



Planning Ideas for Avoiding IRC § 1061's Three-Year Holding Period Requirement

Apr 24, 2018

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Investment fund managers value compensation in the form of carried interests, which allows them to be compensated for services with income that qualifies for long-term capital gains tax treatment. Numerous efforts have been made during the past decade to cut back or eliminate the favorable tax treatment of carried interests. Reports indicate that during the negotiations of the 2017 Tax Cuts and Jobs Act, White House economic advisor Gary Cohn campaigned to end the benefit of carried interest by taxing all income from carried interests as ordinary income, while Treasury Secretary Steven Mnuchin urged keeping the prior tax treatment with new limits.¹ Mnuchin prevailed with the enactment of IRC § 1061, despite President Trump's campaign promise to end the so called "carried interest loophole."

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." Prior to the enactment of IRC § 1061, a carried interest might be issued on Tuesday, and if the partnership sold a capital asset with a long-term holding period on Wednesday, the holder could share in the pass-through of long-term capital gains on the sale. The same hedge fund professional could sell his interest after a year and claim long-term capital gains treatment. Today, this same hedge fund professional would have short-term capital gains in both scenarios.

While IRC § 1061 doesn't change the basic favorable treatment of carried interests (which are typically nontaxable at the time of issuance, can participate in the pass-through of long-term capital gains and be sold as a capital asset, in each case avoiding employment taxes), fund professionals will need to keep IRC § 1061 in mind when structuring compensation arrangements.

In [a recent article](#), we discussed the impact of the new IRC § 1061 and provided a summary of its rules. This article discusses several

potential planning opportunities regarding the new three-year holding period requirement.

While future corrective legislation and agency and legal interpretations may target IRC § 1061 planning, the statute in its current form provides opportunities for taxpayers work around the negative consequences of the three-year holding period. The planning opportunities discussed below may be available to taxpayers given the right facts and circumstances.

Contribute capital in connection with the issuance of carried interests

IRC § 1061(c)(4)(B) provides an exception to the three-year holding period rule for any interest that provides the right to share in partnership capital commensurate with the capital contributed to the partnership by the partner. To transmute a carried interest into a capital interest (*i.e.*, an interest commensurate with capital contributions made by the partner), an investment fund might distribute or loan cash or property to the fund professional, who in turn would recontribute the cash or property to the partnership as a capital contribution. The investment professional and fund would need to consider whether the transaction as structured would be respected for tax purposes.

Consider transferring carried interests to unrelated parties

If the holding period for a carried interest is greater than three years, but the investment fund has assets that will be sold with holding periods of less than three years, some planning should be considered to avoid short-term capital gains treatment. If a carried interest is sold to a "related party," IRC §1061(d) mandates short-term capital gain treatment for the portion of the assets that doesn't have the three-year holding period. But the definition of related parties encompasses only direct family members and fund management colleagues for purposes of IRC § 1061. The attribution rules for corporations, partnerships, trusts and estates appear to be

purposefully omitted. As a result, it may be possible to transfer the carried interest to an entity owned by a related party – rather than directly to the related party. From that point forward, the transferee-holder would qualify for long-term capital gains treatment without regard to IRC § 1061. For this transaction to be respected, the transferee-entity must be respected and regarded as a taxpayer separate and apart from its equity owners.

Consider distributing appreciated assets to holders of carried interests

As drafted, IRC § 1061 appears to permit the holder of a carried interest to avoid the three-year holding period requirement by having the investment fund distribute appreciated partnership assets, which then can be sold by the holder of the carried interest without regard to IRC § 1061.

Before this strategy is adopted, the holder of a carried interest must consider the rules regarding property distributions. IRC § 731 generally provides for nonrecognition of gain or loss when property is distributed. The basis in the distributed property must be determined under IRC § 732. IRC § 732(a)(2) provides that the basis of the distributed property cannot be greater than the partner's adjusted basis of his partnership interest. If, for example, the holder of a carried interest has a partnership basis of \$0, any property distributed to him would also have a \$0 tax basis. So, although gain on the sale of property may qualify for long-term capital gains treatment, the amount of gain may be more than it would have been if the partnership had sold the property itself.

Another issue is the tax treatment of distributions of marketable securities. Under IRC § 731(c), a distribution of marketable securities is treated as a distribution of money, which would result in ordinary gain to the extent that the value of the marketable securities exceeds a carried interest holder's tax basis. If the holder has a \$0 basis at the time of the distribution, the fair market value of the securities, less the taxpayer's share of appreciation in the securities, would be recognized as taxable gain.²

Investment partnerships are, however, excluded from the marketable securities rule. IRC § 731(c)(3)(C) defines an investment partnership as a partnership that has never been involved in a trade or business and substantially all assets held by the partnership are certain investment assets.³ If a fund falls under this definition, the marketable securities will not be treated as money and any distribution of marketable securities will be subject to the normal property distribution rules. For purposes of determining if a partnership has been engaged in a trade or business, any activity undertaken as an investor, trader or dealer in any investment asset described in IRC § 731(c)(3)(C)(i) will not be considered a trade or business.

Special allocations may present a planning opportunity

If the holder of a carried interest is willing to delay the receipt of any carried interest distributions for more than three years, a fill-up special allocation of income after the three-year holding period is achieved may be a viable planning option. This allocation structure would allocate all gains earned during the first three years to non-management partners, then after the third anniversary passes, there would be an allocation of gain first in the following year in a manner designed to “catch up” the carried interest holder.

Special allocations must have “substantial economic effect” to be respected by the IRS. The shifting allocation rule provides that in connection with special allocation, if at the end of a taxable year the partners’ capital accounts are not substantially different than if the special allocations were not in place, and the total tax liability is less because of the special allocations, substantial economic effect is unlikely to exist.⁴ Additionally, the transitory allocation rule provides that if at the time of the special allocation there is a strong likelihood that the special allocation for the years in which the allocations apply would not be substantially different than if the allocations were not in place, and the total tax liability of the partners is less if the special allocations are in place, the allocations will be presumed not to have a substantial economic effect.⁵ Treas. Reg. § 1.704-1(c) provides, however, that if there is a strong

likelihood that the offsetting allocation(s) will not, in large part, be made within five years after the original allocations are made, the special allocation will have substantial economic effect.

It is unlikely that a fill-up allocation will violate the shifting rules, but the transitory rule could prove troublesome. If the fill-up allocation violates the transitory rule, the five-year rule may be available to provide substantial economic effect to the special allocation. Each fund must evaluate its specific facts and circumstances to determine if there is substantial authority to support a proposed fill-up special allocation structure.

Qualified dividends and 1231 property appear to fall outside the scope of IRC § 1061

Certain significant assets that qualify for capital gain treatment appear to fall outside the scope of IRC § 1061. Qualified dividends are not capital assets. Instead, they are taxed at preferential long-term capital gain tax rates under IRC § 1(h)(11). As IRC § 1061 does not refer to qualified dividends specifically and only modifies the requisite holding period for purposes of IRC § 1222, which relates only to capital assets, IRC § 1061 does not appear to affect the treatment of qualified dividends. Unless Treasury regulations ultimately provide otherwise, this same result should be true for Section 1231 property (depreciable real property). In order to take advantage of the exclusion of Section 1231 property, it would be necessary to sell Section 1231 property because a partnership interest (carried interest) itself is generally a capital asset, bringing it within the scope of IRC § 1061.

Should you consider utilizing an S corporation to plan around IRC § 1061?

The IRS has issued administrative guidance indicating S corporations may not be used to avoid the application of IRC § 1061.⁶ But does the IRS have the authority under IRC § 1061 to successfully impose this position without federal legislation?⁷ Notwithstanding the IRS notice, investment professionals may want to have their tax advisors evaluate whether a sufficient legal basis

exists to use an S corporation in a manner that is contrary to the IRS notice, which may require disclosure of the reporting position to the IRS.

The IRS also indicated in Notice 2018-18 that it intends to issue regulations providing general guidance on IRC § 1061. This guidance could apply retroactively, but the timing and content of these regulations (beyond guidance regarding S corporations) are wildcards from a planning standpoint.

No planning idea should be adopted without first applying the then-applicable tax authorities to the actual facts. Undoubtedly, new planning ideas will develop and some of the existing ideas will be shut down by the IRS. The views of tax professionals and the IRS on how new tax provisions such as IRC § 1061 should be interpreted and how they will function in the real world are rapidly evolving in the aftermath of the hurriedly-adopted legislation.

¹ See <http://www.msn.com/en-us/money/personalfinance/how-the-carried-interest-break-survived-the-tax-bill/ar-BBH8U4O?li=AA4Zjn&ocid=ientp>

² IRC § 731(c)(4); IRC § 731(c)(6).

³ I.R.C. § 731(c)(3)(C)(i) provides the following list: money, stock in a corporation, notes, bonds, debentures, or other evidences of indebtedness, interest rate, currency, or equity notional principal contracts, foreign currencies, interests in or derivative financial instruments (including options, forward or futures contracts, short positions, and similar financial instruments) in any asset described or in any commodity traded on or subject to the rules of a board of trade or commodity exchange.

⁴ See Treas. Reg. § 1.704-1(b)(2)(iii)(b).

⁵ See Treas. Reg. § 1.704-1(b)(3)(iii)(c).

⁶ Notice 2018-18.

⁷ If a statute has a clear meaning, the agency must give effect to the intent of Congress and cannot interpret the statute in a contrary

manner. The argument may be made that if Congress had intended the three-year holding period exclusion for corporation to only apply to C corporations, they would have drafted it that way. The term “corporation”, as used in IRC § 1061(c)(4)(A), is therefore clearly not meant to be limited to C corporations and should not be interpreted that way.

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