

# Proposed Regulations on Carried Interest

August 4, 2020

Treasury and the IRS have released long-awaited Proposed Regulations under Section 1061. 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 Proposed Regulations largely follow taxpayers’ expectations on how Section 1061 would operate. Namely, carried interest attributable to investments held for less than three years will be taxed at ordinary rates and carried interest attributable to investments held for more than three years will continue to benefit from long-term capital gain rates. The Proposed Regulations, however, take a narrower view of the capital interest exception than many had anticipated and raise many questions that may be addressed in final regulations.

This Update highlights important aspects of the Proposed Regulations, with an emphasis on the impact on private equity fund sponsors.

## APPLICABLE PARTNERSHIP INTEREST

- 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.
- The Proposed Regulations define an applicable trade or business as any activity where “Specified Actions” are conducted at a level that would constitute a “trade or business” under Section 162 (the “ATB Test”). Specified Actions must include both (1) raising or returning capital and (2) investing or disposing of “Specified Assets” or developing Specified Assets. Specified Assets are defined generally as securities, commodities, real estate, cash and cash equivalents, any partnership interest (to the extent it holds any of the foregoing) and an option or derivative contract with

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respect to any of the foregoing. The ATB Test aggregates Specified Actions of all related persons (using general partnerships rules of relatedness) and agents or delegates.

- Section 1061 does not apply to a partnership interest that is owned by a corporation. However, as previously announced, the Proposed Regulations provide that taxpayers cannot avoid the application of these rules by holding carried interest through an S-corporation. The Proposed Regulations extend this approach to passive foreign investment companies (“PFICs”) that have a qualified electing fund election in effect.

Comment: The IRS’s decision to extend this exclusion to a PFIC with a qualified electing fund election is not surprising since a PFIC with this election would also allow long-term capital gains treatment to pass through to its shareholders.

#### WHAT’S IN AND WHAT’S OUT

- The Proposed Regulations make clear that Section 1061 does not apply to qualified dividend income or various types of income that qualify for long-term capital gain rates without reference to holding period rules, such as Section 1231 gains from depreciable or real property used in a trade or business and gains on derivatives and other financial instruments that are marked to market under Section 1256.

Comment: A fund that sells a portfolio company operating in flow-through form may realize a significant amount of capital gains that is not subject to the three-year holding period requirement as a result of the Section 1231 exception.

- The Proposed Regulations apply a look-through approach to capital gain dividends received from real estate investment trusts (“REITs”) and regulated investment companies (“RICs”).

Comment: Carried interest attributable to investments in REITs and RICs can benefit from long-term capital gains rates with respect to capital gain dividends from investments with a three-year holding period, regardless of how long the investors have held their REIT or RIC shares.

- Gain from investments sold before the three-year holding period is met will be subject to these rules including for cash received after three years, even if the taxpayer uses the installment method for reporting gain.

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Comment: The installment sale rule follows the IRS's approach to installment sales and regular long-term capital gains.

Comment: The Proposed Regulations apply these rules to 2017 dispositions reported under the installment method, even though those dispositions occurred before the enactment of Section 1061.

- The Proposed Regulations allow taxpayers to net gains and losses with a one- to three-year holding period, thereby allowing for gains and losses from multiple APIs to be combined and netted.
- Under the Proposed Regulations, a non-service provider third-party purchaser of an API is not subject to these rules.

#### EXCEPTION FOR CAPITAL INTERESTS

- Section 1061 does not apply to gain attributable to a capital interest in a partnership, which provides the taxpayer with a right to share in partnership capital “commensurate” with the amount of capital contributed or the value recognized by the taxpayer upon receipt or vesting of the capital interest. The Proposed Regulations generally apply a restrictive approach to the capital interest exception.
- The Proposed Regulations measure a service provider's return on capital based on other significant (5% or more) unrelated partners' return on capital. The Proposed Regulations provide that capital interest allocations will generally be respected if they are based on the relative capital accounts of partners and the terms, priority, type and level of risk, rate of return and rights to cash or property distributions are the same.

Comment: The emphasis that capital interest allocations must be consistent with capital accounts may create uncertainty for many common commercial situations, for example, when partners participate in deals in varying percentages to account for excuse or other commercial concerns.

- The Proposed Regulations provide that capital interest allocations in respect of a partnership interest that otherwise satisfies the capital interest requirements will not be disqualified if such allocations (i) are subordinate to that of unrelated partners or (ii) are not reduced by the cost of services charged to unrelated partners.

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Comment: While there is no requirement in the Proposed Regulations that sponsor capital be subject to self-charged management fees, the Proposed Regulations create some ambiguity as to whether sponsors may be required to apply Section 1061 as if they self-charged carry. For example, if the sponsor funds 2% of total capital and earns 20% carry on all LPs (but not on the sponsor's capital), the Proposed Regulations could be read to apply the capital interest exception only to 80% of the return on the GP's 2% capital interest.

- The capital interest allocations must be clearly identified in the partnership agreement and the partnership's books and records as separate and apart from the non-capital interest allocations.

Comment: Funds may need to amend their documents to fit within the Proposed Regulations if they are finalized in current form.

- The Proposed Regulations provide that the capital interest exception does not apply to an interest attributable to any loan or other advance made or guaranteed, directly or indirectly, by any other partner, the partnership or any of their related persons. However, the partnership interest will be eligible for the capital interest exception in respect of amounts repaid on the loan.

Comment: Section 1061 does not include a kick-out rule for capital interests funded with loans, and this aspect of the Proposed Regulations is likely to be controversial. Both loans from sponsors and bank loans guaranteed by sponsors would be covered. A carry participant that sells an API that is subject to the loan rules should consider paying down the debt prior to the sale.

- The Proposed Regulations include rules permitting taxpayers to sell their capital interests while retaining their carried interests.

Comment: Under the normal "single partnership interest" rule, taxpayers selling a portion of a partnership interest generally must apportion their basis and holding periods pro rata between the portion sold and portion retained based on fair market value (e.g., partners cannot track basis and holding periods separately to different classes of partnership interests). While the Proposed Regulations allow taxpayers to track a partial sale to capital interests that are not subject to recharacterization, the general basis allocation rule continues to apply in determining the amount of taxable gain on the sale of a capital interest.

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### SALES OF AN API

- The Proposed Regulations retain the prevailing rule that the relevant holding period of an asset for purpose of Section 1061 is measured at the level of the seller.

Comment: If a partnership sells an asset with a greater than three-year holding period, a carried interest recipient may recognize long-term capital gains with respect to the asset even if the recipient received the grant within three years.

- A carried interest recipient that sells an API generally will recognize long-term capital gain on the sale if the recipient owned the API for more than three years. However, the Proposed Regulations introduce two look-through rules that recharacterize some of this gain as short-term.
- First, in the case of a sale of an API that a taxpayer owns for more than three years, if 80% or more of the fair market value of the assets of the applicable partnership consist of capital assets with a holding period of three years or less (the “Substantially All Test”), the Proposed Regulations recharacterize a portion of the gain from the sale of the API as short term based on the gain with respect to the underlying assets. A similar look-through rule applies in the case of a sale of an interest in a partnership that holds an API if such partnership meets the Substantially All Test.
- The Proposed Regulations also look through certain tiered partnership arrangements to the extent that an underlying API has been held for fewer than three years, even if an individual carried interest recipient has a greater than three-year holding period in an upper-tier partnership.

Comment: This look-through rule will cause a portion of the gain on sale of a platform vehicle used to aggregate carried interest for a number of different vehicles to be taxed at short-term rates to the extent the holding period in the carry vehicles is three years or less.

### RELATED PARTY TRANSFERS

- Related party transfers of APIs are subject to a special gain recognition rule under Section 1061. If a taxpayer transfers an API to a related party, the taxpayer recognizes short-term capital gain equal to the aggregate appreciation in assets with a holding period of less than three years, even if the transfer would not otherwise be taxable.

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- The Proposed Regulations provide that “transfer” includes, but is not limited to, contributions, distributions, sales and exchanges, and gifts. However, the related party transfer rules do not apply to a contribution to a partnership under Section 721(a).

Comment: The Proposed Regulations allow for this exception because they require partnerships to track built-in gain that would otherwise be subject to Section 1061 using principles similar to those used to track other built-in gains under Section 704(c).

- The Proposed Regulations add to the “related person” definition any pass-through entity to the extent that a member of the taxpayer’s family or colleague is an owner.

#### OTHER NOTEWORTHY ITEMS

##### Distributions in Kind

- If a partnership makes a distribution of property with respect to an API, the distributed property must be held for more than three years in total (including the partnership’s holding period) to qualify for long-term rates. Once the three-year holding period has been satisfied, the property will generate long-term capital gains with respect to the portion that reflected the sponsor’s carried interest.

##### Carried Interest Waivers

- The Proposed Regulations do not address waivers of allocations of gains that would otherwise be treated as short-term capital gain under Section 1061. However, the preamble to the Proposed Regulations makes clear that such waivers have to be carefully structured to avoid IRS challenge under existing law.

##### Reporting Obligations

- API holders are required to report certain information to evidence compliance with Section 1061. Partnerships are obligated to provide the information needed by an API holder to comply with their reporting obligations and to determine their recharacterization amount. A partnership that does not provide the necessary information may be subject to penalties.
- In the event an API holder is not provided the necessary information, the Proposed Regulations generally assume that gain with respect to an API has a less than three-year holding period.

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Comment: While for many sponsors it should be easy to provide or obtain the necessary information, U.S. carry recipients should consider requesting additional protections ensuring that the relevant information is provided. This may be particularly important with respect to investments with non-U.S. fund managers, who would not necessarily be required to track this for their own purposes.

### Effective Dates

- Although the Proposed Regulations generally are not effective until final regulations are published, the rules regarding S-corporations apply to taxable years beginning after December 31, 2017, and the rules regarding PFICs are effective on the date the Proposed Regulations are published. Taxpayers may choose to apply the Proposed Regulations as long as they apply them in their entirety and in a consistent manner.

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Please do not hesitate to contact us with any questions.

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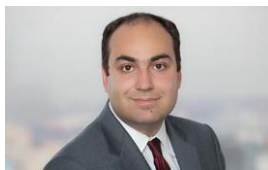
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