WINSTON & STRAWN LLP

CLIENT ALERT

IRS Issues Proposed Regulations for Carried Interest

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On July 31, 2020, the Internal Revenue Service (IRS) released proposed regulations (the Proposed Regulations) regarding the Section 1061 "carried interest" rules that were added to the tax code as part of the Tax Cuts and Jobs Act of 2017. This client alert is meant to provide an overview of how the Proposed Regulations may affect private equity and other investment funds.

In general, the Proposed Regulations operate in the manner that practitioners expected. There are a few exceptions, such as a new transition rule and certain of the requirements to qualify for the Capital Interest Exception. The Proposed Regulations also focus heavily on transactions that taxpayers may have considered to avoid the application of Section 1061.

With limited exceptions, including the S corporation rules discussed below, the Proposed Regulations generally are not effective until adopted in final form. However, taxpayers may rely on the Proposed Regulations currently as long as they follow them in their entirety and apply them consistently.

Background

When enacted in 2017, Section 1061 extended the holding-period requirements from one year to three years for taxpayers to receive long-term capital gains treatment for gains on carried interest in an applicable partnership interest (API). Failure to meet the holding-period requirements would result in such gains being re-characterized as short-term capital gains taxed at ordinary income rates. An API generally means any interest in a partnership that, directly or indirectly, is transferred to the taxpayer in connection with the performance of substantial services by the taxpayer in an applicable trade or business. An applicable trade or business generally includes any activity conducted on a regular, consistent, and substantial basis that consists, in whole or in part, of (i) raising or returning capital and (ii) either investing in or developing securities, commodities, real estate, cash or cash equivalents, options, or derivatives with respect to any of the foregoing (i.e., any investment fund).

The Basics

Consistent with current law, the Proposed Regulations generally look to the holding period of the asset being sold to determine whether the three-year holding period is satisfied. That is, if a partner has an API in a partnership, and the partnership sells an asset, the relevant holding period is that of the partnership in the asset, not that of the partner in the partnership.

The Proposed Regulations also do not change the rules for qualified dividends, which are eligible for long-term capital gains rates if received by an API holder without any special holding period, or for Section 1256 contracts. In addition, gains on property used in a trade or business under Section 1231 (such as intangible gains) is also excluded from the application of Section 1061. A large portion of the Proposed Regulations is focused on potential anti-avoidance transactions. For example, where an individual owns an API indirectly through another flow-through entity, special holding-period rules apply (see discussion under "Application to Tiered Partnerships," below). Similarly, if a service provider receives a distribution of property with respect to an API, the Proposed Regulations provide that the property maintains the API taint, even though it might not itself be an API. Accordingly, any transaction involving an API will need to be reviewed carefully to determine the potential application of Section 1061.

S Corporations and PFICs

Section 1061 provides that, where a corporation is the holder of a carried interest in a partnership, the interest will not be treated as an API. Therefore, under the plain meaning of the Internal Revenue Code's text, an S corporation could provide services to an investment partnership and receive carried interest that would not be subject to the extended holding-period requirement of Section 1061, while also enjoying the benefits of a single level of taxation as a pass-through entity. However, in March 2018, the IRS issued Notice 2018-18 (the Notice), notifying taxpayers that it intended to issue regulations that exclude S corporations from the exemption provided in Section 1061. The Proposed Regulations are consistent with the Notice, and provide that partnership interests held by S corporations are treated as APIs if the interest otherwise meets the API definition. Consistent with the Notice, this rule is effective as of the effective date of Section 1061.

Similarly, while passive foreign investment companies (PFICs) are traditionally taxed as corporations for U.S. tax purposes, a PFIC shareholder may make an election under Section 1295 to treat their investment as a qualified electing fund (QEF), which generally allows the income and loss of the PFIC to pass through to the electing shareholder. While Section 1061 does not itself address this scenario, other legislative proposals related to carried interest had specifically addressed this QEF workaround. The drafters of the Proposed Regulations noted the opportunity for taxpayers to use PFICs to avoid the application of Section 1061 and therefore determined that when an owner of a PFIC has a QEF election in place, the PFIC is not treated as a corporation for purposes of Section 1061. As a result, a partnership interest held by the PFIC will be treated as an API if the interest otherwise meets the API definition.

Capital Interest Exception

Section 1061 further provides that it does not apply to a capital interest in a partnership (the Capital Interest Exception). In general, the Proposed Regulations interpret this exception narrowly and require that (i) the terms of the partnership agreement provide for allocations based on the relative capital accounts of the partners receiving the allocations and (ii) the terms, priority, type and level of risk, rate of return, and rights to cash or property distributions during the partnership's operations and on liquidation must be the same as for non-service-provider partnerships.

As an important exception, the Proposed Regulations provide that an interest will not fail to qualify for the Capital Interest Exception solely because the allocations in respect of such interest are not reduced by the cost of services provided by the applicable partnership interest holder or a related person. Accordingly, the fact that a service provider may not be charged management fees in respect of a partnership interest should not cause the interest to fail to qualify as a capital interest.

This definition of a capital interest is very narrow, and many investment funds provide for allocations based on capital contributions to specific investments and would therefore not satisfy these requirements as currently drafted. In addition, other provisions of fund documents, such as rights to receive tax distributions and waiver of carry-on service-provider investments, should be scrutinized carefully to determine whether a service provider's rights with respect to a capital interest are the same as those of non-service providers.

Also excluded from the definition of capital interest are interests acquired with loans from other partners, the partnership, or related persons. A service provider receives credit only when payments are made on such loans. As such, a capital contribution financed by the partnership or another partner will be treated differently than one financed by a third-party lender.

Application to Tiered Partnerships

Where an API is held through a tiered-partnership structure, the Proposed Regulations distinguish between the person ultimately subject to federal income tax on an amount re-characterized under Section 1061 (the Owner Taxpayer) and a passthrough entity that owns an API (the Passthrough Taxpayer). As noted above, in determining the applicable holding period for Section 1061 purposes, the IRS generally adopted the approach that the holding period for the owner of the asset sold will control, as it is consistent with subchapter K and the intended application of Section 1061. As such, if a Passthrough Taxpayer disposes of an API, it is the Passthrough Taxpayer's holding period for the API that will control, rather than the Owner Taxpayer's holding period in the Passthrough Taxpayer. In expanding on this approach, the Proposed Regulations require that when an Owner Taxpayer disposes of an interest in a Passthrough Taxpayer, which was held for more than three years, a look-through rule applies if either the Passthrough Taxpayer held its interest in the API for less than three years, or the assets of the Passthrough Taxpayer meet the "substantially all" test. The substantially all test is met if 80% or more of the assets of the Passthrough Taxpayer (based on fair-market value (FMV)) are capital assets described in Section 1.1061-4(b)(6) and have a holding period of three years or less.

Additionally, the Proposed Regulations clarify that complex tiered partnerships cannot be used to avoid Section 1061 re-characterization. Previously, there was uncertainty as to whether unrealized gains from an API could be converted to gains that would be exempt from the Section 1061 holding-period requirement under the Capital Interest Exception, discussed above. The Proposed Regulations clarify that unrealized API gains cannot be converted to gains that qualify for the Capital Interest Exception, as API property is required to be revalued upon a contribution from an upper-tier passthrough entity to a lower-tier passthrough entity. The revaluation would be based on a hypothetical sale of the API assets at FMV and would be allocated to the contributing person for 704(b) capital account purposes (creating a reverse layer). *See* §1.1061-2(a)(1)(ii)(B). Therefore, API gain would effectively be tracked and allocated separately from capital-interest gains.

Transfers of AN API

The Proposed Regulations provide special rules on API transfers, giving important guidance to investors seeking to acquire interests in fund sponsors. If a partnership interest qualifies as an API, it retains its status in the hands of the transferee, unless one of the exceptions applies. The new exception in the Proposed Regulations allows for interests to be treated as non-API interests in the hands of bona fide third-party purchasers. If a third-party purchaser acquires an API in a taxable transaction for FMV, if it had not provided and does not anticipate providing services to the partnership or its subsidiaries and is not related to the service provider, then the interest will not be an API in the hands of such third-party purchaser. Investors in fund sponsors can rely on this exception to acquire all or a part of the fund sponsor's API without having the income received from such interest subject to Section 1061.

Transition Rule

Recognizing that there was no reason for a partnership to separately account for capital interests prior to the enactment of Section 1061, the Proposed Regulations provide a transition rule that is intended to alleviate some of

the burden on taxpayers. Under this rule, a partnership can irrevocably elect to treat all long-term capital gains and losses from the disposition of assets (APIs or otherwise) as “Partnership Transition Amounts” if the assets were held for more than three years as of January 1, 2018. Partnership Transition Amounts are not subject to re-characterization under Section 1061.

Carried Interest Waivers

As limited partners in an investment partnership are exempt from the extended holding-period requirements of Section 1061, it has become common for investment managers to waive their right to carried interest on investment gains that do not meet the three-year holding-period requirement (Carried Interest Waiver), electing instead to receive an increased share of gains that qualify for long-term capital gains treatment. While not specifically addressed in the text of the Proposed Regulations, the preamble to the Proposed Regulations acknowledges that the IRS is aware of Carried Interest Waivers and that the IRS may challenge them on audit under existing anti-abuse rules.

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