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Proposed Regulations – Carried Interests under Section 1061[1]

Section 1061, which was enacted as part of the 2017 U.S. tax reform, requires a holding period greater than three years (rather than the general requirement of a holding period greater than one year) for certain carried interest arrangements to qualify for the preferential tax rate for long-term capital gains. Gains that are subject to Section 1061 are recharacterized as short-term capital gains, which are taxed at the rates applicable to ordinary income.

On July 31, 2020, the U.S. Department of Treasury and the IRS issued proposed regulations (REG-107213-18; hereafter the "Regulations") with respect to the carried interest rules set forth in Section 1061. Certain provisions of the Regulations are summarized below. A copy of the Regulations is available at https://www.irs.gov/pub/irs-drop/reg-107213-18.pdf.

Applicable partnership interests. Section 1061 applies to taxpayers that hold an "applicable partnership interest" ("API"), which is defined as a partnership interest that is transferred to, or held by, a taxpayer in connection with the performance of substantial services by the taxpayer or any related person in an "applicable trade or business" ("ATB"). If an interest in a partnership is transferred in connection with the performance of services, the Regulations create a presumption that those services are substantial. Furthermore, solely for purposes of defining an API under Section 1061, the Regulations provide that a partnership interest includes any financial instrument or contract, the value of which is determined in whole or in part by reference to the partnership (including the amount of partnership distributions, the value of partnership assets, or the results of partnership operations).

Under the Regulations, once a partnership interest qualifies as an API, it generally retains that status unless and until an exception from API treatment applies (such as the third-party purchaser exception, discussed below). Thus, even if an individual API holder retires and ceases to provide any services, the carried interest retains its API status and Section 1061 would continue to apply.

Applicable trade or business. An ATB is defined by statute 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 in part, of (1) raising or returning capital ("Raising or Returning Capital Actions"), and (2) either (a) investing in (or disposing of) "specified assets" (or identifying "specified assets" for such investing or disposition), or (b) developing specified assets ("Investing or Developing Actions"). Developing "specified assets" occurs when it is represented to investors, lenders, regulators or other interested parties that the value, price, or yield of a portfolio business may be enhanced or increased in connection with choices or actions of a service provider. However, merely exercising voting rights with respect to shares owned, or similar activities, does not amount to developing specified assets.

[1] References herein to a "Section" are to a section of the Internal Revenue Code of 1986, as amended.

"Specified assets" generally include stock, securities, options and derivatives. A partnership interest constitutes a "specified asset" if the interests in the partnership are publicly traded or widely held, or to the extent the partnership's assets consist of specified assets. Real estate is a "specified asset" if it is held for rental or investment purposes.

For an ATB to exist, the level of Raising or Returning Capital Actions and Investing or Developing Actions conducted must be sufficient to establish a trade or business under Section 162. However, Raising or Returning Capital Actions and Investing or Developing Actions need not both be present in the same year. For example, an ATB can exist if Investing or Developing Actions are not taken in the current taxable year, but sufficient Raising or Returning Capital Actions are taken in anticipation of future Investing or Developing Actions. Additionally, an ATB can exist if no Raising or Returning Capital Actions are taken in the current taxable year, but have been taken in a prior taxable year (regardless of whether an ATB existed in the prior year), and sufficient Investing or Developing Actions are undertaken by the taxpayer in the current taxable year.

All activities conducted by certain persons related to the taxpayer are attributed to the taxpayer for purposes of determining whether an ATB exists. In addition, actions taken by a delegate or agent in its capacity as such are attributed to the principal for purposes of determining whether an ATB exists. For example, if the general partner of a partnership is contractually obligated to manage a partnership and hires a management company to provide management services on the general partner's behalf, then the management company's activities will be attributed to the general partner for these purposes, even if the management company is unrelated to the general partner.

Items excluded from Section 1061. The Regulations provide that certain items of income and loss are not subject to recharacterization under Section 1061. These items include Section 1231 gains, Section 1256 gains and qualified dividend income. In addition, certain gains that are characterized as short- or long-term without regard to holding period rules under Section 1222 (e.g., capital gains and losses identified as mixed straddles under Section 1092(b) and certain regulations promulgated thereunder) are excluded from being recharacterized under Section 1061. Installment sale gains may be subject to Section 1061, even where the sale took place prior to the effective date of Section 1061.

Distributed property. The Regulations contain a special rule for property distributed with respect to an API. Under this rule, the distribution does not accelerate gain recognition under Section 1061 or the Regulations, but a capital gain or loss from a subsequent sale or exchange of such property will be taken into account under Section 1061, if at the time of the disposition the distributee partner's holding period in the property is not greater than three years. However, once the distributed property has a holding period of greater than three years, it is no longer subject to Section 1061.

Capital interest exception. Section 1061(c)(4)(B) creates an exception from API treatment for any capital interest in the partnership which provides the taxpayer with a right to share in partnership capital commensurate with the amount of capital contributed (determined at the time of receipt of such partnership interest), or the value of such interest subject to tax under Section 83 upon the receipt or vesting of such interest (the "Capital Interest Exception").

The Regulations provide that, for an allocation of partnership gain to qualify for the Capital Interest Exception, allocations must be based on the partners' relative capital accounts, and 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. An allocation to an API holder will not fail to qualify for the Capital Interest Exception solely because the allocation is subordinated to allocations made to unrelated non-service partners. Further, an allocation to an API holder will not fail to qualify for the Capital Interest Exception because it is not reduced by the cost of services provided by the API holder or a related person to the partnership.

In addition, for allocations to qualify for the Capital Interest Exception, the partnership generally must make allocations on the same terms to unrelated non-service partners with a significant aggregate capital account balance. An aggregate capital account balance equal to five percent or more of the aggregate capital account balance of the partnership at the time the allocations are made will be treated as significant.

For purposes of the Regulations, a taxpayer's capital account does not include any contributed amounts directly or indirectly attributable to any loan or other advance made, or guaranteed, directly or indirectly, by any other partner or the partnership (or certain related persons with respect to any such other partner or the partnership). However, in general, repayments on the loan are included in the taxpayer's capital account as those repayments are made, unless the repayment is made with the proceeds of a loan described in the previous sentence.

Unrealized capital gains cannot be converted into gains that qualify for the Capital Interest Exception. The preamble to the Regulations (the "Preamble") states that transactions that give rise to a deemed contribution, such as a partnership division or recapitalization, cannot be used to convert API gains and losses into capital interest gains and losses.

Gain on the disposition of an API that is a capital interest does not necessarily qualify for the Capital Interest Exception. Determining the extent to which such gain may be eligible for the exception requires a multi-step process that generally involves a determination of whether gain or losses allocable to the partner from the hypothetical liquidation of the partnership (and any lower-tier partnerships) would be eligible for the Capital Interest Exception.

Corporation exception. Section 1061 excludes interests in a partnership that are directly or indirectly held by a corporation from the definition of an API (and thus from the application of Section 1061) (the "Corporation Exception"). Consistent with the guidance set forth in Notice

2018-18, the Regulations provide that an S corporation is not considered a corporation for purposes of the Corporation Exception. The Regulations provide that the rule excluding S corporations from the Corporation Exception applies to tax years beginning after December 31, 2017.

Exception for employees of non-ATB entities. Section 1061 provides that an API does not include an interest 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. This exception is generally interpreted to cover employees that receive profits interest for providing services to a portfolio company engaged in an operating business. The Regulations generally track statutory language in regard to this exception without providing additional clarification.

Exception for third-party purchasers. The Regulations create a new exception to Section 1061, which provides that an API in a target partnership will cease to be treated as an API if it is acquired in a taxable purchase for fair market value (other than in a related person transfer under Section 1061(d), as described below) by a person who does not currently and has never provided services (and does not anticipate providing future services) to or for the benefit of the target partnership (or any partnership in which it holds a direct or indirect interest) and who is unrelated to any service provider in the relevant ATB and to any service provider who provides services to or for the benefit of the target partnership (or any partnership in which it holds a direct or indirect interest). The Preamble notes that this exception does not apply to an unrelated non-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.

Family office exception. Section 1061(b) provides that, "[t]o the extent provided by the Secretary, [Section 1061](a) shall not apply to income or gain attributable to any asset not held for portfolio investment on behalf of third-party investors." The Regulations reserve on this exception. The Preamble notes that many comments suggested that this exception was intended to apply to family offices and states that the Treasury Department and the IRS generally agree with those comments. The Preamble further states that Treasury and the IRS believe that this exception effectively is implemented through certain aspects of the Regulations' provisions under the Capital Interest Exception. The Preamble requests comments on the application of this provision and whether the relevant provisions of the Capital Interest Exception in the Regulations properly implement the exception for family offices.

Partial entity approach and holding periods. The Regulations adopt a hybrid approach to allocations made with respect to APIs, referred to in the Preamble as a "partial entity approach." This approach treats partnerships and other passthrough entities as taxpayers for purposes of determining the existence of an API; however, the amount of capital gain that is recharacterized as short-term capital gain is determined at the level of the ultimate owners (individuals, estates or trusts). As a result, passthrough entities generally are required to make certain computations with respect to their API-related income and to pass such income through to their owners. Any API-related income generally retains its character as such as it passes through tiers of passthrough entities and up to the ultimate owner taxpayers, who then take such income into account in determining the amount of capital gain that is recharacterized as short-term capital gain.

In applying Section 1061 to gain on the sale or exchange of an asset, the holding period of the asset disposed of generally controls. Similarly, if a partner recognizes gain from the sale or exchange an API (including gain due to an excess distribution under Section 731(a)), the relevant holding period is generally the partner's holding period in the API. However, this rule is subject to important exceptions under the lookthrough rules and the rules on transfers between related persons under Section 1061(d) (both discussed below).

Lookthrough rules. As stated above, in general, the relevant holding period under the Regulations is the holding period of the asset disposed of. However, the Regulations include limited lookthrough rules, which can apply to subject a capital gain on a direct or indirect transfer of an API to Section 1061, even if the interest disposed of (i.e., the API, in the case of a direct disposition, or the interest in a passthrough entity through which an API is directly or indirectly held, in the case of an indirect disposition) has a holding period greater than three years. If the lookthrough rules apply, all or part of the capital gain recognized on the disposition will be recharacterized as short-term capital gain.

The lookthrough rules apply to a disposition of a directly held API in a taxable transaction (other than a related person transfer governed by Section 1061(d)) if the holder of the transferred API has a holding period that is greater than three years and the "substantially all" test (discussed below) is met. The lookthrough rules also apply when a taxpayer disposes of an interest in a passthrough entity through which it indirectly holds an API in a taxable transaction (other than a related person transfer governed by Section 1061(d)) if it held the interest in the passthrough entity for more than three years and either (1) the passthrough entity, through which the API is directly or indirectly held, has held the API for three years or less, or (2) the passthrough entity, through which the API is directly or indirectly held, has held the API for more than three years and the assets of the partnership in which the API is held meets the "substantially all" test.

Generally, the "substantially all" test is met if 80% or more of the partnership's assets (1) are assets that would produce capital gain or loss that is not excluded from Section 1061 (e.g., under the exclusion for Section 1231 gain) if disposed of by the partnership and (2) have a holding period of three years or less to the partnership. The determination is made based on the fair market values of the assets. In applying the substantially all test, if a partnership has held an interest in a lower-tier passthrough entity for more than three years, the upper-tier partnership must treat the interest in the lower-tier passthrough entity as having a holding period of three years or less to the extent of the upper-tier partnership's share of the value of the assets held by the lower-tier passthrough entity that would produce capital gain or loss that is not excluded from Section 1061 (e.g., under the exclusion for Section 1231 gain) if disposed of by the lower-tier passthrough entity and have a holding period of three years or less to the lower-tier passthrough entity. Cash, cash equivalents, and Section 751 unrealized receivables and inventory items are not taken into account for purposes of the substantially all test.

Related person transfers under Section 1061(d). Under Section 1061(d), a taxpayer that directly or indirectly transfers an API to certain related persons is required to include in gross income (as short-term capital gain) the excess (if any) of (1) so much of the taxpayer's long-term capital gains with respect to such interest for such taxable year attributable to the sale or exchange of any asset held for not more than three years as is allocable to such interest, over (2) any amount treated as short-term capital gain under Section 1061(a) with respect to such transfer. These rules may (1) turn a transaction otherwise eligible for nonrecognition into a taxable transaction and/or (2) result in the recharacterization of long-term capital gain into short-term capital gain.

The Regulations expand the general rule in Section 1061(d) to also apply to transfers to certain related persons of property distributed with respect to an API and with a holding period of not more than three years. For purposes of Section 1061(d), the Regulations define a "transfer" to include contributions, distributions, sales, exchanges and gifts. However, the Regulations provide that a contribution under Section 721(a) to a partnership is not a transfer to related person for purposes of Section 1061(d). Instead, under the principles of Section 704(c), any associated gains with respect to the API must be tracked and allocated back to the holder of the API when recognized.

Carried interest waivers. The Preamble mentions tax planning techniques commonly referred to as "carry waivers." A "carry waiver" generally refers to a transaction in which a carried interest holder waives its right to a carried interest distribution, and the accompanying allocation of taxable income, in exchange for the right to receive a potential future distribution and allocation of income from the partnership, contingent on the fund's earning sufficient future income to make the allocation. The income waived is generally of a character disadvantageous to the carried interest holder, such as gain from the sale of a capital asset held for not more than three years. The Preamble cautions that carry waiver strategies may be challenged under various grounds, including the partnership anti-abuse rules and the economic substance doctrine. However, the Regulations do not include new rules on carry waivers.

Unitary basis and bifurcated holding periods. As a general matter, a partner has a single, unitary basis in its partnership interest and a single capital account, even though the partner may hold multiple different classes of interest in the partnership. Therefore, if a partner sells only part of its partnership interest, the partner must equitably apportion the tax basis of the entire interest between the sold and retained portions of the interest. Further, if a partner acquires multiple interests in a partnership at different times (or in exchange for the contribution of assets with different holding periods), the partner may have a split holding period in its partnership interest.

If a partner has a split holding period in its partnership interest and the partner sells only part of its interest, then (except in the case of certain dispositions of an interest in a publicly traded partnership) the sold and retained portions of the interest will each have a split holding period.

Section 1061 and the Regulations generally do not modify the rules described above, except for a proposed modification to the regulations under Section 1223 that would apply for purposes of determining the holding period of a partnership interest that consists in whole or in part of one or more profits interests. Under this rule, the portion of the holding period to which a profits interest relates is determined based on the fair market value of the profits interest at the time that all or part of the partnership interest is disposed of.

Transition rules. Under the Regulations, a partnership that was in existence as of January 1, 2018 may irrevocably elect to treat all long-term capital gains and losses from the disposition of all assets, regardless of whether such gains and losses are with respect to an API in prior periods, that were held by the partnership for more than three years as of January 1, 2018 as "Partnership Transition Amounts." Partnership Transition Amounts that are allocated to the holder of an API are treated as long-term capital gains and losses and are not subject to recharacterization under Section 1061. For amounts to be treated as Partnership Transition Amounts, the partnership must make a signed and dated election by the due date, including extensions, of its federal income tax return for the first partnership taxable year in which it treats amounts as Partnership Transition Amounts.

Reporting. Passthrough entities must report information to the IRS and holders of APIs that is necessary to comply with Section 1061, including: (1) reporting each partner's share of long-term capital gains and losses from assets held more than one year and long-term capital gains and losses from assets held for more than three years; (2) long-term capital gains and losses allocated to the holders of an API that are excluded from Section 1061 (as described above); (3) gains and losses allocated to the API holder qualifying for the Capital Interest Exception; and (4) Partnership Transition Amounts. It is contemplated that the Passthrough Entity generally will be required to provide this information as an attachment to the Schedule K-1 furnished to the holder of an API for the taxable year. Penalties apply to a failure to timely comply with the reporting requirements.

A passthrough entity that owns a lower-tier partnership will need information from lower-tier partnership to satisfy reporting obligations. The passthrough entity must request information from the lower-tier partnership by the later of (1) the 30th day after the close of the taxable year or (2) within 14 days of receiving a request for information from an upper-tier passthrough entity or the holder of an API. The lower-tier partnership must respond by the due date (including extensions) of the Schedule K-1 for the tax year.

Effective dates. Subject to limited exceptions (e.g., the exclusion of S corporations from the Corporation Exception, as discussed above), the Regulations would apply to tax years beginning on or after the date final regulations are published in the Federal Register. However, taxpayers generally may rely on the Regulations before they are published in final form, provided they follow the Regulations in their entirety and in a consistent manner. Taxpayers may rely on the Regulations' transition rules (discussed above) for tax years beginning in 2020 (and subsequent tax years) even without consistently following all the requirements of the Regulations.

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