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INSIGHT: Treatment of Carried Interest—Breaking Down the Long-Awaited Proposed Regulations



BY MOSHE BIDERMAN, JONATHAN R. COLLETT, AND ROBERT RICHARDT

The Treasury Department and IRS recently released proposed regulations governing the treatment of “carried interest” under tax code Section 1061. Section 1061, which was added as part of the 2017 Tax Cuts and Jobs Act (TCJA), increases the required holding period to greater than three years (as compared to the normal rule of more than one year) for fund managers who benefit from the lower long-term capital gains rate on an “applicable partnership interest” (API).

These new proposed regulations clarify some but not all long-standing questions, and make significant adjustments to what is and is not subject to [Section 1061](#) treatment. Though there will likely be further clarifications when the final regulations are published, fund managers should review the proposed regulations carefully, understand the changes, and evaluate their existing arrangements to determine if any modifications should be considered based on this recent guidance.

Who is subject to Section 1061?

Section 1061 recharacterizes gains of a partner who holds an API, which is an interest in a partnership that is transferred to or held by a taxpayer in connection with the performance of substantial services in any applicable trade of business (ATB). An ATB is any regular, continuous, or substantial activity consisting of raising or returning capital, and either investing in or developing certain investment assets such as stocks, securities, commodities, and real estate. This definition

covers most general partners of hedge funds, private equity funds, and venture capital funds.

Exception for capital interests

A partner who holds an API is generally not subject to Section 1061 recharacterization with respect to the portion of his or her “capital interest” in the partnership. The proposed regulations apply a restrictive approach to the capital interest exception. To qualify as a capital interest, the allocations to the API holder need to be based on the partner’s capital accounts that have similar economic arrangements as those of an unrelated partner in the partnership. An example of such arrangements include the same rate of return and the same rights to distributions during partnership operations and on liquidation. The proposed regulations do not require fund managers to charge their LP accounts a management fee to otherwise qualify as an API.

In addition, the proposed regulations indicate that capital contributed by the holder of an API will not meet this exception if it is funded from a loan or guarantee on a loan from another partner or the partnership. As many fund managers have funded their capital interest with debt, these arrangements will need to be evaluated.

It is a common practice for hedge fund managers to reinvest their carried interest in the fund (i.e., profits earned from carried interest are not distributed). One of the most challenging questions for hedge fund managers is whether reinvested incentive allocations qualify for the capital interest exception. While not entirely clear in the proposed regulations, it appears that the reinvestment of realized gains from an incentive alloca-

tion may be treated as a capital interest and not subject to further recharacterization under Section 1061. The reinvestment of unrealized gains from prior allocations of carried interest likely does not meet the capital interest exception and would be subject to recharacterization under Section 1061.

Character issues

The proposed regulations clarify that Section 1061 does not apply to gains whose holding period is not determined under [Section 1222](#). For example, [Section 1231](#) gains, [Section 1256](#) gains, and qualified dividend income are not subject to recharacterization under Section 1061.

Fund managers need to pay close attention to the structure of their transactions based on this rule. For example, in the case of real estate, it may be more efficient to structure a sale of an asset held less than three years as an asset sale qualifying for Section 1231 treatment, as opposed to a sale of the partnership interest, which would be treated as a long-term capital gain and subject to recharacterization under Section 1061.

Disposition of a partnership interest

The proposed regulations clarify that a disposition of a partnership interest that is an API is subject to Section 1061. Additionally, they “provide rules for determining the extent to which long-term capital gain or loss recognized on the disposition of a pass-through interest [composed] of both an API and a capital interest is excluded from Section 1061 because it is treated as a capital interest gain or loss.”

Capital gain dividends from regulated investment companies (RICs) and real estate investment trusts (REITs)

There was uncertainty on whether long-term capital gains distributed from a RIC or a REIT would be excluded from Section 1061 if the gains were from assets held for more than three years. The proposed regulations provide that “long-term capital gain treatment should be available to the extent that the capital gain dividend is attributable to capital assets held for more than three years or is attributable to assets that are not subject to Section 1061.” RICs and REITs must disclose additional information that will allow partnerships that invest in these assets to easily determine how much is potentially subject to the recharacterization rules.

Carry waivers

In an attempt to circumvent Section 1061, some funds modified their partnership agreements to allow fund managers to waive their rights to gains generated from the disposition of a partnership’s capital assets held for three years or less and substitute for gains generated from capital assets held for more than three years. This allowed managers to potentially receive only greater-than-three-year gains as carried interest, thus benefitting from the lower long-term capital gains rate. The proposed regulations do not specifically address these arrangements; however, the preamble

states that these arrangements may not be respected under Section 707 of the tax code or the “economic substance over form” doctrines. Fund managers will need to review their partnerships agreements to evaluate the risk of having carry waiver clauses.

Definition of pass-through entity

The proposed regulations, consistent with prior guidance, clarify that partnership interests held by S corporations and by passive foreign investment companies (when a shareholder has a QEF election in effect) will be treated as APIs, and that gains allocated to shareholders of these entities will be subject to Section 1061 recharacterization if the interest otherwise meets the API definition.

Property distributions

If assets are distributed to an owner of a pass-through subject to Section 1061, the subsequent gain on the sale of such assets would be subject to recharacterization if held for longer than one year but less than three years. This was done to prevent partnerships from distributing unrealized gains to carried interest holders with the thought that such holders would not be subject to Section 1061 at the owner level.

Bona fide purchaser

In many cases, interests in a carried interest pass-through are sold by departing managers, or fund managers may want to bring in an outside investor to realize gains early by selling a piece of their carried interest. The proposed regulations indicate that if the carried interest is sold to an unrelated third party (that is also not a service provider) in an arm’s-length transaction, such interest in the hands of the purchaser is not subject to Section 1061.

Installment sales

The proposed regulations clarify the installment sale rules with respect to gains that occurred before Jan. 1, 2018. The regulations state that installment gains recognized on receipts after Jan. 1, 2018, are subject to Section 1061 if the holding period of such asset was held for more than one but less than three years. For example, a fund sells stock held for two years for a gain in November 2017, and the sales price will be collected in 2018 and 2019. The gains recognized in 2018 and 2019 will be subject to recharacterization.

Final thoughts

The proposed regulations generally are not effective until final regulations are published, but the rules regarding S corporations apply after Dec. 31, 2017. Fund managers should speak to their tax advisors to review how the proposed regulations apply to them.

Many uncertainties pertaining to the original statute have been clarified; however, many questions remain unclear. Fund managers should review their existing fee arrangements, as well as any strategies or positions taken prior to publication of these proposed regulations.

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Author Information

Moshe Biderman , *Jonathan R. Collett*, and *Robert Richardt* are tax partners with CohnReznick and members of the firm's Financial Services Industry practice.