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Key Takeaways From the Carried Interest Proposed Regulations

August 21, 2020

Under current (post-2017) federal income tax law, long-term capital gain allocated to or realized by a non-corporate recipient of a promote or other performance-based allocation (a “Carried Interest”) in the investment management industry generally is recharacterized as short-term capital gain and therefore is not eligible for a reduced federal income tax rate if the gain results from a sale of an asset held for three years or less. Section 1061 of the Internal Revenue Code, which implements the 3-year holding period requirement, left many unanswered questions concerning the scope and application of this requirement to be addressed by the Internal Revenue Service (IRS) and US Treasury, including the potentially broad application of Section 1061 to a vast array of private equity investment vehicles and service providers in a variety of trades or businesses.

The Proposed Regulations under Section 1061 issued on July 31 (the “Carried Interest Regulations”) (REG-107213-18) address some of these issues. The Carried Interest Regulations generally are not effective until taxable years beginning on or after the date on which the final regulations are published (except for certain provisions noted below), and are likely to be revised before they are finalized. Below are the highlights and our high-level observations concerning the practical implications for some businesses, investors and service providers (should these regulations be adopted as proposed).

Which interests are covered?

Perhaps not surprisingly, the Carried Interest Regulations take a broad view of what is subject to the 3-year holding period requirement. Generally, the Carried Interest Regulations look to whether the recipient of the Carried Interest and all related persons collectively are engaged in an applicable trade or business that consists of raising and returning capital to investors and investing or developing certain types of assets (including corporate stock and real estate held for rental or investment but generally not including investments in operating partnerships). As a result, virtually any partnership (or LLC) interest issued by an investment fund vehicle, including hedge funds and private equity funds, to the general partner, managing member or a related person as consideration for providing management or investment advisory services to the fund is covered by these rules.

A limited “out” may exist in certain circumstances for a carried interest in a partnership whose investments are limited to flow-through interests in operating businesses (other than real estate rental businesses). For example, it may be possible for an independent sponsor to take the position that a Carried Interest in a partnership that is conducting a business directly or through other flow-through entities is not held in connection with an applicable trade or business and, accordingly, is not subject to the 3-year holding period requirement. This position would presumably only be reasonable if, at a minimum, the economics of the carried interest are limited to the performance of the operating partnership and are not affected by the performance of other investments, but other factors related to the independent sponsor’s activities may be relevant. In addition, Carried Interests issued as incentive compensation to employees of an entity that is not engaged in an applicable trade or business are generally excluded so long as the employee only provides service to that entity.

Are Carried Interests received in exchange for capital contributions exempt?

Section 1061 as enacted includes a carve-out for "capital interests" that provide the taxpayer with the right to share in partnership capital commensurate with the taxpayer's after-tax investment. The scope of this exception for capital interests is a critical issue for which practitioners have been awaiting guidance. Unfortunately, the Carried Interest Regulations take a very restrictive view of what a capital interest is, and define it so narrowly as to exclude — we believe unintentionally in some instances — many interests that we believe should be considered capital interests. Even in the seemingly straightforward case where a service provider receives a partnership interest in consideration for making a capital contribution, the interest would fail to be treated as a capital interest under the Carried Interest Regulations unless it has the same terms, priority, rate of return and rights to distributions over the partnership term and on liquidation as non-service providing investors.

There is a limited exception to the requirement of the "same" rights whereby the interest will not be disqualified solely because it is subordinated to allocations to the investors or because it is reduced by the cost of the service provider's services. Customary differences in treatment of Carried Interests and investor interests, respectively, such as those relating to withdrawal rights, allocations of certain expenses, rights to receive tax distributions and possibly even exempting interests held by the service provider and related persons from Carried Interest allocations, may disqualify the service provider's entire interest from the capital interest exemption. Moreover, an interest received for capital contributions made using amounts borrowed from or guaranteed by the partnership or a partner or related person will not be treated as a capital interest. In the less straightforward situation where the service provider elects to re-invest Carried Interest income on which it has not yet been taxed, it is not altogether clear (although we believe it should be) that the re-invested amount will qualify as a capital interest. We expect that at least some of these concerns will be addressed before the regulations are finalized.

The Carried Interest Regulations also indicate the need to distinguish — both in the partnership agreement and on the partnership's books and records — between allocations made with respect to a Carried Interest and allocations made with respect to a capital interest in order for any allocations to the service provider to qualify for the "capital interest" exemption. The Carried Interest Regulations impose corresponding additional tax reporting obligations for many partnerships that issue carried interests (and potentially lower-tier partnerships in tiered structures), and also require that partnership agreements be drafted so as to clearly distinguish between Carried Interest allocations and capital interest allocations if the service provider wants to be able to rely on the "capital interest" exception to the 3-year holding period requirement. Notably, we anticipate that the additional reporting and record-keeping requirements (e.g., with respect to 3-year versus 1-year holding periods in assets) that are necessary to implement the Carried Interest Regulations may affect many partnerships as well as certain real estate investment trusts and regulated investment companies.

Are Carried Interests in family offices exempt?

The Carried Interest Regulations reserve on this question, but it is our view that a Carried Interest issued by a family office to a family member (or related person) for services performed for the family office should not be subject to the Carried Interest rules if there are no third-party investors. Each family office is unique, so it is important to reach out to your tax advisors to discuss potential application of the Carried Interest Regulations to your family office.

Are gifts of Carried Interests impacted?

Under the Carried Interest Regulations, otherwise non-taxable transfers of a Carried Interest to a related person, including by gift or inheritance, result in the service provider's immediate recognition of short-term capital gain to the extent of any gain attributable to underlying assets held for three years or less. The Carried Interest Regulations define "related persons" to include (1) family members within the meaning of Section 318 of the Code (i.e., spouse, children, grandparents and parents); and (2) colleagues (i.e., any person who provides services in the calendar year or the three proceeding calendar years in the relevant trade or business). If you intend to make future gifts and are

considering a gift of a Carried Interest, it is important to discuss the gift and estate tax implications as well as the federal income tax implications with your tax advisor.

Are Carried Interests held by corporations exempt?

Carried Interests held by subchapter C corporations are not subject to Section 1061. Shortly after the enactment of Section 1061, the IRS announced that it intends to apply the statute to Carried Interests held by subchapter S corporations because of their flow-through tax treatment, and the Carried Interest Regulations adopt a consistent position (which is retroactive to 2018 regardless of when the Carried Interest Regulations are finalized). The Carried Interest Regulations adopt a similar position in the case of a carried interest held by a passive foreign investment corporation (PFIC) with respect to which the shareholder receives the benefit of long-term capital gain treatment as a result of a qualified electing fund (QEF) election. This position was not previously announced by the IRS, and the Carried Interest Regulations indicate that such Carried Interests will be subject to these rules, in the case of a shareholder who makes or has made a QEF election, beginning (for most shareholders) in taxable years beginning after the Carried Interest Regulations are finalized. (Outstanding Carried Interest held by PFICs that were issued prior to the effective date would not be grandfathered.)

What types of gains are excluded from the recharacterization requirement?

The Carried Interest Regulations take a generally taxpayer favorable interpretation of Section 1061 as it relates to certain special types of gains that are characterized as long term capital gains (or otherwise subject to reduced rates) under specific provisions of the tax code. For example, Section 1231 gains (which are common in the real estate industry) are specifically excluded from the recharacterization requirement. Section 1231 applies to gain on any property used in a trade or business, including amortizable goodwill and certain other intangibles. The Carried Interest Regulations also exclude gains from Section 1256 contracts, qualified dividend income and certain gains with respect to mixed straddles. The Section 1231 exclusion, in particular, could give rise to structuring opportunities to mitigate the impact of Section 1061. For example, in the context of the disposition of an investment in an operating partnership by a private equity sponsor where the investment has a 3-year or less holding period, depending on the nature of the assets of the business, structuring the transaction as a sale of assets by the partnership may give rise to gains eligible for the Section 1231 exclusion and, accordingly, relatively less recharacterization under Section 1061 with respect to the portion of any such gains allocable to an upper-tier Carried Interest.

Do in-kind distributions avoid the 3-year holding period requirement?

The Carried Interest Regulations provide that gain with respect to property received in an in-kind distribution made to the holder of a Carried Interest is subject to Section 1061 until the asset has been held for more than three years (based on the combined holding period of the partnership and the Carried Interest holder). However, if the asset distributed is one which, if sold by the partnership, would have generated long-term capital gain for the holder of a Carried Interest without regard to the partnership's holding period (such as Section 1231 property or Section 1256 contracts), then the asset should not be subject to the 3-year holding period requirement once distributed to the Carried Interest holder.

Can a partnership substitute qualifying capital gain for less than 3-year gains?

The Carried Interest Regulations take notice of provisions in private equity fund partnership agreements that attempt to waive current allocations of capital gain that do not satisfy the 3-year holding period requirement in exchange for the right to receive future allocations of capital gain from the sale of assets held for more than three years or other qualifying gains (e.g., qualified dividend income). While stopping short of saying that such allocations don't work, the Carried Interest Regulations indicate that such allocations will be scrutinized and may be challenged. We continue to believe that properly drafted waivers that expose the Carried Interest holder to economic risk should be given effect.

How is the 3-year holding period determined generally and in connection with add-on acquisitions?

The Carried Interest Regulations confirm that for purposes of measuring the 3-year holding period, the relevant holding period is the holding period of the owner of the applicable asset giving rise to long-term capital gain subject to potential recharacterization. This is an important clarification and addresses concerns that had been raised by many practitioners related to situations where the holder of the Carried Interest may have a less than 3-year holding period in the Carried Interest itself but the underlying fund could have a longer than 3-year holding period in an investment asset being sold at a gain. The Carried Interest Regulations generally confirm that the gain from an underlying asset with a 3-year holding period is not subject to recharacterization, regardless of the holding period of the investment manager in the Carried Interest. Gain realized on the direct or indirect disposition of a partnership interest that is a Carried Interest or through which a Carried Interest is directly or indirectly held, however, is subject to a special look through rule if substantially all of the assets of the underlying partnership consist of capital assets that would be subject to Section 1061, looking through tiers of partnerships for this purpose.

Add-on acquisitions can have an adverse impact on the relevant holding periods for purposes of the Carried Interest Regulations, especially with respect to investments in partnerships. When a fund purchases additional stock in a portfolio corporation, the fund would have a new, separate holding period for each new "block" of stock starting on the acquisition date. An add-on investment in a portfolio company treated as a partnership, however, results in a divided holding period in a single partnership interest based on the proportion of the fair market value of the new investment relative to the existing investment and upon disposition the same proportion generally applies to determine the nature of any gain for purposes of the Carried Interest Regulations.

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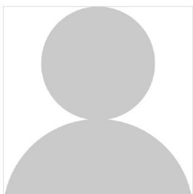
Please contact any of the following attorneys with any questions that you may have.



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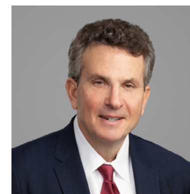

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06/20/20