IRS Issues Proposed Carried Interest Regulations

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Asset managers should be aware that on July 31, 2020, the IRS released proposed regulations (the "Proposed Regulations") intended to implement section 1061 of the Code, which governs the character of carried interest gains allocated to a service partner in an investment fund. Very generally, the statute denies access to the 20% rate for long-term capital gains on a carried interest unless the interest and applicable underlying assets have 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 Proposed Regulations are directly relevant to the taxation of investment managers of private equity funds, venture capital funds, hedge funds, and family offices. The Proposed Regulations are also directly relevant to seed investors that acquire a slice of the investment manager's returns. The Proposed Regulations may influence the capital structure of investment funds with multiple classes of capital interests and therefore also may be relevant to other portfolio investors.

Statutory Background

The Tax Cuts and Jobs Act of 2017 (the "TCJA") enacted section 1062 in response to a longstanding controversy about whether long-term capital gains attributable to a carried interest should retain their character and be taxable at a preferential rate or be characterized as compensation, taxed at the significantly higher rate for ordinary income. Section 1061 permits income attributable to the carried interest to be taxed at long-term capital gains rates, but extends the holding period requirement for most types of capital gains from one year to three years.

Very generally, section 1061(a) imposes the general three-year holding period requirement for long-term capital gains in respect of a carried interest (or "applicable partnership interest") 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"). Exceptions are provided for capital interests held by carried interest holders, carried interests held by portfolio company employees not involved in the fund's management business, and carried interests held by corporations. Further, an exception is authorized under regulations for capital gain on any asset not held for portfolio investment on behalf of third party investors, which is typically understood as intended to apply to family offices.

Proposed Regulations

The Proposed Regulations implement the statute through an elaborate framework of defined terms and computations. The regulations are intended to be comprehensive and can be relied upon prior to the date they are finalized if applied consistently by the taxpayer. However, they may create more confusion than clarity for many partnerships because they leave many issues unaddressed or unclear, apply their interpretive authority in unexpected ways, and are disconnected from how the funds industry actually operates.

Real Estate and Certain Other Gains

Section 1061(a) applies by extending the generally applicable holding period for long-term capital gains under section 1222 of the Code. The Proposed Regulations provide that section 1061(a) will not recast any gain as short-term if it is eligible for long-term capital gains rates under a provision of the Code with its own holding period requirements, including real estate and other property gains under section 1231, the long-term gain portion of section 1256 contracts, and qualified dividend income eligible for long-term capital gains rates.

Importantly, this interpretation generally exempts gains on real estate held in a trade or business for more than one year, which derive their eligibility for long-term capital gain rates from section 1231, despite the fact that real estate rental and investment are explicitly described as an applicable trade or business under the statute. The Proposed Regulations extend the benefit of this rule to capital gain dividends paid by a REIT to the extent attributable to section 1231 gain on a look-through basis.

Capital Interests

The statutory exception for capital interests applies to in interest that provides the taxpayer the right to share in partnership capital commensurate either with the amount of capital that was contributed, or with the value that was taxable on receipt or vesting of the interest. The Proposed Regulations limit this principle in several ways that are likely to affect common fund arrangements, but that are without clear authority to the extent they prevent a carried interest holder from claiming an exemption on an arm's length return on a contribution of its own capital.

Defining "commensurate" returns". Under the proposed rules, capital interest allocations will be "commensurate" with capital contributed only if the capital interest allocations are made based on the partners' relative capital accounts; the capital interest allocations have the same terms, priority, type and level of risk, rate of return, and rights to distributions for all partners receiving the allocation (ignoring any subordination of the management interest or the absence of a self-charged management fee); the partnership agreement clearly demarcates allocations on the capital interest from allocations on the carried interest; and the partners receiving the allocation include unrelated non-service partners with a "significant" capital account balance (*e.g.*, at least 5%).

These requirements will create significant practical problems for many funds:

- Allocations by partnerships that have multiple classes of capital interests, or that make allocations in respect of specific investments, generally will not be able to make allocations with respect to capital that comply with this rule. This is due to the fact that the rule requires capital interest allocations to be made based on the partners' relative capital account balances, but a partner has a single capital account in its partnership interest no matter how many classes of interests it holds.

- Managers are apparently required to charge themselves carried interest (as opposed to management fees) and exclude those amounts from their capital interest allocations. This result seems inappropriate because it applies the section 1061 character rule to income from business activity conducted for the manager's own account rather than for unrelated investors. Moreover, it does not reflect the practices of the funds industry.

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. Future allocations to the holder attributable to the increase in the capital account appear to be exempt from section 1061, provided the allocations meet the other requirements of the rule, even though no capital has been contributed or could be withdrawn and no tax has been paid on the gain.

Debt-financed capital interests. A capital interest will not be eligible for the exception to the extent the carried interest holder acquires its capital interest with the proceeds of an advance from the partnership, another partner, or a person related to any of them. The capital interest will become eligible for the exception only as the advance is repaid. Although this rule may have a valid anti-abuse purpose in the case of a non-recourse loan secured only by the borrower's partnership interests, the rule appears beyond the scope of the IRS's authority to the extent the debt is recourse or even if it is non-recourse but the carried interest holder has material assets at risk.

Family Offices

The preamble to the Proposed Regulations states that Congress intended a particular grant of regulatory authority to be used to exclude family offices from the scope of section 1061. Treasury and the IRS did not exercise this grant, but state that they believe the Proposed Regulations accomplished the same result using a general criterion applicable to capital interests, which requires the taxpayer to have a capital interest in the partnership.

The Proposed Regulations do not account for the breadth of arrangements that constitute family offices. The exclusion they provide generally will not be available to a family office that manages funds for other family entities or provides a carried interest to service providers (whether or not family members).

Seed Investors

Seed investors that receive a portion of the carried interest are not specifically addressed in the Proposed Regulations. Non-corporate seed investors should be aware that the application of the regulations to their carried interest may depend on structure of the fund and, for example, generally would be tainted if the carried interest flows through an entity providing service to the fund.

Corporate Holders

The statute does not apply to carried interests held by corporate partners because C corporations are taxed at the same rate on long- and short-term capital gains. The Proposed Regulations confirm the position taken in Notice 2018–18, 2018–12 I.R.B. 443 (March 19, 2018) that the exception for carried interests held by corporations does not apply to interest held by S corporations, and extended the prohibition to carried interests held by passive foreign investment companies treated as a qualified electing funds, because those entities pass through the character of long-term capital gains.

The Proposed Regulations are likely to engender debate on many key points and may evolve before they are finalized. Fund managers and family offices concerned about the application of section 1061 in their particular situations should consider submitting comments on the regulations.

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

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