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Key Takeaways from the Proposed Regulations on Carried Interest

August 6, 2020

On July 31, 2020, the Internal Revenue Service (the "IRS") and the U.S. Department of the Treasury (the "Treasury") issued proposed regulations (the "Proposed Regulations") providing guidance on Section 1061 of the Code, as implemented by the law commonly referred to as the Tax Cuts and Jobs Act of 2017. In general, Section 1061 imposes a three-year holding period rule for an investment fund manager's share of gains earned through the fund to be eligible for lower tax rates applicable to long-term capital gain. This is a departure from the one-year holding period that typically results in long-term capital gains. The Proposed Regulations provide clarification and guidance on the application of Section 1061, although many questions remain unanswered, including the extent to which Section 1061 would apply to gains that are not attributable to the fund manager's "carried interest" or "incentive allocation" earned from third-party investors.

As background, Section 1061 applies to an applicable partnership interest (an "API") held by or transferred to a taxpayer in connection with the performance by that taxpayer (or a related person) of substantial services in an applicable trade or business (an "ATB"). ATB activities include raising or returning capital and developing, investing in and disposing of "specified assets" (generally, stock, securities, commodities, real estate held for rental or investment and certain partnership interests). The activities of private fund managers will generally constitute an ATB, and therefore any carried interest or incentive allocation will generally be an API subject to these rules.

The Proposed Regulations apply to tax years beginning on or after the date that final regulations are published (with some exceptions noted below), though taxpayers are generally allowed to rely on them prior to that date, if applied consistently. The IRS and the Treasury have requested comments on the Proposed Regulations. The Proposed Regulations could change significantly prior to finalization.

Below, we provide our brief "key takeaways" from the Proposed Regulations. We will release a more detailed analysis in the near future.

- **Carry waivers are not explicitly prohibited, but must be carefully implemented**. Fund managers may, in certain cases, desire to waive an allocation of gain from a fund that is treated as short-term capital gain pursuant to Section 1061, with the ability to be made whole in the future with an allocation of gain that is treated as long-term capital gain. The IRS and the Treasury indicate that they are aware of the use of these types of waivers being employed by fund managers, and further warn such arrangements may be subject to challenge on various grounds. The Proposed Regulations, however, do not provide any further guidance on these waiver strategies other than noting that they need to comply with generally applicable tax laws, including those that also apply to so-called "management fee waivers", which we previously have discussed in a prior alert.
- **Certain income is not subject to recharacterization under Section 1061**. The Proposed Regulations confirm that Section 1061 does not apply to (1) "qualified dividend income", (2) Section 1231 gains (generally, gain from the sale of real property and depreciable personal property used in a trade or business and held for over one year), (3) gains characterized as long-term without regard to the holding period rules defined in Section 1222 (which include gains characterized under the mixed straddle rules), and (4) "mark-to-market gains" under Section 1256 (generally, gain from certain futures and options contracts). Capital gain dividends received from regulated investment companies ("RICs") and real estate investment trusts ("REITs") are also subject to Section 1061, unless the dividends are attributable to properly identified excluded gain and certain other requirements are met.
- **Several "applicable partnership interest" exceptions are confirmed.** The Proposed Regulations, consistent with the statute, confirm that the following are exceptions from the definition of an API: (1) capital interests (*e.*, a fund manager's "commitment" to a fund discussed further below), (2) interests held by certain corporations (discussed further below), (3) interests held by employees of an entity not engaged in an ATB, and (4) gain attributable to assets not held for portfolio investment on behalf of third-party investors. In addition, the Proposed Regulations introduce a new exception from the definition of an API for interests held by unrelated bona fide purchasers at fair market value. The Proposed Regulations also clarify that once a partnership interest becomes an API, the partnership interest remains an API unless and until an exception applies (*e.g.*, if a member of a general partner entity retires, and is no longer active in a fund management business, such retired member's interest in fund carry will still be an API subject to these rules). We discuss below two provisions in the Proposed Regulations that explicitly affect the capital interest exception.

- **General guidance on the exception for capital interests**. Section 1061 provides an exception for gain with respect to "capital interests", which was generally understood to mean gain earned with respect to invested capital. The Proposed Regulations appear to narrowly define the scope of this exception, and adopt an approach that may be unworkable in many closed end private investment funds. For example, certain special allocations of fees or expenses not borne by a fund manager may be problematic under the Proposed Regulations' approach. As a result, without more guidance, some or all of a fund manager's gains attributable to capital invested in a fund may be subject to the rules of Section 1061. Fund managers should review the application of the Proposed Regulations to their investment in the fund and consider alternative structures.
- **No exception for capital interests funded with loans from or guaranteed by another partner, the partnership or a party related to either**. Any loan (including a recourse loan) or other advance made or guaranteed, directly or indirectly, by any partner, the partnership or any person related to another partner or the partnership may cause an interest not to qualify for the capital interest exception, and, therefore, income or gains from such interest may be subject to Section 1061 recharacterization. Such arrangements could include a loan from a management company to the general partner or individual members of the general partner to fund capital commitment amounts, a loan provided by the fund to the general partner, or even a bank loan guaranteed by the management company or other partners.
- **Further guidance on the exception for APIs held by a corporation.** While statutorily there is an exception for APIs held by "corporations", the Proposed Regulations provide that there is no exception for APIs held by S-corporations. This is not unexpected, as the IRS previously announced its intention to more narrowly define "corporation" for purposes of Section 1061 in a prior administrative notice. Importantly, this rule is applicable for taxable years beginning after December 31, 2017. In addition, the Proposed Regulations further provide that a "corporation" for purposes of this exception does not include a "passive foreign investment company" with respect to which the applicable owner has made a "qualified electing fund" election. This rule is applicable for taxable years beginning after July 31, 2020.
- **Distributions in-kind are subject to Section 1061**. Stock of a portfolio company that a fund distributes to a fund manager continues to be subject to Section 1061. The Proposed Regulations confirm that a fund manager needs to continue to hold such shares following a distribution until the three-year holding period under Section 1061 has been met in order to obtain long-term capital gains treatment upon an ultimate sale of such stock.

- **Certain otherwise tax-free transfers (e.g., gifts) will be taxable.** The Proposed Regulations provide that certain types of transfers of an API to a "related person" will be taxable. "Related persons" for purposes of this rule include a taxpayer's spouse, children, grandchildren, and parents, as well as colleagues. "Transfer" for purposes of this rule is broadly defined, but it remains unclear whether the term includes a transfer at death or a forfeiture of an API. The Proposed Regulations go on to provide that these deemed taxable events only apply to gain that would otherwise be short-term capital gain under Section 1061. This provision is not applicable until the Proposed Regulations are finalized, so it is important for fund managers to make such API transfers prior to finalization in order to avoid inadvertently triggering short-term capital gain.
- **Installment Sale Considerations**. As expected, the Proposed Regulations confirm that when applying Section 1061 to gain recognized under the installment sale method (generally, a sale of property where one or more payments is received in a year after the sale is concluded) the relevant inquiry is the holding period of the property at the time of the sale. For example, if a fund sells the stock of a portfolio company and receives payments in later years, the date under Section 1061 for whether the three-year holding period has been met is the sale date, rather than when payments are later received.

Please consult with the members of your Proskauer tax team to further discuss the details of the Proposed Regulations and how they may apply to your particular circumstances.

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