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Memorandum

IRS Releases Proposed Regulations Under Section 1061 on Carried Interest

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On July 31, 2020, the Internal Revenue Service ("IRS") issued a series of Proposed Treasury Regulations promulgated under Section 1061 of the Internal Revenue Code (the "Code") (such regulations, the "Proposed Rules"). The Proposed Rules address a special three-year holding period requirement for investment managers to treat carried interest proceeds as eligible for preferential tax rates. Below is a high-level summary of the background giving rise to the Proposed Rules, along with their key provisions and implications.

Background: Section 1061

- The Tax Cuts and Jobs Act of 2017 ("TCJA") introduced Section 1061 to the Code, increasing the holding period that applies for reduced capital gains rates to investment managers that receive carried interest from more than one to more than three years (for tax years beginning after 2017).
  - More specifically, Section 1061 applies to "applicable partnership interests" ("APIs"), which are defined as interests in a partnership transferred to or held by the taxpayer in connection with the performance of services in an applicable trade or business. An applicable trade or business is the conducting of the following activities on a "regular, continuous, and substantial basis":
    - Raising or returning capital, *and*
    - Investing in or disposing of "specified assets" or identifying specified assets for such investing or disposition, or developing specified assets. "Specified assets" means securities, real estate held for rental or investment, cash, options, derivatives, and certain other assets.
  - Section 1061 also contains a number of exceptions for certain interests and items of income, including the following:
    - Partnership interests held by an employee of a trade or business that is providing non-qualifying services to the API business;
    - Partnership interests held directly or indirectly by a corporation;
    - Capital interests in a partnership commensurate with the capital contributed or the value of such interest subject to tax as compensation income (upon receipt or vesting of such interest); and
    - Income or gain attributable to assets not held for portfolio investment on behalf of third party investors (investors unrelated to the service providers).

- Section 1061 also causes transfers of an API to a related person (family members and certain colleagues), directly or indirectly, to result in the acceleration of gain recognition (as short term capital gain) in an amount equal to:
  - the transferee's long term capital gain for assets held for three years or less, *minus*
  - the transferee's short term capital gain with respect to the transfer of such API.

Summary of Proposed Rules

- *Proposed Rules' Treatment of APIs*
  - The Proposed Rules expand the definition of API to include interests in a partnership held by or transferred to an "Owner Taxpayer" *or* a "Passthrough Taxpayer."
    - Owner Taxpayer is defined as the person subject to tax on the net gain with respect to an API and includes individuals, simple and complex trusts, and estates.
    - Passthrough Taxpayer is defined as an entity that holds an API that generally does not pay tax itself (*e.g.*, a partnership).
  - Tests to determine the existence of an API are conducted at the level of the partnership issuing the interest and therefore may be held directly by a Passthrough Taxpayer or an Owner Taxpayer.
  - Recharacterization calculations (discussed below) are conducted at the Owner Taxpayer level.
  - The Proposed Rules provide clarification on the threshold levels of applicable activity required for Section 1061 to apply.
    - Generally, the Proposed Rules indicate that the required threshold is the level of activity that would lead an entity to be considered in a trade or business under Section 162.
    - In addition, the Proposed Rules provide for the following activity rules:
      - A partnership must perform activities consisting of *both* (1) raising or returning capital *and* (2) investing, developing or disposing of certain investment assets. The two activities do not need to each individually rise to the level of a trade or business to meet the test.
      - If one partnership conducts raising or returning activity, and a related partnership conducts investing, developing or disposing activity, then both activities can be combined to cause both partnerships to be treated as API partnerships.
      - Qualifying actions do not have to occur in a single year. For example, if one activity rises to the qualifying level, and the other activity has been taken in past years and does not rise to the level required, the taxpayer is still subject to Section 1061 under the Proposed Rules.
      - Actions of related persons are taken into account in the determination.
  - The Proposed Rules have also added a "once an API, always an API" rule unless and until an exception in the Proposed Rules applies. Therefore, the characterization is not impacted by the holder ceasing to

provide services, or the partnership ceasing to meet the activity tests (discussed above) in a subsequent year.

- The applicable holding period with respect to the sale of an asset is the holding period of the asset's direct owner.
  - If a partnership disposes of an asset, the applicable holding period is the partnership's holding period in the asset for purposes of the Owner Taxpayer's distributive share of the gain.
  - Subject to the "Lookthrough Rule" described below, if a holder (whether it is a Passthrough Taxpayer or Owner Taxpayer) disposes of an API, the applicable holding period is that holder's holding period in the API.
  - For dispositions of an API with a holding period of over three years a "Lookthrough Rule" applies if 80 percent or more of the value of the assets held by the partnership at the time of the API disposition are assets held for three years or less that would produce capital gain or loss subject to Section 1061 if disposed of by the partnership at such time. If the Lookthrough Rule applies, a percentage of the gain or loss on the disposition of the API will not be treated as having a more than three year holding period regardless of the holding period in the API.
  - The Proposed Rules also contain amendments to Treasury Regulation 1.1223-3, adding clarification on the treatment of APIs where the holder has a divided holding period in the partnership. When determining the allocation of the holding period, the relative fair market value of any profits interests are determined at the time of the interest's disposition (or partial disposition).

- *Rules Regarding the Section 1061 Exceptions*
  - Notably, the Proposed Rules exclude both S corporations and "passive foreign investment companies" ("PFICs") with respect to which the shareholder has made a "qualified electing fund" ("QEF") election from the exception for partnership interests held by corporations. Instead, S corporations and such PFICs are treated as pass-through entities.
    - The possible inclusion of S corporations and such PFICs in the exception was considered a mistake in the drafting of the statutory rule as those entities generally provide for a single level U.S. federal income tax at the level of the individual owner. The IRS previously warned taxpayers in Notice 2018-18 that S corporations would be excluded from the exception.
  - Under the Proposed Rules, there would be an additional exception for interests acquired by a bona fide purchaser who
    - is unrelated to the service provider attributing API,
    - does not also conduct activities qualifying for the Section 1061 restrictions, *and*
    - acquired the interests at fair market value.
  - The Proposed Rules also clarify that the exception for ownership of a capital interest is meant to apply to capital interests determined in accordance with rules contained in Treasury Regulation 1.704-1(b) for

maintaining capital accounts, and provide detailed rules as to the qualification of allocations made with respect to the API holder's capital interest, including through tiers of pass-through entities, and how to determine the amount of capital gain or loss that may be excluded from Section 1061 with respect to a disposition of a partnership interest that consists both of an API and a capital interest.

  - The Proposed Rules reserve, and fail to provide guidance, with respect to the exception for income or gain attributable to any asset not held for portfolio investment on behalf of third party investors described in Section 1061(b). Section 1061(b) excludes such income or gain from the general rules of Section 1061 "to the extent provided by the Secretary. . . ." Taxpayers likely will be disappointed that the IRS and Treasury did not take this opportunity to provide guidance contemplated by Congress.

- *Computation of the Recharacterized Amounts*
  - The Proposed Rules would apply the Section 1061 rules by recharacterizing gain with respect to a taxpayer's APIs held during the taxable year that, but for Section 1061 and the Proposed Rules, would be long term capital gain as short term capital gain according to a particular formula.
    - The calculation includes gain both as a result of the net distributive share of gain or loss from such APIs and as a result of any dispositions by the taxpayer of any APIs.
    - The calculation occurs at the Owner Taxpayer level (in contrast to API determinations at the entity level, as discussed above).
  - This calculation, generally, is the excess of
    - the net capital gain from assets with a more than one year (but no more than three year) holding period, *over*
    - the net capital gain from assets with a more than three year holding period.
  - The Proposed Rules exclude the following types of income from the calculation:
    - Gains and losses from the application of Section 1231 (relating to the sale or exchange of trade or business property or involuntary conversion property),
    - Gain from the application of Section 1256 (generally relating to gain with respect to a futures or derivatives contract),
    - "Qualified dividend income" under Section 1(h)(11), and
    - Capital gain determined to be either long or short term *not* by reference to a holding period.
  - For the purposes of this calculation, the Proposed Rules instruct taxpayers to aggregate gain or loss from all APIs held during a taxable year.
- *Miscellaneous Rules*
  - The Proposed Rules clarify that, for the purposes of the rule requiring acceleration of gain on a transfer of API to a related party, tax-free contributions to a partnership under Section 721 are excluded.

- While the addition of this rule is welcome and should increase flexibility to implement fund restructurings, these related party transfer rules are broad as written and taxpayers would benefit from additional guidance.

- There is a series of rules coordinating the application of the Proposed Rules to "regulated investment companies" ("RICs") and "real estate investment trusts" ("REITs"), instructing RICs and REITs to disclose two amounts of capital gain dividends to interest holders based upon the holding period of the property that was disposed of and generated the capital gain: one for amounts exclusive of Section 1061 amounts and another of just amounts to which Section 1061 applies.

- *Applicability Date*
  - The Proposed Rules generally apply to Owner Taxpayers and Passthrough Taxpayers for taxable years beginning on or after the date final regulations are published.
  - The Proposed Rules also contain a series of transition rules, acknowledging that taxpayers subject to the Proposed Rules may not have all information necessary for compliance. For example, a partnership existing as of January 1, 2018 may irrevocably elect to treat all long term capital gain from assets held for more than three years as long term capital gain, regardless of the recharacterization calculations described above.
  - Taxpayers may rely upon the Proposed Rules until publication of final regulations so long as they are applied consistently and in their entirety. However, the transition rules may be relied upon for tax years beginning in 2020 and subsequent tax years until publication of final regulations.

Considerations for Fund Clients

- Investment funds and fund managers should be aware that S corporations and PFICs with respect to which a QEF election has been made will not be afforded an exception from the API rules.
- Applicable taxpayers may be able to implement restructuring transactions without accelerating gain as a result of a transfer to a related party if the transfer qualifies as a tax-free contribution to a partnership under Section 721.
- Certain taxpayers may benefit from the exclusion of Section 1231 property from the rules. In particular, real estate funds that hold significant Section 1231 property will continue to be subject to a one-year holding period on carried interest with respect to such property in order to receive long term capital gains treatment.
- Investment fund managers should be aware that the applicable holding period with respect to disposition of assets is generally the holding period of the direct owner of the asset. Therefore, a holder of an API could have short term capital gain with respect to their distributive share of gain on property disposed of by the partnership even if the API has been held more than three years. Alternatively, if a holder of an API has not held the API for more than three years, the holder may benefit if the partnership disposes of its assets and has more than a three year holding period in some of its assets.

Furthermore, subsequent contributions to a partnership can result in a divided holding period with respect to an API such that a portion of the API is treated as held for three years or less even if the initial grant of an API occurred more than three years before.

- While the Proposed Rules do not introduce any applicable rule, the preamble accompanying the Proposed Rules contain a warning that the IRS is aware of carried interest waivers (described as arrangements allowing an API holder to waive its right to carry allocations or distributions of capital gains, and/or substitute allocations of capital gains with respect to assets held for three or fewer years for capital gains from assets held for more than three years) and that such arrangements may be scrutinized and not respected under partnership tax rules and economic substance doctrines.

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