

Inflation Reduction Act of 2022 Would Expand Scope of Carried Interest Rule

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The Inflation Reduction Act of 2022 (the “Bill”) would extend the reach of section 1061, enacted as part of the 2017 Tax Cuts and Jobs Act, which taxes long-term capital gain with respect to certain carried interests in partnerships held by service providers as short-term capital gain. The Bill extends the scope of section 1061 by (i) taxing additional types of income currently taxed at long-term capital gain rates at short-term capital gain rates; (ii) extending the holding period necessary to avoid recharacterizing long-term gain as short-term gain from three years to five years; and (iii) redefining the way in which the holding period is measured.

Extension of the Scope

Section 1061, which under current law recharacterizes only long-term capital gain, will now recharacterize any gain that is treated as capital gain or subject to tax at the rate applicable to capital gain as well. This means that section 1061 will now apply to types of income not previously covered by the rules, such as (i) qualified dividend income; (ii) 1231 gains from the sale of depreciable property used in a trade or business (this is especially important for real estate funds because rental real property is generally treated as section 1231 property); (iii) 1256 gains from derivatives or other financial instruments that are marked to market; and (iv) capital gains that are characterized as long-term or short-term without regard to the holding period rules in section 1222, such as certain capital gain subject to the mixed straddle rules of section 1092(b).

Extension of the Holding Period

The Bill generally requires a five-year holding period, rather than a three-year holding period, to avoid taxation at short-term capital gain rates. A three-year holding period will apply to (i) a taxpayer (other than a trust or estate) with an adjusted gross income of less than \$400,000; and (ii) any income with respect to a carried interest attributable to a real property trade or business (development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business).

A New Definition of a Holding Period

The Bill determines the relevant holding period by reference to the later of (i) the date on which the taxpayer acquired substantially all of the carried interest in the partnership; or (ii) the date on which the partnership acquired substantially all of the assets held by the partnership. This is a change from current law, under which the relevant holding period is the partnership’s holding period in the asset being sold or disposed of. There is considerable uncertainty as to how “substantially all the assets” should be applied. In addition, there is a look-through rule for lower tier partnerships.

Other Changes Worth Noting

- The relevant holding period will be determined without regard to any section 83(b) election.
- Regulations are to provide rules under which section 1061 would apply only to gains attributable to assets that are held for portfolio investment on behalf of third-party investors.

- Only carried interest held by C corporations (and not S corporations) are exempt from section 1061.
- Transfers of carried interests would be taxable notwithstanding any other provisions of the Internal Revenue Code, presumably even if the relevant holding period is met.
- The Secretary is authorized to issue regulations that will prevent avoidance through (i) the distribution of property by a partnership; (ii) the use of carry waivers; or (iii) the use of financial instruments, contracts or interests in entities other than partnerships.

If enacted, the provisions would be effective for taxable years beginning after December 31, 2022. Taxpayers that currently meet the three-year holding period, but might not meet the new five-year holding period, should consider acting before the Bill takes effect.

For more information, please contact a member of Caplin & Drysdale's Business, Investment & Transactional Tax group.

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