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How New IRC § 1061 Impacts Carried Interests

During the past decade, the White House, Congress and the IRS have threatened on numerous occasions to reduce or eliminate the tax benefits of carried interests (“promotes” in the real estate world). In 2009, legislation was introduced that would have taxed all income from carried interests as ordinary income. That proposed bill and similar efforts in later years failed in the face of strong opposition. The 2017 Congress took a moderate approach to scaling back the benefits of a carried interest. IRC § 1061 increases the holding period required for long-term capital gains treatment from more than one year to more than three years for an “applicable partnership interest.” Although this provision won’t affect many holders of incentive equity, professionals who work in the hedge fund, private equity or real estate industries will need to keep IRC § 1061 in mind when structuring their compensation arrangements.

IRC § 1061 doesn’t change the basic favorable treatment of carried interests or other grants of profits interests. Profits interests, including carried interests, continue to be nontaxable at the time of issuance. Subject to the new three-year holding period under IRC § 1061, the holder of a carried interest continues to enjoy long-term capital gains treatment (not subject to employment taxes) from the sale of partnership assets, or the sale or redemption of the carried interest.

Prior to the enactment of IRC § 1061, a hedge fund professional might be issued a carried interest on Tuesday and a day later share in an allocation of long-term capital gains if the partnership sold a capital asset held for more than a year. The same hedge fund manager could sell his interest after a year and claim long-term capital gains treatment (subject to ordinary income for “hot assets” under IRC § 751 and perhaps sweating the impact of Revenue Procedure 93-27’s two-year holding period requirement). Today, this same hedge fund professional would have short-term capital gains on the sale of both the partnership’s capital asset and his carried interest.

IRC § 1061 may impact real estate professionals more than hedge fund or private equity (PE) professionals. IRC § 1061 could apply to carried interests issued to hedge fund or private equity professionals, but the holding period for hedge fund assets is often less than 12 months and for PE firms often more than three years, which reduces the potential impact of the three-year holding period requirement. The three-year holding period requirement could have an impact on the tax treatment of a carried interest (promote) issued to a real estate professional. In the past, some real estate deals development projects have included a put or sale of the professional's interest after a year. As discussed below, the apparent exclusion of depreciable real estate (Section 1231 property) from the reach of IRC § 1061 may provide a useful workaround for real estate professionals.

A High-Level Discussion of Carried Interests and IRC § 1061

What is a carried interest?

Within the real estate industry, the developer/sponsor often bears the most entrepreneurial risk associated with a project. The developer/sponsor may identify and secure the property, obtain necessary governmental approvals, provide or source the capital and financing, manage the development and construction team of architects, engineers and contractors, and assume personal responsibility for cost overruns. As compensation for the developer's/sponsor's expertise, efforts, contributions and risk taking, the compensation package will often include a carried interest providing for an extra share of profits upon sale of the project. A typical deal would be one where the developer/sponsor has no significant cash investment in the project, but is issued a profits interest with a 20% share of profits after a return of the investors' capital. Like real estate developers/sponsors, professionals in the hedge fund and private equity industries are compensated for their entrepreneurial risk with carried interests.

IRC § 1061 applies only to an "applicable partnership interest"

IRC § 1061 increases the required long-term capital gains holding period for an **applicable partnership interest** from more than one year to more than three years. Understanding what is and what isn't an applicable partnership interest is critical from a planning standpoint.

The capital interest portion of a partnership interest is not an applicable partnership interest

For purposes of IRC § 1061, a “capital interest” is defined to include “any capital interest in the partnership which provides the taxpayer with a right to share in partnership capital commensurate with (i) the amount of capital contributed (determined at the time of receipt of the partnership interest), or (ii) the value of such interest subject to tax under IRC § 83 upon the receipt or vesting of such interest.” If a hedge fund professional is issued a capital interest, his pro rata share of profits based on invested capital is not an applicable partnership interest. For example, if the hedge fund professional and three investors each contribute \$2 million in exchange for 25% LLC interests, then the hedge fund professional's interest would not be an applicable partnership interest.

The portion of a partnership interest that falls within the definition of a profits interest may be an applicable partnership interest

If the hedge fund professional in the previous paragraph was issued an additional 20% interest in profits after return of each investor's \$2 million investment, then this additional interest would have the economic features typically associated with a profits interest and would potentially be subject to IRC § 1061.

The tax treatment of a profits interest is generally governed by Revenue Procedure 93-27. New regulations were proposed in 2005 that would have replaced Revenue Procedure 93-27, but the regulations were never finalized. Under Revenue Procedure 93-27, a “profits interest” is a partnership interest that would not entitle the holder to a share of the proceeds if partnership assets were sold for their fair market value and the net sale proceeds were distributed to the partners in liquidation. If a partnership interest qualifies as a profits interest, the service provider is not taxed upon receipt, the

interest is a capital asset in the hands of the service provider, and the service provider is considered a partner and as such will be issued a Schedule K-1.

The IRS detailed three exceptions to this general treatment: (1) if the profits interest relates to a substantially certain and predictable stream of income; (2) within two years of receipt, the service provider disposes of the profits interest; and (3) a profits interest in a “publicly traded partnership” within the meaning of IRC § 7704(b). Of the three exceptions to profits interest treatment, the two-year holding period is a potential planning issue. But from the standpoint of IRC § 1061, the two-year holding period only matters if the partnership interest is subject to vesting and no IRC § 83(b) election is made. The greatest risk of a disposition of an unvested profits interest within the two-year period is that the proceeds would be taxable as compensation under IRC § 83 (so don’t take a chance and make the IRC § 83(b) election). In the pre-IRC § 1061 era, if the plan included the possible sale or redemption of the carried interest during the first 24 months, a reasonably safe approach would have been to have the service provider contribute \$1,000 in connection with the issuance of the interest. The interest would then be a capital interest subject to immediate taxation under IRC § 83, but the service provider would often take the position that the value of the interest at the time of issuance was only \$1,000.

Assuming the interest has vested or the IRC § 83(b) election has been made, the issue of whether the interest was taxable under IRC § 83 when issued, or nontaxable under Revenue Procedure 93-27, won’t change the analysis for purposes of IRC § 1061. In either case, IRC § 1061 potentially treats the portion of the interest that would otherwise be defined as a profits interest (using the Revenue Procedure 93-27 test) as an applicable partnership interest subject to the three-year holding period requirement. It is worth keeping in mind that while not all profits interests are applicable partnership interests for purposes of IRC § 1061, all applicable partnership interests will have the economic features associated with a profits interest. A difference between a profits interest and an applicable partnership interest is that Revenue Procedure 93-27 doesn’t

contemplate splitting an interest into separate “capital interest” and “profits interest” components.

In order for a partnership interest to be an applicable partner interest, it must be issued in connection with the performance of substantial services in an “applicable trade or business”

An applicable trade or business is an activity that consists, in whole or in part, of (a) raising or returning capital, and (b) either (1) investing in or disposing of “specified assets,” or (2) developing specified assets. Specified assets include securities, commodities, real estate held for rental or investment, options or derivative contracts with respect to the foregoing assets, or an interest in a partnership to the extent of the partnership’s interest in the foregoing assets. Developing specified assets occurs if representations are made to investors, lenders, regulators, or others that the value, price, or yield of a portfolio business may be enhanced or increased in connection with the service provider’s choices or actions.

The preceding rules brings most profits interests issued to financial and real estate professionals in deals involving investors within the potential scope of IRC § 1061. For example, if a PE fund’s portfolio company (e.g., an auto parts supplier) issues a profits interest to the PE firm (e.g., a 20% back-end interest that kicks in after return of the fund’s initial investment), that carried interest would be subject to IRC § 1061. If the PE firm issues profits interests as part of compensating its management team, those profits interests are also likely to fall within the scope of IRC § 1061, as the PE firm is engaged and the management team are working in an “applicable trade or business.” But if the auto parts supplier issues profits interests to its operating management team as part of its incentive plan, those profits interests would not be subject to IRC § 1061 because the auto parts supplier isn’t engaged in an applicable trade or business. IRC § 1061 has no applicability to an incentive compensation plan adopted by a business that is not engaged in an applicable trade or business.

The second sentence of IRC § 1061(c)(1) provides that a profits interest is not subject to IRC § 1061 if it is “held by a person who is

employed by another entity that is conducting a trade or business (other than an applicable trade or business) and only provides services to such other entity.” If John is the CEO of a PE firm’s portfolio company and is rewarded with the grant of a profits interest in the PE firm’s limited partnership, the preceding sentence would appear to take that interest outside the scope of IRC § 1061.

Certain partnership interests are carved out from the scope of IRC § 1061

IRC § 1061 provides that it doesn’t apply to profits interests issued to corporations. But does this mean that a profits interest held through an S corporation escapes IRC § 1061? The IRS has indicated that it will issue administrative guidance answering this question by confirming that S corporations are not a workaround for avoiding IRC § 1061.

IRC § 1061(b) anticipates that the IRS will issue regulations addressing the circumstances under which the provision would not apply to “income or gain attributable to an asset not held for portfolio investment on behalf of third party investors.” It’s unclear what this exception is intended to address, but presumably the exclusion could apply to a hedge fund or PE firm’s ownership of investment or business assets in LLCs that don’t include outside investors. For example, a PE firm might own its own office building and issue incentive units to the PE firm’s employees in an LLC holding the office building. This carve-out may have application to profits interests issued to employees by certain “family office” investment firms.

Does IRC § 1061 apply to Section 1231 property?

IRC § 1061(a)(2) implements the increase in the required long-term capital gains holding period by referencing paragraphs (3) and (4) of IRC § 1222 and substituting 3 years for 1 year in those provisions. But this change doesn’t appear to directly affect or apply to the separate one-year holding period requirement for IRC § 1231 property (e.g., depreciable real property used in a trade or business, such as rental property). It isn’t clear whether this failure to bring Section 1231 property within the scope of IRC § 1061 is intentional,

but there are numerous glitches and drafting errors and oversights in the 2017 Tax Act. So, unless IRC § 1061 is amended or the IRS takes some other step to extend the scope of IRC § 1061 to Section 1231 property, it appears that Section 1231 property is excluded. For example, if a partnership sells Section 1231 property with a one-year holding period, the holder of an applicable partnership interest should be entitled to long-term capital gain on his share of the profits, even if he has held his interest for less than three years.

How IRC § 1061 Works

If an interest falls within the scope of an applicable partnership interest, then gain on the sale of capital assets will be recharacterized as short-term capital gains unless the holder satisfies the more than three-year holding period requirement. This more than three-year holding period requirement potentially applies to both the sale of the capital assets by the partnership (i.e., with respect to gain passing through on a Schedule K-1) and the sale of the interest.

If an applicable partnership interest is sold after being held for three years or less, IRC § 751 would apply to treat any gain on “hot assets” as ordinary income (e.g., depreciation recapture, inventory or depreciable real estate held for less than a year) and the balance of the gain would be treated under IRC § 1061 as short-term capital gains.

If an applicable partnership interest is sold after the more than three-year holding period requirement is satisfied, IRC § 751 would apply to treat any gain on “hot assets” as ordinary income and the balance of the gain would be long-term capital gains. But what if the partnership is holding capital assets that don’t satisfy the more than three-year holding period requirement? IRC § 1061(d) does apply a look-through concept if the partnership interest is sold to a person related to the taxpayer, but there doesn’t appear to be any look-through rule to capture any partnership assets that have less than a three-year holding period. So, gain on the sale of the interest after more than three years would qualify for long-term capital gains treatment in spite of the partnership’s shorter holding period for its capital assets.

If a partnership sells a capital asset with a holding period of 24 months, partners would typically be entitled to long-term capital gains treatment on the income passing through on their Schedule K-1s. But if a partner is holding an applicable partnership interest, this gain passing through would be short-term capital gains regardless of whether the holder's interest has satisfied the more than three-year holding period requirement.

If a partnership sells a capital asset with a four-year holding period, the holder of an applicable partnership interest would be entitled to long-term capital gains treatment on the gain passing through on the Schedule K-1, even if his interest had a holding period of less than three years.

The more than three-year holding period requirement appears to apply to applicable partnership interests issued prior to the enactment of IRC § 1061.

Planning for IRC § 1061

Service professionals should keep an eye on possible future guidance from the IRS on whether IRC § 1061 applies to an applicable partnership interest owned through an S corporation.

For real estate professionals, a key planning issue (and opportunity) will revolve around whether Section 1231 property falls within or outside the scope of IRC § 1061. If Section 1231 rental property is excluded, most real estate professionals involved in commercial and industrial property deals won't be forced to plan for the impact of IRC § 1061, unless the deal involves the anticipated sale or redemption of their interest.

If the real estate deal involves investment property potentially subject to IRC § 1061, another planning idea might be to focus on the real estate professional's contributed real or intangible assets. Shifting the real estate professional's interest from a carried interest to an interest issued for contributed capital blunts the impact of IRC § 1061. Some planners are already considering the possibility of having a partnership make a recourse or nonrecourse (secured by the interest) loan to a real estate professional, the proceeds of which would fund the professional's investment in the partnership.

If a real estate professional will be issued a carried interest, then deal terms should include a restriction on the sale of the interest until IRC § 1061's more than three-year holding period is satisfied.

Attorneys at Frost Brown Todd have developed substantial expertise assisting business clients in structuring their incentive compensation arrangements. If you need assistance or would like additional information, contact [Scott Dolson](#) or any other member of the [Tax Law Practice Group](#) for *Tax Law Defined™*.

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