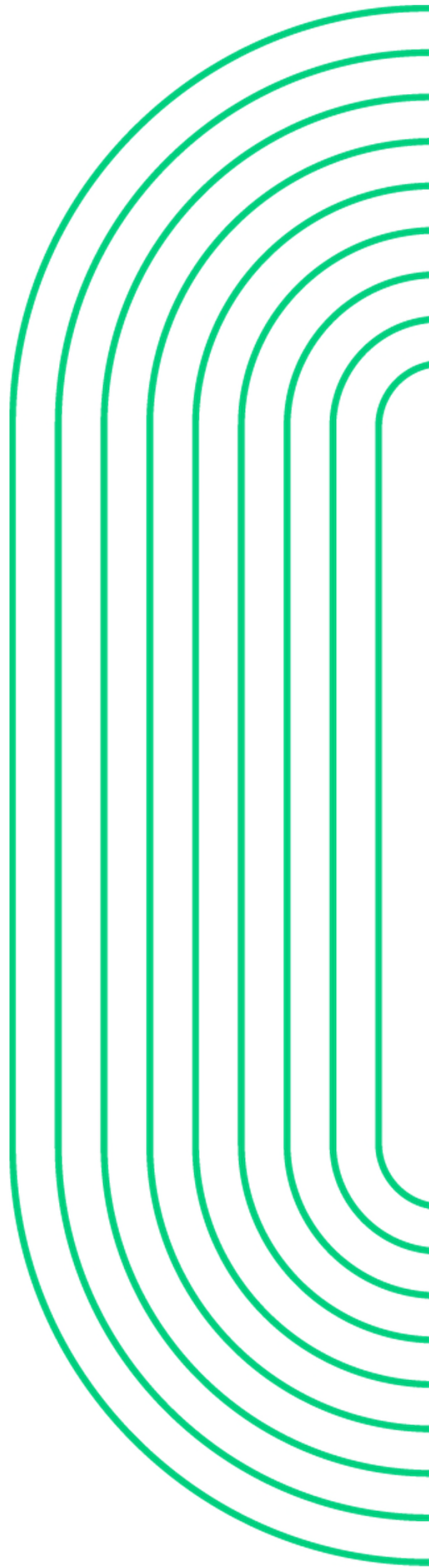


The Taxation of Carried Interest

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What is a carried interest?

- Common usage typically refers to a grant of equity awarded to a fund manager in exchange for the manager's services during the life of the fund
- Often called a “loophole”
- Enables manager to achieve long-term capital gain treatment
- Typically a “profits interest”



Carried Interest Timeline

- 1993 - Revenue Procedure 93-27: After years of uncertain treatment and litigation, IRS decided it would not assert that a compensatory grant of a profits interest is a taxable transaction.
- 2001 - Revenue Procedure 2001-43: The IRS announced that vesting of a profits interest is not a taxable event.
- 2005 – Proposed Section 83 regulations and Notice 2005-43 (never finalized): Section 83 would apply to grants of partnership interest but grantee allowed to use a liquidation value.
- December 2017 – Tax Cuts and Jobs Act Section 1061: Congress attempted to close the carried interest loophole by requiring a three-year holding period with respect to applicable partnership interests.
- July 2020 – Proposed Section 1061 Regulations released.
- January 2021 – Section 1061 Regulations finalized and effective.
- Spring/Summer 2021 – Biden Administration and Congress contemplating changes (also to capital gain rates).



Section 1061 Generally

- “Section 1061 recharacterizes certain net long-term capital gain with respect to applicable partnership interests (APIs) as short-term capital gain.” T.D. 9945 (Preamble, approved Jan. 5, 2021).
- Three-year holding period requirement.
- Rules have more “teeth” than many expected and apply to all partnership interests that meet the definition of an “applicable partnership interest” regardless of whether the interest is a profits interest.
- Affects primarily two categories of income:
 - Long-term capital gain from the sale or disposition of a carried interest.
 - Long-term capital gain allocated to the carried interest holder while a partner.



Section 1061 – Generally

- Section 1061 (a):

(a) In general

If one or more applicable partnership interests are held by a taxpayer at any time during the taxable year, the excess (if any) of—

(1) the taxpayer's net long-term capital gain with respect to such interests for such taxable year, over

(2) the taxpayer's net long-term capital gain with respect to such interests for such taxable year computed by applying paragraphs (3) and (4) of sections 1222 by substituting "3 years" for "1 year",

shall be treated as short-term capital gain, notwithstanding section 83 or any election in effect under section 83(b).



Section 1061 Regulations

- Section 1.1061-1: definitions and terms
- Section 1.1061-2: applicable partnership interests and applicable trades or businesses
- Section 1.1061-3: exceptions to the definition of applicable partnership interest
- Section 1.1061-4: computational rules and guidance
- Section 1.1061-5: related-party transfers
- Section 1.1061-6: reporting rules



Section 1061(c) – Applicable Partnership Interest

- Any interest in a partnership which, directly or indirectly, is transferred to (or is held by) the taxpayer in connection with the performance of substantial services by the taxpayer, or any other related person, in any applicable trade or business.
- If an interest is transferred “in connection with the performance of services”, there’s a presumption that substantial services were provided for purposes of Section 1061. Treas. Regs. Section 1.1061-2(a).
- Once a partnership interest becomes an API, it remains an API (until it meets the requirements of an exception) regardless of whether the service partner continues to perform services in the ATB. Treas. Regs. Section 1.1061-2(a).



Section 1061(c) – Applicable Trade or Business

- Applicable trade or business (“ATB”) – regular, continuous and substantial activity (Section 162 standard) of raising or returning capital *and* either investing in specified assets or developing specified assets.
 - Raising or returning capital and investing or developing need not occur in a single tax year
 - Activities conducted by persons related to the taxpayer are attributed to the taxpayer; activities not limited to a single entity
- Specified assets – securities (as defined Section 475(c)(2)), commodities, real estate held for rental or investment, cash/cash equivalents, options or derivative contracts with respect to any of the foregoing, and an interest in a partnership to the extent of the partnership’s proportionate interest in any of the foregoing.



Section 1061(c) – Applicable Partnership Interest

- Regulations provide examples. Treas. Regs. Section 1.1061-2.
 - Multiple entities – GP conducts raising and returning capital actions and related Management Company conducts investing actions. Activities are combined to satisfy the ATB rules. Both treated as engaged in an ATB.
 - Hardware store – Manager of hardware store organized as a partnership is awarded profits interest. Even though partnership owns the real estate that houses the store, such real estate is not held for rental or investment purposes. Partnership is not an ATB and the profits interest is not an API.



Treasury Regulations Section 1.1061-3 - Exceptions

- 1) Non-ATB employee exception – An API does not include any interest transferred to a person in connection with the performance of substantial services by that person as an employee of another entity that is conducting a trade or business (other than an ATB) and the person provides services only to such other entity.
- 2) Corporate exception – Any interest in a partnership directly or indirectly held by a corporation (other than S corps or certain PFICs)



Section 1061 - Exceptions

- 3) Capital interest exception – Any capital interest that provides a right to share in partnership capital commensurate with (i) the amount of capital contributed or (ii) the value of the capital interest subject to tax under Section 83 upon receipt or vesting
 - Capital interest disposition amount – Uses a hypothetical sale of the partnership's assets to determine the capital interest amounts that would be attributable to the sale of the equity interest
 - Capital interest allocations – Allocations must be determined in a similar manner as allocations with respect to capital interests held by unrelated non-service partners



Section 1061 - Exceptions

- 4) Unrelated purchaser exception – Unrelated purchaser not treated as acquiring an API if purchaser pays FMV for the partnership interest, does not (and did not) provide services to the partnership, and is unrelated to any person providing services to the ATB or partnership
- 5) Family office exemption – Section 1061 recharacterization does not apply to gain attributable to any asset not held for portfolio investment on behalf of third-party investors (reserved in Regulations)
- 6) Certain types of gain are excluded –
 - Qualified dividend income
 - Gains and losses under Section 1231 (depreciable property and real estate used in an active trade or business)
 - *Potential trap* – Exclusion for Section 1231 gains applies to gain from the direct sale of such assets, not gain from the sale of a partnership interest of the partnership that owns such assets



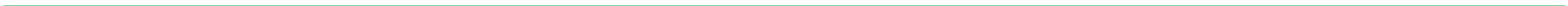
Section 1061 - Mechanics

- Treats what would have been long-term capital gain as short-term capital gain (Recharacterization Amount).
- Must determine the Recharacterization Amount each taxable year that taxpayer holds an interest in a partnership subject to Section 1061.
- Relevant holding period is the direct owner's holding period in the asset sold. Treas. Reg. Section 1.1061-4(b)(8).
 - Recharacterization of allocation of long-term gain – partnership's holding period
 - Recharacterization of gain from the sale of a carried interest – partner's holding period (except if Lookthrough Rule applies)



Treasury Regulations Section 1.1061-4(b)(9): Lookthrough Rule

- Anti-abuse rule
- Even if carried interest has been held for more than three years, two situations where gain is recharacterized as short-term capital gain:
 - (1) Holding period would be less than three years if the holding period excluded any period before which investors have capital commitments; or
 - (2) A transaction or series of transactions has taken place with a principal purpose of avoiding potential gain recharacterization under Section 1061.



Section 1061(d) – Transfers to Related Parties

- Gain from the transfers of API to related persons (primarily family members) may be recharacterized.
- Proposed regulations included nontaxable transfers such as gifts, which would have accelerated gains.
- Final regulations clarify that recharacterization rules for transfers to related parties do not accelerate gain for nontaxable transfers such as contributions to partnerships or gift transfers but future gains would potentially remain subject to recharacterization.



Section 1.1061-6 – Reporting Rules

- New reporting requirements for API holder and partnerships subject to the rules
- Additional information required on Schedule K-1s
- Failure to provide information may result in failure to file and failure to furnish correct statement penalties



Anti-Abuse Rules – Carry Waivers

- Preamble of proposed regulations identifies “carry waivers” as a potential abuse that may not be respected but no specific rules in the Proposed Regulations of the Finalized Regulations.
- “Carry waiver” – carried interest holder waives its right to gains from the disposition of the partnership’s capital assets held for three years or less and substitutes gains generated from capital assets held for more than three years.



Current Proposal - Budget Reconciliation Bill

- Extend the holding period from 3 years to 5 years in order to qualify for long-term capital gain treatment.
- 3-year holding period retained for real property trades or businesses and taxpayers with an adjusted gross income of less than \$400,000.
- Rules would apply to gains from the sale of all assets eligible for long-term capital gain rates; means that Section 1231 gain would be subject to the Section 1061 rules.
- If this becomes law, effective beginning in 2022.





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