposed

Regulations in their entirety and in a consistent manner. However, the rules regarding transition amounts may be relied on for 2020 and later years without consistently following all of the Proposed Regulations. The exclusion of S corporations from the corporate taxpayer exception is proposed to apply to taxable years beginning after December 31, 2017, while the exclusion of PFICs with a QEF election in place would not apply until final regulations are published.

For more information about the topics raised in this Legal Update, please contact any of the following lawyers.

Jeff M. Bruns
+1 312 701 8793
jbruns@mayerbrown.com

Matt A. McDonald
+1 312 701 8321
mmcdonald@mayerbrown.com

JoonBeom Pae
+1 212 506 2194
jpae@mayerbrown.com

Mark H. Leeds
+1 212 506 2499
mleeds@mayerbrown.com

Alison Appleby
+1 312 701 7696
aappleby@mayerbrown.com

Stephanie F. Wood
+1 212 506 2504
swood@mayerbrown.com

Endnotes

1 Prop. Treas. Reg. § 1.1061-1(a).

2 Prop. Treas. Reg. § 1.1061-2(a)(2), Example 1.

3 Prop. Treas. Reg. § 1.1061-2(b)(1), Example 1.

4 Prop. Treas. Reg. § 1.1061-2(b)(2), Example 5.

5 Section 1061(c)(1).

6 Section 1061(c)(4)(A).

7 Prop. Treas. Reg. § 1.1061-3(b)(2)(i).

8 Prop. Treas. Reg. § 1.1061-3(b)(2)(ii).

9 Section 1061(c)(4)(B).

10 Section 1061(b).

11 Section 1061(c)(5).

[12] Prop. Treas. Reg. § 1.1061-3(d).

[13] Sections 852(b)(3)(B) and 857(b)(3)(A).

[14] Prop. Treas. Reg. § 1.1061-5(e)(1).

[15] Prop. Treas. Reg. § 1.1061-5(a).

[16] *Id*.

[17] Prop. Treas. Reg. § 1.1061-5(c)(2).

[18] *Id*.

[19] Prop. Treas. Reg. § 1,1061-5(b).

[20] Prop. Treas. Reg. § 1.1061-5(e)(2).

[21] Prop. Treas. Reg. § 1.1061-6(b)(1).

[22] *Id*.

[23] Prop. Treas. Reg. § 1.1061-6(b)(2)(i).

[24] Prop. Treas. Reg. § 1.1061-6(b)(2)(iii).

[25] Prop. Treas. Reg. § 1.1061-6(b)(2)(vi); Treas. Reg. § 1.1061-6(a)(2).

[26] Prop. Treas. Reg. § 1.1061-6(b)(2)(vii).

[27] Prop. Treas. Reg. § 1.1061-6(c).