IRS Releases Final Carried Interest Regulations

January 14, 2021

Asset managers should be aware that on January 7, 2021, the IRS released final regulations (the "Final Regulations") implementing section 1061 of the Code, which governs the character of carried interest gains allocated to or derived by a service partner in an investment fund. Very generally, the statute denies access to the 20% rate for long-term capital gains attributable to a carried interest unless the holder of the asset has a holding period of more than three years. Capital gains for which long-term treatment is denied will be taxable as short-term capital gain at marginal rates of up to 37%.

The Final Regulations provide many welcome clarifications to the proposed regulations published on August 14, 2020 (the "Proposed Regulations"). Among other changes, the Final Regulations provide a more flexible definition of a capital interest, to which the three-year holding period requirement of section 1061 does not apply. Funds should review and possibly amend their partnership agreements in order to ensure they are eligible for the capital interest exception.

The Final Regulations are generally applicable for taxable years of service partners in investment funds and the partnerships in or through which they hold their carried interests beginning on or after the date they are published in the Federal Register. The transition to the Biden Administration may delay publication or reopen the comment period if the Final Regulations are not published before January 20, 2021. If not so delayed, the Final Regulations would apply to interests in calendar-year partnerships beginning in 2022.

Statute and Proposed Regulations

The Tax Cuts and Jobs Act of 2017 (the "TCJA") enacted section 1061 in response to a longstanding controversy about whether long-term capital gains attributable to a carried interest should retain their character in the hands of service partner and be eligible for the 20% preferential rate, or instead should be characterized as compensation and taxed at the higher rates for ordinary income. Section 1061 permits income attributable to a carried interest to continue to be taxed as capital gains, but generally extends the holding period requirement for the long-term capital gains rate from one year to three years. Thus, the principal change brought about by section 1061 is that capital gains on assets held for between one and three years are generally taxed to carried interest holders at the up to 37% rate for short-term capital gains.

Section 1061(a) of the Code imposes the general three-year holding period requirement for long-term capital gains in respect of a carried interest (an "applicable partnership interest" or "API") directly or indirectly transferred to or held by a taxpayer in connection with the performance of services by the taxpayer or any related person in an asset management business (an "applicable trade or business"). Section 1061(c)(4)(B) provides a significant exception in the common situation in which the carried interest holder also owns a capital interest, to the extent of income "commensurate" with the amount of capital contributed by the partner (the "Capital Interest Exception").

The Proposed Regulations implemented the Capital Interest Exception through restrictive rules that were likely to prove unworkable in practice, and that in many common situations could prevent a carried interest holder from claiming an exemption on an arm's length return on a contribution of its own capital. The Final Regulations retain some limitations, but adopt a more flexible approach tied more closely to the statute.

Capital Interest Exception

The Final Regulations provide that gain allocated to or derived by a service partner is generally eligible for the Capital Interest Exception if:

- Gain allocated to the service partner on the capital interest is determined in a manner similar to the allocations on capital interests held by unrelated non-service partners that have made significant capital contributions to the fund (the "Commensurate With Capital Requirement").

- Allocations on the capital interest are clearly identified as separate and apart from allocations on the carried interest in the partnership agreement and in contemporaneous books and records of the partnership (the "Clear Identification Requirement").

If a service partner disposes of a partnership interest, the allocation of gain between its capital interest and its carried interest is made by reference to the gain the partner would have been allocated if the partnership sold the underlying assets for fair market value and distributed the proceeds in liquidation. Thus, these rules are relevant if a service partner may sell its capital interest in a fund to another partner or to the partnership, or may sell all of its interests in the fund in connection with a sale of the management business, within three years of receipt.

Commensurate With Capital Requirement. The Final Regulations treat capital interest allocations as made in a similar manner to those of significant unrelated non-service partners ("Third-Party Investors") if they are "reasonably consistent" with the allocations to those third parties, taking into account various economic factors including the amount and timing of capital contributed, the rate of return, the terms, priority, type and level of risk, and rights to cash or property distributions during the partnership's operations and on liquidation. The allocations need not be made based on capital accounts, and can vary by investment or class of interest.

The fact that interests held by management are not burdened by management fees or by the carried interest itself, are subordinated to the capital interests of Third-Party Investors, or have enhanced rights to tax distributions in the nature of advances against future distributions, are ignored in determining whether those interests are capital interests. Thus, many common fund arrangements will satisfy the Commensurate With Capital Requirement.

Clear Identification Requirement. The Final Regulations provide that allocations on a capital interest must be separately identified from allocations on a carried interest in the partnership agreement and books and records created when determining the allocations. The Final Regulations have no grandfathering rule for existing partnership agreements that do not satisfy these rules. Many funds with highly negotiated partnership agreements will already satisfy this requirement, as the carried interest earned by fund managers is often stated separately from and coordinated with the return on their capital. However, some partnership agreements may require attention, in particular if they make target allocations and the distribution waterfall does not break out amounts paid in respect of the carried interest separate from the asset managers' other returns.

Asset managers may wish to ensure that their partnership agreements satisfy this requirement, even if they anticipate that all of the fund's assets will be held for at least three years, in order to avoid adverse consequences on a sale or redemption of their partnership interests. For calendar-year taxpayers, modifications generally will need to be effective under the partnership agreement and for tax purposes as of January 1, 2022, in order to apply to gain allocated to or derived by a carried interest holder. While the deadline will vary by partnership, in some cases this may allow modifications to be made as late as March 15, 2023.

Mark-to-market events. If a partnership's revaluation of its assets causes a carried interest holder to have a capital account at any tier of the holding structure, the unrealized capital gain or loss attributable to the profits interest for services will retain its character under section 1061. However, the Final Regulations confirm that future allocations to the holder attributable to the increase in the capital account will be exempt from section 1061, provided the allocations otherwise satisfy the Capital Interest Exception, even though the service partner has not paid any tax on the gain. This clarification is expected to be of importance to hedge funds and other vehicles that allocate pre-carry returns based on marked-to-market capital accounts.

Debt-financed capital interests. The Final Regulations provide that the Capital Interest Exception generally will not apply if the service partner funded its interest with an advance made by the partnership, another partner, or a person related to any of them. In that case, the Capital Interest Exception will apply only to the extent that the carried interest holder is personally liable for repayment (without guarantee or reimbursement by another party) or actually repays the advance.

Other Changes and Clarifications

Look-through rules for holding periods. The Final Regulations provide new rules for determining what holding period applies when an asset manager recognizes gain on a disposition of its carried interest. The general rule when applying section 1061(a) is that the holding period taken into account is the direct owner's holding period in the asset sold, whether that is the manager's holding period in the carried interest or the partnership's holding period in an underlying asset. However, the Final Regulations include exceptions that override the application of this rule in some common situations, with the result that long-term capital gain recognized on the disposition of a carried interest will be recast as short-term by reference to the partnership's holding period in its assets.

Section 1061(d). Section 1061(d) requires look-through when a carried interest is transferred directly or indirectly to related parties, including a family member of the holder or to another service provider in the applicable trade or business. The Final Regulations define a "transfer" to include any transaction in which gain is recognized, and treat an indirect transfer as occurring to the extent a partnership is owned by related parties. As a result, the look-through rule under section 1061(d) applies when the general partner of a fund (holding a carried interest) redeems the interest of a withdrawing partner. It is not entirely clear that this was intended.

The Final Regulations implementing section 1061(d) are complex, and should be scrutinized in connection with any transaction involving a carried interest. The Final Regulations provide welcome relief, however, in that they limit the effect of section 1061(d) to recharacterizing long-term capital gain otherwise recognized on a related-party transfer, whereas the Proposed Regulations would have accelerated the recognition of gain realized on related-party transfers in many types of non-recognition transactions.

Dormant funds and abusive situations. To prevent asset managers from extending the holding periods of their carried interests by creating dormant funds that become active only at a later date, a new look-through rule applies when an asset manager would have a holding period of less than three years if the calculation excluded the time before significant unrelated non-service partners became legally obligated to contribute substantial money or property to the partnership. The new look-through rule also applies if transactions have occurred with a principal purpose of avoiding potential recharacterization under section 1061. When applying the look-through rule, however, the computation excludes any assets not held for portfolio investment on behalf of third-party investors. The new look-through rule should be considered in connection with any transfer of a carried interest to an unrelated party, such as in connection with a sale of an asset management business.

Real estate and certain other gains. The Final Regulations confirm that section 1061 applies only to long-term capital gains as defined in section 1222 of the Code. As a result, the carried interest rules do not apply to gains from real estate treated as long-term gains under section 1231 or to gain on commodities contracts treated as long-term gains under section 1256. The exception applies on a look-through basis to capital gain dividends paid by REITs and certain mutual funds, provided that the shareholding partnership receives adequate disclosure.

Fund managers should be aware, however, that the determination of whether gain on the disposition of a partnership interest is long-term gain is made under the general rule of section 1222, and there are currently no principles permitting one to look through to the partnership's assets. The preamble to the Final Regulations states that Treasury and the IRS may provide further rules on this and other computational issues in the future. Unless such regulations are issued, however, service partners may have less favorable outcomes under section 1061 on the disposition of a partnership interest than on the sale of the partnership's underlying assets.

Family offices. Section 1061(b) of the Code provides that the carried interest rules do not apply to "income or gain attributable to any asset not held for portfolio investment on behalf of third party investors," which has been seen as intended to apply to family offices. The preamble to the Final Regulations clarifies that section 1061 is intended to apply to professional money managers that earn a carried interest for services to family offices, and that Treasury and the IRS have declined to issue special rules for other arrangements pending further study.

For more information on this Alert, please contact a member of Caplin & Drysdale's Business, Investment & Transactional Tax Group.

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