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INSIGHT: Overview of Proposed Carried Interest Regulations

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On July 31, 2020, Treasury and the IRS issued proposed regulations under tax code Section 1061 regarding taxing gain from certain carried interests held less than three years as short term capital gain. Section 1061 was enacted under the 2017 Tax Cuts and Jobs Act. Section 1061(a) in general treats gain attributable to an applicable partnership interest (API) received or held by a taxpayer during a tax year as short term capital gain taxable at an ordinary income tax rate under the tax code, which ranges from 10% to 37%, rather than the rate for long-term capital gain of 0% to 20% for 2020, depending on the income level of the taxpayer.

Under Section 1061(c)(1), the interest has to be transferred or held in connection with substantial performance of services by the taxpayer, or any other related person, in any applicable trade or business. Furthermore, the partnership interest may be either transferred to or held by a taxpayer. In addition, a taxpayer may have received or held the partnership interest directly or indirectly. This article reviews key concepts in the proposed regulations affecting fund investors, sponsors, and executives in the private equity space. Treasury and the IRS responded in the proposed regulations to certain concerns in the private equity community, addressed to an extent in public comments submitted pursuant to IRS Notice 2018-18.

Recharacterization Amount, Owner Taxpayer, API Holder, and Other Key Terms

Under the proposed regulations, the amount subject to Section 1061(a) is the difference between net long-term capital gain with respect to one or more APIs and the net long-term capital gain with respect to such APIs calculated by substituting a three-year holding period for a one-year holding period under Section 1222(3) and 1222(4). The amount subject to Section 1061(a) is the ''recharacterization amount'' under the proposed regulations. Notably, Section 1061(a) does recharacterize a long-term capital loss as a short-term capital loss with respect to an API.

A taxpayer may be subject to income tax consequences under Section 1061(a) with respect to an API whether the taxpayer receives or holds the API directly or indirectly, in some cases, through one or more ''passthrough entities,'' another defined term in the proposed regulations. Taking this rule into account, the person who is required to recognize a gain or loss on the recharacterization amount for federal income tax purposes is the ''owner taxpayer,'' and such recognized gains or losses are ''API gains and losses'' under the proposed regulations. API gains and losses exclude amounts calculated outside the holding period rules in Section 1222. API gains and losses not realized yet by a taxpayer, including partnership allocations through a tiered structure, on the other hand, are termed ''unrealized API gains and losses'' in the proposed regulations.

In a tiered structure, the owner taxpayer may be the ultimate owner of the API. Intermediate passthrough entities also are deemed each to hold the API. Each of the intermediaries are termed an ''API holder'' under the proposed regulations. In addition, partnerships or other pass-through intermediaries, which are treated as a taxpayer for purposes of determining whether a partnership interest is an API, but are not taxpayers with respect to the API, are ''passthrough taxpayers'' under the proposed regulations. Moreover, in summary, to determine whether a partnership interest is held or transferred in connection with performance of substantial services in an applicable trade or business, an ''applicable trade or business activity test'' applies under the proposed regulations.

Section 1061(c)(2) defines an applicable trade or business generally as any activity conducted on a regular, continuous, and substantial basis, which consists, in whole or in part, of raising or returning capital, and either investing in (or disposing of) specified assets (or identifying specified assets for such investing or disposition), or developing specified assets. Section 1061(c)(3) defines a specified asset generally as securities in Section 475(c)(2), commodities in Section 475(e)(2), real estate held for rental or investment, cash or cash equivalents, options or derivative contracts with respect to any such assets, and an interest in a partnership to the extent of the partnership's proportionate interest in any such asset.

The preamble provides the proposed regulations generally track the statutory definition of ''Specified Assets.'' Thus, the proposed regulations do not carve out an exception for cash or cash equivalents, which may result in broader applicability by including interests in

partnerships that actively identify, invest in, or dispose of only cash or cash equivalents.

Exceptions to Section 1061

Section 1061(c)(4) sets forth exceptions to converting long-term capital gain to short term capital gain with respect to an API under Section 1061(a). First, Section 1061(a) does not apply to any partnership interest held directly or indirectly by a C corporation. Second, the definition of an API in Section 1061(c)(2) does not include certain capital interests. The exempt capital interest has to be commensurate with the amount of capital contributed at the time of issuance or has to be taxed as property transferred in connection with performance of services under Section 83 upon receipt or vesting of such capital interest. In sum, under the capital interest exception in the proposed regulations, realized long-term capital gain or long-term capital loss on a return on capital invested in a passthrough entity is not subject to Section 1061(a). Consistently, capital interest allocations, passthrough interest capital allocations, and capital interest disposition amounts are treated as capital interest gains and losses, all defined terms in the proposed regulations. The proposed regulations permit bifurcation of an interest upon disposition into a capital interest subject to the capital interest exception and an API subject to Section 1061(a).

The proposed regulations ''track'' the statutory language in the Section 1061(c)(1) exemption for partnership interests held by a person employed by another entity that conducts a trade or business other than an applicable trade or business, and who provides services only to such other entity. The proposed regulations add an exception for a partnership interest, generally acquired by an unrelated purchaser, who does not provide services, in an arm's-length transaction. But the proposed regulations reserve on Section 1061(b) statutory authority for an exception to Section 1061(a) for income or gain attributable to any asset not held for portfolio investment on behalf of third-party investors.

Accelerated Recognition of Gain on a Related Party API Transfer in Section 1061(d)

Section 1061(d) provides that, upon a direct or indirect transfer of an API to a person related to the taxpayer, the taxpayer includes in gross income as short term capital gain the long-term capital gain with respect to the API for the tax year, which would be attributable to the sale or exchange of a capital asset held for less than three years, and which would be allocable to the API, less any long-term capital gain with respect to the API already converted to short term capital gain under Section 1061(a). Section 318 attribution rules apply for identifying a related person with respect to the taxpayer under Section 1061(d). The proposed regulations clarify that only family members of a taxpayer, colleagues of a taxpayer who were service providers in the applicable trade or business during certain time periods, and a passthrough entity to the extent of ownership by a family member or colleague of the taxpayer may be a related person. The proposed regulations also clarify that gain recognition is required under Section 1061(d)(1), even if the transfer of the API otherwise would not be a taxable event. Under the proposed regulations, a transfer includes transactions, such as contributions, distributions, sales and exchanges, and gifts.

Section 1061(e) Information Reporting by Owner Taxpayer and Passthrough Entities

Section 1061(e) authorizes the IRS to prescribe reporting requirements under Section 1061. The proposed regulations provide that an owner taxpayer must report any information the IRS may require in forms, instructions, or other guidance to evidence compliance with Section 1061. Also, under the proposed regulations, a passthrough entity in which an owner taxpayer holds its interest must provide information needed by owner taxpayer to comply with Section 1061 and to determine the recharacterization amount. Thus, the passthrough entity must provide to the owner taxpayer the API one year distributive share amount under the proposed regulations.

Moreover, the passthrough entity must provide to the owner taxpayer the adjustments that must be made to the distributive share of owner taxpayer's long-term capital gain or long-term capital loss, so as to enable owner taxpayer to calculate independently its API one year distributive share amount and its API three year distributive share amount, as defined in the proposed regulations. Absent substantiation of the amounts in a manner satisfactory to the IRS, owner taxpayer would not be allowed to take into account any Section 1061 exclusions.

Furthermore, a passthrough entity that has an API holder must furnish sufficient information to the API holder to assist in compliance with Section 1061 Treasury Regulations. The preamble states that this requirement means the passthrough entity generally would furnish the information to the API holder as an attachment to Schedule K-1 for the tax year. Under the proposed regulations, the information furnished to the partner in this manner would include the API one year distributive share amount, the API three year distributive share amount, long-term capital gain and long-term capital loss allocations to the API holder that are excluded from Section 1061 under Proposed Regulation Section 1.1061-4(b)(6), capital interest gains and losses allocable to the API holder and ''API holder transition amounts,'' as defined in the proposed regulations.

In addition, if there is a disposition by the API holder of an interest in a passthrough entity during the tax year, the passthrough entity must provide any information required by the API holder for purposes of Section 1061 as may be applicable to the disposition. Required information with respect to the disposition would include information on the application of the ''look-through rule'' in Proposed Regulation Section 1.1061-4(b)(9) and for determining the capital interest disposition amount. A passthrough entity would be subject to reporting penalties under the tax code for failure to furnish the required information.

Finally, a lower-tier partnership or other entity, in which a passthrough entity holds an interest, may be required to provide information to the passthrough entity for compliance with reporting rules under the proposed regulations. Thus, the passthrough entity must request this information from any lower-tier entities in which it

holds an interest not later than 30 days following the close of the tax year, or if later, within 14 days of receipt of the request for information from an API holder. The lower-tier entity must respond to the request not later than the filing date for Schedule K-1 for the tax year, including extensions.

In some instances, a lower-tier passthrough entity might fail to report the requested information. In that case, Proposed Regulation section 1.1061-6(b)(2)(vi) provides that the upper-tier passthrough entity must take actions to otherwise determine and substantiate the missing data. Absent requisite substantiation and determination of the amounts, the upper-tier passthrough entity generally would not take into account Section 1061 exclusions, unless the owner taxpayer independently is able to substantiate the amounts to satisfaction of the IRS. Furthermore, the upper-tier passthrough entity must notify both the API holder and the IRS that paragraph (b)(2), the tiered-structure information requirement, applies to the disclosures as required by the IRS.

Effective Date for Applicability, Certain Corporations, Partner's Distributive Share

Under the proposed regulations, the final Section 1061 regulations apply to taxable years of owner taxpayers and passthrough entities beginning on or after the date the final regulations are published in the Federal Register. Generally, owner taxpayers and passthrough entities may rely on the proposed regulations for tax years beginning before the date of publication of the final regulations, provided they follow the proposed regulations in their entirety and in a consistent manner. As an exception, in some instances, a partnership may treat capital gains and losses from certain assets as partnership transition amounts and API holder transition amounts, as defined in the proposed regulations, for the year in which the election is made and all subsequent years beginning before the publication date for the final regulations. In that event, owner taxpayers and passthrough entities do not have to follow all the rules in the proposed regulations consistently regarding the partnership transition amounts and API holder transition amounts.

The proposed regulations, consistent with Notice 2018-18, provide that the term corporation with respect to the corporate exception under Section 1061(c)(4)(A) does not include an S corporation, effective for taxable years beginning after Dec. 31, 2017. In addition, under the proposed regulations, a corporation does not include a passive foreign investment company (PFIC) with respect to which the shareholder has in effect a qualified electing fund (QEF) election under Section 1295, effective for tax years beginning after the publication date of the proposed regulations.

Section 706 requires generally taking into account in computing the taxable income of a partner for a tax year the distributive share of separately stated partnership items for any tax year of the partnership ending within or with the tax year of the partner. Under the proposed regulations, Section 706 applies to an API in a partnership with a fiscal year ending after Dec. 31, 2017. Thus, a partnership with a fiscal year that ends after Dec. 31, 2017, may have sold an API prior to Dec. 31, 2017. Section 1061 would apply in determining the distributive share of long-term capital gain or long-term capital loss of an individual owner taxpayer with respect to the API in calendar year 2018.

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