

Legal Update

IRS Publishes Carried Interest Reporting Guidance and Worksheets

By Michelle Jewett, Mark Leeds, Greg Matlock and James Kelly¹

If you were focused on the legislative proposals to make it even more difficult for private fund managers to achieve long-term capital gains from carried interests,² you may have missed the flurry of Internal Revenue Service (“IRS”) guidance on the existing rules. On November 3, 2021, the IRS published [four FAQs](#), two worksheets and two tables instructing partnerships and partners how to report income with respect to carried interests under the Section 1061 of the Internal Revenue Code of 1986, as amended (the “Code”). In this Legal Update, we provide an overview of these new rules.

Background on IRC § 1061

Code Section 1061 limits the ability of investment managers that hold carried interests (i.e., profits interests issued in connection with the performance of services for the investment partnerships that they manage) to be eligible for long-term capital gain treatment with respect to income derived from such interests. Specifically, Code Section 1061 increased the required holding period for net long-term capital gain “with respect to”³ an “applicable partnership interest” (“API”) to three years.⁴ Accordingly, if the holder of an API receives an allocation of gain from the disposition of a partnership asset held for more than one year, but less than three years, or recognizes gain on the disposition of an API held for more than one year, but less than three years, such gain will generally be treated as short-term capital gain.⁵

An “applicable partnership interest” is one held or transferred to the taxpayer “in connection with” the taxpayer’s (or a related person’s) performance of substantial services in an “applicable trade or business” (“ATB”),⁶ which is a business engaged in the activity of raising or returning capital and investing in or developing “specified assets.”⁷ Specified assets is defined broadly to include securities, commodities, real estate held for rental or investment, cash or cash equivalents, options or derivative contracts, and the interests in partnerships holding such assets.⁸ In light of these definitions, Code Section 1061 applies primarily to carried interests in hedge, real estate and private equity funds and real estate joint ventures.⁹

Reporting Guidance

Treasury Regulations Section 1.1061-6, issued in January 2021, prescribes reporting requirements for applicable partnerships and holders of APIs.¹⁰ Passthrough entities¹¹ and “Owner Taxpayers” (defined as

taxpayers subject to tax with respect to an API as a result of direct ownership of the API or indirect ownership through one or more passthrough entities) are required to apply the final regulations to taxable years beginning on or after January 19, 2021, and may choose to apply them to tax years beginning after December 31, 2017.¹² The FAQs state that, even if the taxpayer is not applying the final regulations for the 2021 tax year, the partnership and partners must provide similar information. Accordingly, taxpayers filing tax returns for the 2021 taxable year may, but are not required to, use the forms contained in the FAQs. As a practical matter, however, taxpayers may simply want to use such forms given that they would need to provide substantially similar information in any event.

The FAQs provide the following guidance clarifying the reporting requirements. It is expected that this guidance will provide a streamlined method for investment partnerships to provide relevant information to holders of APIs and for holders of APIs to report such information in connection with filing their income tax returns.

FAQ 1

Passthrough entity reporting requirements.

Passthrough entities that apply the final regulations for income tax returns filed after December 31, 2021, are required to attach [Worksheet A](#) to each Schedule K-1 issued to any API Holder,¹³ noting the appropriate box and code.¹⁴ Rather than attaching Worksheet A to a Schedule K-1, regulated investment companies and real estate investment trusts provide this information in connection with IRS Form 1099-DIV, dividends and distributions.¹⁵ PFICs may provide such information to shareholders who are API Holders and have qualified electing fund elections in effect, and FAQ 1 requires that a PFIC shareholder must retain such information.

Worksheet A shows the partner's distributive share of partnership income potentially subject to recharacterization under Code Section 1061. It begins by providing the partner's distributive share of net capital gain or loss on assets held longer than one year. It subtracts from that (i) capital gains or losses of the kind not subject to Code Section 1061¹⁶ and (ii) qualifying capital gains and losses with respect to a partner's capital interest¹⁷ to arrive at the API One Year Distributive Share Amount. It subtracts from that (i) amounts treated as long-term capital gain or loss if a three-year holding period rather than a one-year holding period were applied and (ii) any adjustment under the "Lookthrough Rule" of Treasury Regulations Section 1.1061-4(b)(9) applicable to the disposition of an API by the passthrough entity to arrive at Three-Year Distributive Share Amount.

FAQ 2

Owner Taxpayer calculation of amounts treated as short-term capital gain under IRC § 1061.

An Owner Taxpayer must use [Worksheet B](#) and Tables [1](#) and [2](#) to determine the amount of income recharacterized under Code Section 1061 and attach all three to its income tax return.

Table 1 provides the API One Year Disposition Amount, or the amount of long-term capital gain, using a one-year holding period, recognized with respect to APIs from dispositions, distributions in excess of basis¹⁸ and dispositions of distributed assets. Table 2 provides the corresponding computations using three-year holding periods.

On Worksheet B, the Owner Taxpayer adds its API One Year Distributive Share Amount from its Schedules K-1 and Worksheet A and its API One Year Disposition Amount from Table 1 to obtain its One Year Gain Amount and adds the corresponding three-year information from Schedules K-1 and

Table 2 to obtain its Three Year Gain Amount. It subtracts its Three Year Gain Amount from its One Year Gain Amount to arrive at its Recharacterization Amount. It calculates any recharacterization from transferring an API to a related person¹⁹ and adds this to its Recharacterization Amount to obtain its total Section 1061 Adjustment to Form 8949.

FAQ 3

Owner Taxpayer reporting of recharacterized amounts on Schedule D and Form 8949.

The taxpayer first reports its short- and long-term gains and losses with respect to APIs on Schedule D (for Forms 1040 and 1041) and Form 8949, Sales and Other Dispositions of Capital Assets, as if Code Section 1061 did not apply. It then enters recharacterization transactions on its [Form 8949](#).

FAQ 4

Owner Taxpayer reporting of collectibles gain and unrecaptured Code Section 1250 gain.

Pending further guidance, the Owner Taxpayer must use a reasonable method to compute the amount of the inclusion of collectibles gain and/or unrecaptured Code Section 1250 gain in its Recharacterization Amount. It must report such items on specific lines in Worksheet B.

Summary

The infamous quip that “the devil is in the details” certainly applies to these new reporting requirements. The IRS is clearly seeking fulsome disclosure on how taxpayers are determining the amount treated as long-term capital gain for holders of carried interests. These new reporting requirements may make it more difficult for affected taxpayers to address ambiguities in the rules that could help them in reporting without significant IRS scrutiny.

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

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Endnotes

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- ² We covered these proposals in our Legal Update on the Build Back Better Act, which, in reduced form, is still pending before Congress. See <https://www.mayerbrown.com/en/perspectives-events/publications/2021/09/overview-of-us-tax-provisions-of-build-back-legislation-approved-by-house-ways-means-committee>.
- ³ Under regulations finalized earlier this year, capital gain “with respect to” a partnership interest includes the taxpayer’s distributive share of the partnership’s gains, gain from disposition of its partnership interest (including distribution in excess of basis treated as gain on disposition under Code Section 731(a)) and gain on the disposition of property distributed by the partnership to the taxpayer. Treas. Reg. § 1.1061-4(a). The following items of income are excluded from Code Section 1061’s reach: Code Section 1231 capital gain and loss (property used in trade or business); Code Section 1256 capital gain and loss (contracts marked to market); qualified dividend income; and capital gains and losses characterized without regard to the holding period rules, such as those under mixed straddle rules. Treas. Reg. § 1.1061-4(b)(7).
- ⁴ IRC § 1061(a).
- ⁵ Under the Final Regulations, there is an anti-abuse rule that is applicable only where, at the time of disposition of an API held for more than three years, (i) the partnership interest would have a holding period of three years or less if the holding period of such partnership interest were determined by excluding any period before which third-party investors have capital commitments to the partnership, or (ii) a transaction or series of transactions has taken place with a principal purpose of avoiding potential gain recharacterization under Section 1061(a). Treas. Reg. § 1.1061-4(b)(9)(i). In such cases, a Lookthrough Rule applies that recharacterizes gain based on the holding period of the assets held by the partnership. Treas. Reg. § 1.1061-4(b)(9)(ii).
- ⁶ IRC § 1061(c)(1).
- ⁷ IRC § 1061(c)(2). An ATB does not include (i) interests held directly or indirectly by a corporation (excluding, per regulation, corporations without entity-level taxation under Treasury Regulations Section 1.1061-3(b)) or (ii) capital interests that provide a right to share in partnership capital commensurate with an amount contributed or subject to tax under Code Section 83. IRC § 1061(c)(4).
- ⁸ IRC § 1061(c)(3).
- ⁹ Section 1061 of the Code also imposes a look-through rule triggered by a taxpayer’s transferring an API to a related person.⁹ Specifically, it converts to short-term capital gain any long-term capital gain with respect to the transferred interest attributable to the sale or exchange of an asset held for three years or less, to the extent not already treated as such under Section 1061. IRC § 1061(d)(1).
- ¹⁰ See T.D. 9945.
- ¹¹ Passthrough entities include partnerships, trusts, estates, S corporations and PFICs.
- ¹² Treas. Reg. § 1.1061-6(e).
- ¹³ An “API Holder” is a person who holds an API. Treas. Reg. § 1.1061-1(a).
- ¹⁴ Box 20, code AH, for a Form 1065 partnership return; box 17, code AD, for a Form 1120S S corporation return; and box 14, code Z, for a Form 1041 for trust and estate returns.
- ¹⁵ See Treas. Reg. § 1.1061-6(c).
- ¹⁶ See note 1, *supra*.
- ¹⁷ See Treas. Reg. § 1.1061-3(c)(2).
- ¹⁸ See IRC § 731(a).
- ¹⁹ See IRC § 1061(d) and Treas. Reg. § 1.1061-5(c).

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