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[Scott W. Dolson](#)

2019 Update – How to Deal with Section 1061’s Three Year Holding Period Requirement for Carried Interests

Hedge fund, private equity and real estate professionals value the carried interest because it allows them to be compensated for their services at long-term capital gains rates. In [a prior article](#), we discussed the impact of the new IRC § 1061 and provided a summary of its rules. This article provides an update on the status of IRC § 1061 and discusses methods for avoiding its application.

Earlier failed efforts to reduce or eliminate the benefits of the carried interest.

During the past 20 years, members of Congress and the Executive Branch have made numerous efforts to cut back or eliminate the favorable tax treatment of carried interests. Prior to 2017, these efforts failed. During 2016, then-candidate Donald Trump promised to end the so-called “carried interest loophole.”

Congress enacted IRC § 1061 during 2017.

Reports indicate that during negotiation of the 2017 Tax Cuts and Jobs Act, White House economic advisor Gary Cohn campaigned to end the benefit of carried interests 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.

How IRC § 1061 works.

For “applicable partnership interests”, IRC § 1061 increases the holding period required for long-term capital gains treatment from more than one year to more than three years. Hedge fund, private equity and real estate professionals who receive profits interests

for services generally hold an applicable partnership interest.

In the absence of IRC § 1061, a PE fund holding long-term capital assets could issue a carried interest to PE sponsors, and those sponsors might immediately qualify for the pass-through of long-term capital gains if the partnership sold capital assets with a one-year holding period. The same PE sponsors could sell (or have redeemed) their carried interests after two years and potentially claim long-term capital gains treatment.[2] Under IRC § 1061, the PE sponsor would be subject to short-term capital gains treatment if the partnership sold property with less than a three-year holding period or if the PE sponsor's carried interest was sold prior to achieving a three year holding period.

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), hedge fund, PE firm and real estate professionals will need to keep IRC § 1061 in mind in connection with structuring their compensation arrangements.

IRS provides notice of its plan to issue IRC § 1061 regulations.

In Notice 2018-18, the IRS announced that it plans to issue regulations providing guidance on the application of IRC § 1061. Proposed regulations have not been issued as of May 13, 2019.

Democrats introduced new legislation during 2019 to eliminate the carried interest's tax benefits.

On March 13, 2019, several Democrats, including presidential hopefuls, introduced legislation that would treat income associated with carried interests as ordinary income rather than capital gain.[3] So far, this legislation has not advanced.

IRS clarifies that S corporations holding carried interests are subject to IRC § 1061.

Under IRC § 1061, corporations holding carried interests are not subject to the IRC § 1061 three year holding period requirement. The IRS clarified in Notice 2018-18 that S corporations are subject to IRC § 1061.

Not all carried interests (profits interests) are subject to IRC § 1061's requirements.

IRC § 1061 only applies to carried interests (i.e., profits interests) which fall within the scope of an “applicable partnership interest.” So, if a partnership engaged in an operating business issues a profits interest to a service provider, that interest won’t be subject to IRC § 1061’s three-year holding period requirement.

IRC § 1061 doesn’t apply to a partnership interest issued in exchange for the contribution of capital or property.

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. The holder of a carried interest subject to IRC § 1061 might also hold a capital interest not subject to the reach of that statute. One planning basic should be to clearly keep the carried interest distinct from the capital interest for tax reporting purposes. Possible planning ideas include having the partnership distribute or loan funds to the service provider, who in turn then contributes those funds back to the partnership in exchange for the issuance of a capital interest. The parties would need to carefully consider whether any transaction as structured would be respected for tax purposes.

Section 1231 property and qualified dividends fall outside the reach of IRC § 1061.

IRC § 1061 recharacterizes capital gains by changing the long-term holding period of IRC §§ 1222(3) and (4) from one year to three years. Because the drafters of the statute choose this approach, IRC § 1061 doesn’t expressly apply to any income which qualifies for long-term capital gains rates under Internal Revenue Code

provisions outside of IRC §§ 1222(3) and (4).

This means that the three-year holding period requirement doesn't expressly apply to:

- qualified dividend income (taxed at long-term rates under IRC § 1(h)(11),
- gain on the sale of certain depreciable property used in a trade or business (IRC § 1231), and
- capital gain dividends from real estate investment trusts.

Section 1231 property generally includes depreciable real estate and personal property used in a trade or business, including commercial and industrial rental property. IRC § 1231(a) provides that net Section 1231 gain shall be treated as long-term capital gains. But Section 1231 property is specifically excluded from the scope of capital assets under IRC § 1221 and does not fall within the scope of capital assets subject to the holding period rules of IRC § 1222(3) or (4). Nevertheless, some commentators have speculated that the IRS will attempt to pull Section 1231 gain within the scope of IRC § 1061 because the definition of "specified assets" in IRC § 1061(c)(3) includes rental real estate. Perhaps it is possible that the drafting error, if there was one, was actually leaving the reference to rental property in the statute's language, instead of leaving Section 1231 income outside of the scope of the provision. One interesting note is that the 2019 Proposed Legislation is careful to bring Section 1231 income within the scope of the carried interest killing provision. It remains possible that the IRS will try to plug through regulations the hole in what they might consider to be a drafting error in IRC § 1061[4], but the normal course would be to "correct" the scope of the statute through a technical corrections bill, which is something that may not be possible in today's political climate. In fact, the American Bar Association's comments submitted to the IRS on March 22, 2019, in connection with a request for proposed regulations addressing IRC § 1061 both acknowledge that Section 1231 property falls outside of the current scope of IRC § 1061 and recommend that the IRS confirm in regulations that Section 1231 gain or loss is not subject to recharacterization under IRC § 1061(a). The bottom line is that as the date of this article, IRC § 1061 does

not include Section 1231 property within its scope and there is no tax authority or IRS statement attempting to pull Section 1231 within the scope of IRC § 1061.

One important point to keep in mind is that it is necessary to sell Section 1231 property rather than the carried interest itself to take advantage of the exclusion of Section 1231 gain because a carried interest, unlike the actual property, is a capital asset falling within the scope of IRC § 1061, if the property held by the partnership is Section 1231 property with a one-year holding period.

Does holding a carried interest in a PE fund that owns through disregarded subsidiaries or joint ventures operating businesses fall within the scope of IRC § 1061?

In order to fall within the scope of IRC § 1061, someone must hold an “applicable partnership interest” (i.e., the carried interest) in a partnership engaged in an “applicable trade or business.” An applicable trade or business is defined to mean an activity involving the raising or returning of capital and either investing in “specified assets” or developing “specified assets”. Specified assets are defined to mean securities, real estate, options and the like. The definition doesn’t include operating businesses. So, what if a private equity fund holding interests in several operating business joint ventures issues a carried interest? Wouldn’t that carried interest be excluded from the scope of IRC § 1061? IRC § 1061(c)(3) provides that you look through to the activities undertaken by the JV for purposes of determining whether or not the issuer of the carried interest is holding specified assets. This language suggests that the answer should be that the PE fund’s carried interest is not subject to IRC § 1061 where its activities are limited to owning subsidiaries or interests in joint ventures engaged solely in operating businesses.

In spite of the plain language of IRC § 1061, the Conference Report for the 2017 Tax Act attempts to pull the example outlined above within the scope of IRC § 1061. Example 6 of the Conference Report provides that in the example above, the interest in the operating business joint venture would be a specified asset, in spite of the fact that the joint venture is holding an operating business.[5] If the

PE fund is holding interests in disregarded entities engaged in operating businesses, there is no similar example in the Conference Report and it would appear that a carried interest issued by the PE fund should fall outside the scope of IRC § 1061. Whether the drafters of IRC § 1061 intended to pull hedge funds within the scope of statute, but at the same time exclude PE funds holding operating businesses from the scope of the statute, is subject to conjecture, but the language of IRC § 1061 certainly wasn't drafted to clearly bring the PE firm holding interests in operating businesses within its scope. IRC § 1061(c)(3) does cross-reference IRC § 475(c)(2), which includes within its definition of a security a share of stock in a corporation, so if a PE fund holds stock in a corporation, the "specified asset" requirement of IRC § 1061 would be satisfied.

Planning idea – consider issuing equity compensation in a corporation.

Bonus and equity compensation, including options and stock grants, by a C corporation, do not fall within the scope of IRC § 1202. Given the reduction in the corporate tax rate from 35% to 21% and the potential availability of the tax benefits of IRC § 1202, many business owners and investors are considering the benefits of operating through a C corporation.

Planning idea – 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.

Planning idea – structure the economics to defer the triggering of taxes for the carried interest until the holder achieves the three-year holding period milestone.

This strategy involves either the voluntary or mandatory deferral of allocation of profits during the initial three-year holding period for the carried interest. Once the three-year holding period is achieved, there can be make-up allocations and distributions to the carried interest holder.

The waiver and subsequent fill-up provisions in an LLC or limited partnership agreement will be subject to the book allocation rules under IRC § 704(b). 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.[6] 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.[7] 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.

There will also be risks associated with the strategy outlined above. The holder of the carried interest may not be able to catch-up if investments sold after the three-year holding period is achieved fail to provide the necessary amount of profits to fund the catch-up. It could be complicated to structure the economic terms of the waiver and catch-up where there are co-investors or other further complicating factors. There is always the additional risk that there will be intervening legislation transforming the carried interest's right to capital gains into ordinary income, as currently threatened in the 2019 Proposed Legislation.

Planning idea – 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.[8] 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.[9] 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.

Planning ideas – structuring investments by PE funds to avoid establishing new holding periods subject to IRC § 1061.

Holders of carried interests and other investors, including a PE fund will have a holding period in the stock of a platform company. The goal will be to achieve a three-year holding period for the stock. To the extent possible, efforts should be made to fund additional capital for add-on investments as pro-rata capital contributions rather than transactions involving the issuance of additional stock (with new holding periods for IRC § 1061 purposes). In situations where pro rata capital contributions don't work, other options might include funding the additional capital needs with debt or preferred stock.

One common structure is to place an LLC or LP as a holding company over the corporate portfolio company. If additional funding for an add-on investment at the portfolio company is required, investors and holders of carried interests would handle that at the LLC/LP holding company level and the funds would be contributed to the capital of the corporate portfolio company, with no additional stock issued by the corporation.[10] Under this

scenario, the stock of the portfolio company would be eventually sold and there would be no issues with respect to multiple holding periods (the capital gain on the sale of the portfolio company stock held for three years would pass through the LLC/LP to its owners, and so long as the portfolio company's stock has the necessary three-year holding period, IRC § 1061 would not come into play).

Another planning technique where there are blocks of portfolio company stock with different holding periods is to time the sale/redemption of blocks to avoid triggering the sale of shares that haven't achieved the three-year holding period.

If the platform company is taxed as a partnership (usually an LLC or LP), then the contribution of additional cash with respect to a partnership interest (including the carried interest) starts a new holding period attributable to the additional cash.^[11] The same result would occur if the cash is contributed in exchange for the issuance of an additional partnership interest. To further complicate matters, liability adjustments that are treated as contributions and distributions of cash under IRC §§ 752(a) and 752(b) are taken into account for purposes of determining the partner's holding period if the contributions or distributions are taken into account for capital account purposes. It may be possible with careful planning using debt or preferred partnership interests to fund the partnership.

Disclaimers

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.

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

[1] See

<https://www.apnews.com/8a8f4bf6f3594e0f92d8e5e603a1e5c3>

[2] Subject to the “hot assets” rules of IRC § 751. Note that Section 4 of Revenue Procedure 93–27 requires the partnership interest be held for at least two years post-grant to fall within the safe harbor created by such administrative guidance, so there is a risk that the IRS would take the position that the interest was taxable upon issuance if a profits interest is sold or transferred prior to the second anniversary date of issuance. The reality is, however, that the value of the interest might well be nominal at the time of issuance given the economic rights of a profits interest on the date of issuance.

[3] The Carried Interest Fairness Act of 2019 (the “2019 Proposed Legislation”).

[4] One commentator suggests that since the plain reading of IRC § 1061 excludes Section 1231 property “without making the provision unreasonable, incoherent, or without effect”, any statutory amendment should have only prospective effect, although the possibility of a retroactively effective amendment cannot be ruled out. Rubin, Whiteway and Pakuluk, *Real Estate Owners: Don’t Get Carried Away by the New Carried Interest Provision* (March 15, 2018), Practising Law Institute.

[5] Conference Report, J. Rept. 115–466 at p. 268 (2017).

[6] See Treas. Reg. § 1.704–1(b)(2)(iii)(b).

[7] See Treas. Reg. § 1.704–1(b)(3)(iii)(c).

[8] IRC § 731(c)(4); IRC § 731(c)(6).

[9] 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.

[10] In 2009, regulations were proposed under IRC § 351 (Prop. Regs. § 1.358-2(g)(3); REG-143686-07) that addressed IRC § 351 exchanges where no stock is issued and whether or not the contribution should be coupled with a deemed stock distribution. This provision has possible application under IRC §§ 1061 and 1202, but in the absence of the regulations being finalized and the dearth of other IRS authority addressing the issue, taxpayers should consult with their tax professionals regarding the risks associated with adopting this approach.

[11] IRC § 1223 and Treasury Regulation § 1.1223-3.

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