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# Treasury and IRS Release Final Regulations on Treatment of Carried Interest

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

The Treasury Department and IRS recently released final 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 to benefit from the lower long-term capital gain rates on allocations of carried interest.

An initial round of proposed regulations published in July 2020 clarified some but not all of the long-standing questions on how the law is applied. Many commenters felt that the proposed regulations did not address common industry practices and were overly complex.

The final regulations generally adopt the proposed regulations; however, Treasury and the IRS have made substantial taxpayer-friendly modifications in the areas described below.

## Capital interest exception

Capital interests are exempt from recharacterization under Section 1061 to the extent that they represent a return on the capital invested in a partnership. The proposed regulations provided a very narrow interpretation of this exception, as they required (a) that the partnership agreement base allocations on the relative capital accounts of the partners receiving the allocations, and (b) that the terms, priority, type and level of risk, rate of return, and rights to cash or property distributions during the partnership's operations and on liquidation be the same as for non-service provider partnerships. Many commenters were concerned that hedge fund, venture capital, and private equity fund managers would not be able to use the capital interest exception as many funds do not allocate based on Section 704(b) capital accounts, but may instead allocate based on targeted allocations or other methods.

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The final regulations, while retaining some of the factors in the proposed regulations, have scaled back these rules and were updated to provide that ''capital interest allocations must be commensurate with capital contributed [by unrelated non-service partners] to qualify for the exception.'' The test may be applied on an investment-by-investment basis or on the basis of allocations made to a particular class of interests. As a result of these changes, it is anticipated that common economic arrangements in private equity and hedge funds will now qualify for the capital interest exception, where they would not have qualified based on the language in the proposed regulations.

## Reinvestment of API gain

It is very common for hedge fund managers to reinvest carried interest in the fund, and there was a lack of guidance whether the reinvested carry would be subject to Section 1061. The final regulations provide that reinvestment of an applicable partnership interest (API) gain (either as the result of an actual distribution and recontribution of the API gain amount or the retention

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of the API gain by the partnership) will be treated as a capital interest. Based on an example in the final regulations, the reinvestment of realized API gains will qualify as a capital interest; however, it appears that the unrealized API gains will continue to be subject to Section 1061 recharacterization.

## The treatment of capital interest acquired with loan proceeds

The proposed regulations did not apply the capital interest exception to a partner who borrows funds from the partnership, another partner, or a related entity to make capital contributions. Several commenters said that the rule ''inhibits common and reasonable business practices and creates barriers to entry for service partners.'' The Treasury and IRS considered some of the comments, but still thought that loans could be used to abuse the capital interest exception. However, they felt the potential for abuse is reduced if the service provider is personally liable for repayment of the loan used to make a capital contribution, and so the final regulations state that capital contributed by a service partner with borrowed funds will be considered a capital interest if the service partner is personally liable for the loan.

## The lookthrough rule for certain API dispositions

The proposed regulations included a lookthrough rule with respect to the sale of an API held for more than three years. The holding period of the assets in the partnership must also be tested to see if 80% of such assets have a holding period of three years or less, a requirement called the ''substantially all'' test. In a tiered partnership structure, the administrative burden of applying these rules to lower tiered partnerships was significant. The final regulations have simplified this rule by eliminating the ''substantially all'' test.

## Transfers of APIs to related persons

The proposed regulations provided that if an API is transferred to a related party, the transferring partner may recognize short-term capital gain based on a hypothetical sale of the underlying assets of the API. Such transfers were defined as including contributions, distributions, sales and exchanges, and gifts. This was very controversial, as it created an acceleration event in a transaction that would otherwise be non-taxable.

The final regulations state that to the extent a transfer was otherwise non-taxable, this transfer will not accelerate tax recognition, and the transferee holding the API will be subject to Section 1061. This is a welcome change; gifting carried interest is a common estate planning technique, which is now permissible, but would have been a trap for the unwary under the proposed regulations.

## Bona fide purchaser

In many cases, interests in a general partnership (GP) entity with a carried interest entitlement are sold by departing managers. Or, in some cases, non-service partners may get a portion of the carried interest entitlement as an enticement for providing seed capital. The final regulations provide that if a non-service partner purchases a partnership interest in an API, Section 1061 would not apply to the purchased interest. However, if in lieu of purchasing a partnership interest, a non-service partner contributes capital to a partnership that holds an API, there is no similar exception. Accordingly, although the purchasers aren't providing services, they would be subject to Section 1061. Seed investors should be mindful of the impacts of Section 1061 when structuring their acquisitions of entities that have an API.

## In-kind distributions

For distributions of securities held more than one year and less than three years to an API holder, the proposed regulations stated that the API must hold the distributed securities for more than three years, inclusive of the transferor's holding period in a non-taxable transfer, in order to recognize long-term capital gains. The final regulations clarify that if securities not subject to Section 1061 are distributed (Section 1231 or Section 1256 assets), the three-year holding requirement by the distributee partner does not apply.

## Final thoughts

The government has clearly narrowed the scope and reduced the complexity of the carried interest regulations, which is a welcome change. The final regulations provide much more flexibility for investment funds to qualify for the capital interest exception and will allow fund managers to gift carried interests to family members, which is a very common estate planning technique. Fund managers should be aware of these changes, and review fund documents to ensure that their capital interests avoid gain recharacterizations under Section 1061.

While the final regulations provide much needed guidance on the taxation of carried interest, the future of this legislation remains unclear. It appears that both chambers of Congress will be narrowly controlled by Democrats at the beginning of the Biden Administration. This majority may allow the Democratic Party to make significant tax law changes. President-elect Biden may seek to eliminate the tax break for carried interest entirely, and his proposed tax plan would eliminate preferential capital gain rates for people who earn over $1 million per year, which would significantly reduce the tax benefit of carried interest for fund managers.

*This column does not necessarily reflect the opinion of The Bureau of National Affairs, Inc. or its owners.*

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