IRS Issues Final Regulations on Carried Interest

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Treasury and the IRS have released Final Regulations under Section 1061 of the Internal Revenue Code, following the release of Proposed Regulations in August 2020. Section 1061, which was added by the Tax Cuts and Jobs Act, requires certain taxpayers that hold profits interests in partnerships (such as "carried interest" arrangements) to satisfy a three-year holding period to qualify for long-term capital gains rates.

The Final Regulations largely retain the rules set forth in the Proposed Regulations, with some notable exceptions, and make a number of taxpayer-friendly clarifications. This Debevoise In Depth highlights important aspects of the Final Regulations and how the Final Regulations compare to the Proposed Regulations, with an emphasis on the impact on fund sponsors.

TAXPAYERS THAT ARE SUBJECT TO CARRIED INTEREST RULES

- Section 1061 applies to individuals, trusts and estates that hold an "API." An API is a partnership interest that is transferred in connection with the performance of services to an applicable trade or business. The rules apply to APIs that the taxpayer holds directly or indirectly through a pass-through entity (including a passive foreign investment company or S corporation). An applicable trade or business is one that involves raising or returning capital and investing in, developing and/or disposing of securities or other specified classes of assets—a definition intended to target fund sponsors.

EXCEPTION FOR CAPITAL INTERESTS

- Under Section 1061, the three-year holding period does not apply to partnership interests attributable to the holder's capital contributions. The Proposed Regulations applied a restrictive approach to this exception, requiring that capital interest allocations be tied to relative capital accounts. In response to a significant number of

comments that the capital account formulation did not accord with the distribution waterfall provisions in most private equity fund documents, the IRS abandons this approach in the Final Regulations.

- Under the Final Regulations, allocations to API holders in respect of their capital contributions will be respected (and therefore excluded from Section 1061) if such allocations are determined and calculated in a manner similar to allocations made to other significant (5% or more) unrelated partners in respect of their capital contributions (the "Capital Interest Exception"). The test may be applied on an investment-by-investment basis or based on a particular class of interests. Moreover, the Final Regulations clarify that API holders do not need to charge carried interest (or management fees) on their capital investment. The Final Regulations, however, retain the requirement from the Proposed Regulations that capital interest allocations be clearly identified under both the partnership agreement and in the partnership's books and records (reflected contemporaneously) as separate and apart from allocations made to API holders with respect to their API.

  Comment: The typical distribution waterfall in most private equity funds provides that (i) proceeds from an investment are first apportioned to the partners based on capital contributions funded to make such investment, (ii) the amount apportioned to the general partner is distributed to the general partner and (iii) the amount apportioned to each limited partner runs through the carry waterfall. Allocations to the general partner in respect of amounts distributed to the general partner under clause (ii) would seem to qualify for the Capital Interest Exception, although the Final Regulations do not provide specific rules around how such allocations must be identified in the partnership agreement.

  Comment: Commentators requested that the IRS waive the documentation requirements for existing partnership agreements. The IRS declined to provide such relief—in its view, because the Capital Interest Exception now more closely aligns to standard industry practice, the number of partnership agreements that will need to be amended to fit within the exception is reduced. Still, we anticipate that new funds will more clearly identify distributions to the general partner in respect of its capital contributions, together with allocations in respect of such capital contributions, as intended to fall within the scope of the Capital Interest Exception.

  Comment: The Final Regulations continue to require that capital interest allocations be compared to allocations made to significant unrelated partners. Establishing that the Capital Interest Exception applies to sponsor co-invest vehicles, where only API holders fund capital contributions, may be

challenging. No specific guidance is provided in the Final Regulations regarding such co-invest vehicles. Rather, the IRS is continuing to study this issue.

- The Proposed Regulations provided that capital funded by an API holder from a loan to the API holder by the partnership, a partner or a related person does not qualify for the Capital Interest Exception. The Final Regulations relax this rule somewhat. Under the Final Regulations, a loan from a partner or related person (but not from the partnership) will not disqualify the Capital Interest Exception from applying if (i) the loan is fully recourse to the API holder, (ii) the API holder has no right to reimbursement from any other person and (iii) the loan is not guaranteed by any other person.

  Comment: Managers that facilitate lending programs for their employees will unfortunately need to be mindful about this third prong. Under the Final Regulations, a management company may loan amounts to its employees on a fully recourse basis to enable such employees to fund their capital contributions. However, a guarantee provided by a management company in respect of a fully recourse loan provided to an employee by another partner or related person (such as a bank) may cause such employee's capital contributions to fail to satisfy the Capital Interest Exception, even though the employee remains fully liable in respect of the loan.

  Comment: As with the Proposed Regulations, the Final Regulations provide that the Capital Interest Exception will apply once the loan is paid off. An employee that sells a partnership interest that is subject to the loan rules should consider paying down the loan prior to the sale.

- The Final Regulations clarify that taxable gain allocated to an API holder in respect of an API that is invested in the fund, whether or not actually distributed and recontributed, will be treated as a capital contribution so that the earnings on such amount may qualify for the Capital Interest Exception.

  Comment: This guidance is helpful to hedge fund managers that receive an annual incentive allocation of profits from the hedge fund that becomes part of the hedge fund manager's capital interest as well as private equity funds with significant "recycling" of proceeds from investments. The Final Regulations, however, make clear that this applies only to earnings on taxable income. An incentive allocation on unrealized appreciation will not be treated as a capital contribution and earnings on this "reinvested" amount will not qualify for the Capital Interest Exception.

RELATED PARTY TRANSFERS

- Section 1061 requires a taxpayer that transfers an API to a related party to recognize short-term capital gain equal to the aggregate appreciation in assets with a holding period of less than three years. The Final Regulations walk back the approach taken by the IRS in the Proposed Regulations requiring that a transferor of an API immediately recognize gain on a transfer to a related party that would not otherwise be taxable. Instead, the Final Regulations only recharacterize a portion of the capital gain recognized on a taxable sale or exchange of an API with a related party as short-term.

  Comment: The approach in the Proposed Regulations would have created many traps for the unwary with respect to otherwise nontaxable transfers of APIs to related parties. By narrowing this rule so as to apply only to taxable sales or exchanges of APIs, the Final Regulations eliminate these traps.

- The Final Regulations clarify that gains that are not otherwise subject to recharacterization under Section 1061 will not be recharacterized as a result of a transfer of an API to a related party.

- The Final Regulations also clarify that gain recognized on a transfer to a related party of an interest in an S corporation or passive foreign investment company treated as an API, or of property that has been previously distributed in kind with respect to an API, is subject to recharacterization.

LOOK-THROUGH RULE

- The Final Regulations include a look-through rule under which the seller of an API held for more than three years may be required to look to the holding period of the underlying assets when applying Section 1061. However, the look-through rule in the Final Regulations is significantly narrower than the mechanical "substantially all" rule set forth in the Proposed Regulations. Under the Final Regulations, the look-through rule is limited to sales of an API held for more than three years if (i) there is a principal purpose of avoiding gain recharacterization under Section 1061 or (ii) the API would have a less than three-year holding period if that period started on the date that significant third-party investors are obligated to fund capital to the underlying partnership. To be significant, the capital obligation must be at least 5% of the partnership's total capital contributions as of the date of the sale of the API.

Comment: The Final Regulations continue to provide that, if a partnership sells an asset with a greater than three-year holding period, a carried interest recipient may recognize long-term capital gains even though the grant of carried interest was within three years. Similarly, if an API held for less than three years is sold, the gain will be recharacterized under Section 1061 even if the underlying assets have been held for longer than three years.

Comment: Even if the look-through rule applies, for example, if a partnership was set up and carry was granted before third-party capital was invested, carry recipients would only have an issue if the underlying assets have been held for less than three years.

Comment: The Final Regulations do not include an example demonstrating how the test in (ii) above applies in the case of an interest in a partnership that is entitled to receive carried interest in respect of more than one underlying partnership. This would be welcome clarification in future guidance.

OTHER NOTEWORTHY ITEMS

- The Final Regulations apply a look-through approach to capital gain dividends received from real estate investment trusts ("REITs") and regulated investment companies ("RICs"). The Final Regulations permit, but do not require, REITs and RICs to report the necessary information to their owners for them to benefit from the look-through approach.

  Comment: API holders in partnerships that invest in REITs and RICs should confirm that they will receive the necessary disclosure information in order to avoid capital gain dividends attributable to investments held by the REIT or RIC for at least three years being taxed at ordinary rates.

- The IRS is studying whether API holders that sell their interest in a management company whose assets consist of investment management contracts could be subject to tax under Section 1061 on the enterprise value of the management company at ordinary rates.

Effective Dates and Additional Changes in Law

- The Final Regulations generally will become effective for taxable years beginning on or after the year they are published in the Federal Register. However, if the Final Regulations are not published before the change in administration on January 20, 2021, they likely will be subject to an automatic freeze that will apply to all

unpublished regulations, which may create uncertainty for taxpayers applying these rules.

- Given some of the recent electoral results and the Democratic Party's effective control of the Senate, there is an increased possibility of further changes to tax law, including around carried interest and capital gains rates.

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