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IRS Issues Final Regulations Addressing Carried Interests

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On January 7, 2021, the Department of Treasury and the Internal Revenue Service ("IRS") released final regulations addressing the "carried interest rules" contained in section 1061 of the Internal Revenue Code of 1986, as amended (the "Code"). These regulations finalize the rules contained in proposed regulations that were released on July 31, 2020 and published on August 14, 2020, with various modifications.

Background

Section 1061 generally limits long-term capital gains treatment for carried interests to gains from assets held for more than three years, rather than the one year period that is normally required. Long-term capital gains that do not meet the three-year requirement are converted into short-term capital gains, which are taxed at the same federal income tax rates as ordinary income (i.e., up to 37% as opposed to the 20% rate that generally applies to long-term capital gains of individuals).

More specifically, this rule applies to taxpayers that hold an "applicable partnership interest" as defined in section 1061, which means a partnership interest that is transferred to or held by the taxpayer in connection with the performance of substantial services by the taxpayer, or a related person, in a trade or business of raising or returning capital, and investing in, disposing of or developing various types of investment assets (including securities, commodities and investment real estate). Section 1061 was effective for tax years beginning after December 31, 2017.

Highlights of Final Regulations

The final regulations make several key changes to the proposed regulations, including:

- The proposed regulations implemented the capital interest exception in a complex manner that would have been unavailable in many fund structures. The final regulations replace these rules with a simplified approach that more closely aligns with common fund practice.

- The final regulations provide that reinvested gains may qualify for the capital interest exception.

- The final regulations narrow the circumstances in which the sale of a partnership interest held more than three years may be subject to recharacterization.

- Under the proposed regulations, a transfer of an applicable partnership interest to a related person could have triggered a taxable event in the case of an otherwise non-taxable transfer, such as a gift. Under the final regulations, related person transfers do not accelerate gains, but may still result in long-term capital gain being converted into short-term capital gain.

In addition, the final regulations retain various concepts of the proposed regulations, including:

- Special categories of income, taxed at long-term capital gains rates, are not subject to recharacterization regardless of whether the three year holding period is satisfied. This includes qualified dividend income and long-term section 1231 gains.

- Although interests held by corporations are not subject to section 1061, this exception does not apply to interests held by S corporations or by PFICs having a "qualified electing fund" election in effect.

Overview of Final Regulations

Applicable Partnership Interest

The final regulations define an "Applicable Partnership Interest" (an "API") in a manner consistent with the proposed regulations. Under the final regulations, an API means a partnership interest which, directly or indirectly, is transferred to (or held by) an Owner Taxpayer or a Passthrough Taxpayer in connection with the performance of substantial services by the Owner Taxpayer or a Passthrough Taxpayer, or any related person, in any Applicable Trade or Business unless an exception applies. An "Owner Taxpayer" means a person subject to federal income tax (such as an individual) with respect to the API, and a "Passthrough Taxpayer" includes partnerships, trusts, estates, S corporations and certain passive foreign investment companies (PFICs).

Thus, the existence of an API is tested both at the level of a passthrough entity such as a partnership (Passthrough Taxpayer) as well as at the level of the ultimate persons subject to tax, such as an individual taxpayer (Owner Taxpayer). For example, if an API is held by a Passthrough Taxpayer, the ultimate Owner Taxpayers holding an interest in that entity are subject to section 1061 with respect to their flow-through gains unless an exception applies. Once an interest is an API, it continues to be an API — even if the API is transferred or the service provider retires — unless and until an exception applies.

An "Applicable Trade or Business" (an "ATB") exists if the applicable taxpayer or related persons engage in actions involving raising or returning capital, and investing in, disposing of, or developing Specified Assets, and those combined actions rise to the level of a "trade or business" under section 162 of the Code. "Specified Assets" means securities (which include corporate stock and interests in publicly traded partnerships), commodities, real estate held for rental or investment, cash, and interests in partnerships (or entities treated as partnerships for federal income tax purposes) to the extent the partnership holds Specified Assets.

For purposes of identifying an ATB, the final regulations provide rules that generally group activities that may occur over different taxable years or by related persons, agents and delegates. For example, actions undertaken by a fund's general partner and a separate management company would be grouped if the management company were related to, or a delegate of, the general partner.

What gains may be recharacterized?

The amount of net long-term capital gain that is required to be treated as short-term under section 1061 is determined at the level of the ultimate person subject to tax with respect to an API (that is, the Owner Taxpayer). If one or more APIs are held through one or more passthrough entities, amounts subject to section 1061 flow through and are netted at the Owner Taxpayer level.

In general, the amount treated as short-term capital gain is determined by combining the Owner Taxpayer's long-term capital gain or loss from all APIs, and then subtracting the portion of such gain or loss that is attributable to assets held for more than three years. The recharacterization rule takes into account both "flow-through" net long-term capital gains and losses (such as a fund's gain from the sale of a portfolio company that flows through to the individual owners) as well as gains and losses from the sale of a directly held API.

The relevant holding period is determined with reference to the direct owner of the asset that was sold. For example, gain from a fund's sale of a portfolio company held by the fund for two years would be subject to recharacterization, even if the general partner held its API for more than three years. If the Owner Taxpayer does not have a combined net long-term capital gain with respect to its APIs for a year (or if such amount if a loss), the recharacterization rule does not apply because there is no gain to recharacterize.

Excluded Income. Various categories of income escape recharacterization under the three year rule, even if attributable to assets held for three years or less. Such amounts include qualified dividend income ("QDI") included in net capital gain, long-term capital gain or loss under section 1231 (which applies to certain depreciable property used in a trade or business that has been held for more than one year and real property used in the trade or business that has been held for more than one year) or under section 1256 (which provides "60/40 treatment" for gains and losses on certain futures and options contracts), and any other capital gain characterized as long-term or short-term without regard to the holding period rules in section 1222.

Thus, depending on how an exit is structured, fund managers may be able to mitigate short-term recharacterization for investments that do not meet the three-year holding period. For example, a distribution by a corporate portfolio company that is considered a "dividend" under the Code generally would escape recharacterization (and would be taxed at long-term capital gains rates if all other QDI requirements are met). Moreover, an asset sale by a passthrough entity (but not the sale of the interests in a passthrough entity) may generate section 1231 gains for certain depreciable assets (including goodwill that had previously been purchased by the passthrough entity) held for more than one year.

Distributed Property. If a partnership makes an "in kind" distribution of property with respect to an API, section 1061 does not require that any gain be immediately recognized. However, when the person receiving the property subsequently sells the property, any gain recognized is subject to the rules of section 1061, unless the person's holding period in the property, inclusive of the partnership's holding period, exceeds three years at the time of the sale. The final regulations clarify that amounts otherwise excluded from section 1061 (such as section 1231 gains) are also excluded from recharacterization when such distributed property is sold.

Lookthrough Rule. Under a lookthrough rule, a sale of an API held for more than three years can nonetheless produce gains subject to recharacterization. In general, this rule applies if (a) the API would have a holding period of three years or less, determined by ignoring the period before the date unrelated non-service partners are legally obligated to make substantial capital contributions (meaning at least 5 percent of total capital contributions) or (b) one or more transactions have taken place with a principal purpose of avoiding Section 1061. If the lookthrough rule applies, the amount of long-term gain recharacterized is generally the portion attributable to the relevant underlying assets that do not meet the three year requirement.

This rule is substantially narrower than the lookthrough rule in the proposed regulations. Under the proposed regulations, the lookthrough rule generally would have applied if 80 percent or more of the partnership's assets were held for three years or less.

RIC/REIT Dividends. Special rules address capital gain dividends from regulated investment companies ("RICs") and real estate investment trusts ("REITs"). In general, all such amounts are treated as capital gains from assets held for three years or less, unless the RIC or REIT reports certain information regarding the nature of its gains.

Capital Interest Exception

In General. Section 1061 provides an exception for "capital interests" that provide the taxpayer with a right to share in partnership capital commensurate with the amount of capital contributed. The proposed regulations implemented this exception in a narrow manner that would have been impossible to achieve in many fund structures. Fortunately, the final regulations adopt a simplified approach that is more in line with common business arrangements.

Under the final regulations, section 1061 does not apply to “Capital Interest Gains and Losses.” These fall into two categories: “Capital Interest Allocations” and “Capital Interest Disposition Amounts.”

An allocation qualifies as a “Capital Interest Allocation” if the allocation to an API holder with respect to its capital interest is made in a similar manner to the allocations made to similarly situated unrelated non-service partners (i.e., third-party investors) who have made significant aggregate capital contributions (meaning at least 5 percent of total contributions). An allocation to an API holder is considered made “in a similar manner” if the allocation and distribution rights with respect to capital contributed by the API holder, and capital contributed by the unrelated non-service partners, are reasonably consistent.

The final regulations permit variances that result if management fees or carried interest are not assessed against the service provider, or if the service provider is entitled to tax distributions (treated as advances against future distributions) while the unrelated non-service partners are not. The partnership agreement and the partnership’s books and records must clearly demonstrate that the requirements of the exception are met.

The exception for “Capital Interest Disposition Amounts” is relevant upon the sale of a partnership interest comprised of both an API and a capital interest. In that case, the exception generally applies to the portion of the long-term gain or loss from the sale of the interest that is proportional to the Capital Interest Allocations, as a percentage of total long-term capital gain or loss, that would be allocated to the selling partner if the partnership sold all its assets for their fair market value. Special rules are provided to address situations where a selling partner may have a “outside” gain but an “inside” loss, or vice versa.

Loaned Amounts. The capital interest exception does not apply to the extent the holder makes a capital contribution of amounts attributable to a loan directly or indirectly made or guaranteed by another partner, the partnership or a related person. Repayments of the loan may generate qualifying capital contributions. However, if the loan is made to a service provider who is an individual (or a disregarded entity owned by such person) and is fully recourse to the service provider, the capital interest is not disqualified by reason of the loan. The exception for recourse loans is newly added by the final regulations.

Reinvestment of Gains. The final regulations provide that reinvested gains will be treated as capital contributions that may then produce Capital Interest Allocations discussed above. The reinvestment may be accomplished by an actual distribution and contribution, or by having the partnership retain such amount. However, the exception applies only to the reinvestment of realized and recognized gains. Unrealized gains continue to be subject to section 1061.

This rule is of particular interest to the hedge fund industry, where a general partner may reinvest its performance allocation by having it retained in its capital account. However, as noted above, reinvestments of gains that are unrealized (i.e., untaxed) do not give rise to the exception, limiting its usefulness.

APIs Held by S Corporations and PFICs

Under section 1061, an API does not include a partnership interest held directly or indirectly by a corporation. Consistent with the proposed regulations, the final regulations provide that the exception for corporations does not apply to interests held by S corporations or by PFICs with respect to which the shareholder has a qualified electing fund election in effect.

Other Exceptions

Non-ATB Employees. An API does not include a partnership interest transferred to a person in connection with the performance of substantial services as an employee of another entity that is conducting a trade or business (other than an ATB) and the person provides services only to such other entity. The language of the regulations generally follows the Code on this point.

Third-Party Purchasers. Moreover, an API does not include an interest in a partnership that is acquired in a taxable purchase for fair market value. To qualify for this exception, the purchaser cannot be related to a person providing services to the ATB or the partnership in which the interest is issued, the transfer must not be covered by the related party rules (discussed below), and the purchaser must not provide or anticipate providing services to or for the benefit of the partnership. This exception generally would permit a fund principal to sell its API to an unrelated purchaser, without the API taint continuing over to the purchaser (although the seller would not escape the rules of section 1061). However, the exception does not apply to an unrelated service provider who becomes a partner by making a contribution to a passthrough entity that holds an API and in exchange receives an interest in the passthrough entity's API.

Transfers of APIs to Related Parties

Under the final regulations, a transfer of an API to a related party may generate more short-term capital gain than would be the case if the holder transferred the interest to an unrelated party. In the case of such a transfer, amounts that otherwise would have been treated as long-term capital gain are recharacterized as short-term, to the extent attributable to the transferor's share of net gain from the partnership's assets held for three years or less (determined based on a hypothetical liquidation of the partnership). This rule can trigger short-term gains even if the transferred interest itself is held for more than three years.

For these purposes, a related party means a family member as defined in section 318(a)(1) (i.e., a spouse, child, grandchild or parent), a person that performed a service for the Applicable Trade or Business relating to such API in the current or preceding three years, and a partnership to the extent owned by the foregoing.

In a significant departure from the proposed regulations, the final regulations apply the related person rule only to transfers that are otherwise taxable. However, in the case of a non-recognition transfer (such as a gift), the API "taint" continues in the hands of the transferee.

Carried Interest Waivers

In the preamble to the proposed regulations (but not in the operative rules), the IRS cautioned that so-called carried interest waiver arrangements may not be respected and may be challenged under existing tax principles. The final regulations neither repeat nor retract this warning.

Reporting Requirements

The regulations impose various reporting requirements. Failure to comply with such requirements could result in penalties.

Effective Dates

Section 1061 was effective beginning in 2018. The rules in the final regulations are generally effective for tax years beginning on or after the date the regulations are published in the Federal Register. Thus, for calendar year taxpayers, the final regulations are generally effective for tax years beginning on or after January 1, 2022.

The provision excluding S corporations from the exception for corporations, however, is effective for tax years beginning after 2017, and the provision excluding PFICs from such exception is effective for tax years beginning after August 14, 2020. Taxpayers may choose to apply the final regulations in their entirety for a taxable year beginning after 2017, provided they consistently apply the regulations in their entirety to that year and all subsequent years.

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