Dealing With Section 1061's Three Year Holding Period Requirement for Carried Interests

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Hedge fund, private equity and real estate professionals are often compensated through the grant of a carried interest (promote) that usually isn't taxed at the time of issuance. This partnership interest is treated as a capital asset and income passed through from the partnership (or upon the sale of the interest) is usually taxed at favorable long-term capital gains rates. In response to significant pressure, Congress enacted Section 1061 of the Internal Revenue Code. This statute made it somewhat more difficult to reap the benefits of holding carried interests by increasing the holding period required for long-term gain treatment from more than one year to more than three years for partnership interests that fall within the scope of the statute (referred to as an "applicable partnership interest" or "API"). When someone holds an API, the three-year holding period requirement applies both with respect to gains triggered by the sale of the interest itself and gains passed through to the holder on a Schedule K-1 when there is a sale of a capital assets at the partnership level. Property distributed tax-free to the holder of an API also continues to be subject to Section 1061's three-year holding period requirement in the hands of the holder.

Perhaps the most significant aspect of Section 1061 is what it doesn't do – tax income received by holders of carried interest as compensation. Final regulations issued in January 2021 provided much needed guidance and some clarity with respect to interpreting how Section 1061 works. This article focuses on identifying what planning opportunities remain to reduce the negative tax consequences of the Section 1061 rules after issuance of the final regulations. For a more comprehensive discussion of Section 1061, see our article IRS Finalizes its Section 1061 Carried Interest Regulations.

What Interests Are Subject To Section 1061?

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Section 1061 applies to any API. An API is any partnership interest transferred to or held by a taxpayer, directly or indirectly, in connection with the taxpayer (or any related person) performing services in an "applicable trade or business" (ATB). Generally, if the activities of a partnership meet the ATB definition, any person receiving the profits interest in exchange for services, directly or indirectly, in such partnership, is subject to Section 1061, unless an exclusion otherwise exists.

Section 1061(c)(2) defines an ATB as any activity conducted on a regular, continuous, and substantial basis, through one or more entities that consist of, in whole or in part, (1) returning or raising capital and (2) investing in or disposing of "specified assets," identifying specified assets for investment or disposition, or developing specified assets. "Specified assets" include securities, real estate held for rental or investment, cash or cash equivalents, and options and derivative contracts of any of the foregoing.[1] The final regulations provide that the level of activity described above must satisfy the level of activity required to establish a trade or business under section 162. Courts have held that a trade or business for purposes of Section 162 is met when a taxpayer (1) is involved in the activity with continuity and regularity and (2) the primary purpose of the activity is income or profit. As such, certain ventures that require limited activity by the partners and service providers may be excluded from the API definition. However, the ATB definition is overly broad and will capture within its scope the activities of many real estate, venture capital, private equity, and hedge fund professionals and their entities.

Generally, Section 1061 pulls within its scope many investment partnerships, but will impact hedge funds more often than PE funds given the fact that most PE funds hold investments for more than three years. Many promotes issued by real estate funds and development projects will fall outside of the scope of Section 1061 because the funds or project will involve property used in a trade or business. Promotes issued by partnerships holding investment real property and perhaps some partnerships holding triple net leases will fall within Section 1061's scope. Note, however, that exclusion from Section 1061's scope only applies to gain passed through to

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the holder of a carried interest from the direct sale of property used in a trade or business, not to the sale (including redemption) of the carried interest itself, so selling a promote held for less than three years could trigger an unwanted tax result under Section 1061.

Planning Opportunities

There are several ways to avoid the impact of Section 1061 when final Section 1061 regulations are taken into consideration.

Capital gain items not subject to Section 1061 (including Section 1231 gain on the sale of depreciable property and commercial, industrial, and residential investment real property)

The final regulations provide that the following items are not taken into account for purposes of Section 1061: (1) long-term capital gain or loss determined under Section 1231 (property used in the trade or business); (2) long-term capital gain or loss determined under Section 1256 (certain securities contracts), (3) qualified dividends included in net capital gain, and; (4) capital gain items and losses characterized as short-term and long-term gain without regard to the holding period rules of Section 1222 (e.g., gains and losses under the mixed straddle rules).

Section 1231 property generally includes depreciable real estate and personal property used in a trade or business, including commercial, industrial and residential investment property. This exclusion provides a significant advantage to the real estate funds and private equity funds owning interests in operating partnerships, as these entities may own a significant amount of Section 1231 property. It will be important to structure any sale involving Section 1231 property to trigger Section 1231 gains rather than gains from the sale of the API interest itself or the stock or interests in the LLC/LP that own the Section 1231 property.

A sale of the API (carried interest) will be subject to Section 1061, regardless of whether the entity owns Section 1231 property.

Avoid ATB characterization – profits interests issued by companies that are not engaged in raising or return capital should not be subject to Section 1061

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Not all carried interests (profits interests) are subject to Section 1061. If a profits interest is issued by a partnership in consideration of the performance of services by an individual or entity that isn't involved in raising or returning capital, then it shouldn't fall within the scope of Section 1061. But in spite of the plain language of Section 1061, the final regulations denied commenters request that the regulations declare a profits interest in a partnership that owns a non-ATB business and is held by the employee manager of such business is per se not an API, even if the partnership operated the non-ATB business through a corporate subsidiary and therefore holds specified assets. The preamble to the final regulations state that, depending on the facts and circumstances of the situation, the ATB test could be met, and, by extension, the profits interest would be an API. As such, incentive arrangements for employees in operating businesses should be carefully evaluated to determine if specified assets are present at the operating business level.

Many companies issue profits interests to employees, independent contractors and business partners in exchange for services that fall outside of the scope of raising or returning capital. For example, profits interests issued to an executive of a manufacturing company for services as CFO or to an individual for services as restaurant manager should fall outside of the scope of Section 1061.

Avoid ATB characterization – family offices

Section 1061(b) provides that income or gain attributable to any asset not held for portfolio investment on behalf of third party investors is excluded from Section 1061's scope. This means that the holder of a carried interest issued by an LLC/LP that doesn't have third party investors should avoid Section 1061's scope. The preamble to the proposed regulations indicates that the IRS' position is that family offices where the portfolio investments are made on behalf of the service partner(s) and persons related to the service partner fall under the Section 1061(b) exclusion. However, the Treasury did not address this issue further in the final regulations. Because the preamble to the proposed regulations only mentions situations where the service partner is an investor and is also related to the other investors, it appears that a profits interest granted to an unrelated service provider could be subject to

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Section 1061.

Take advantage of the capital interest exception

Section 1061(c)(4) provides that an API shall not include any capital interest with a right to share in partnership capital commensurate with the capital contributed or the value of such interest subject to tax under Section 83. The final regulations require that partnership allocations must be proportionate with the amount of capital invested (property or taxable service), meaning allocations must be reasonably consistent to non-service partners, and separately identified from non-capital interests in the partnership's books and records to meet this exception.

Ensuring that service partner's capital interests are reasonably consistent to non-service partner's is critical to this exception. Each class of interest or partnership investment is separately tested for this exclusion. First, there must be similar non-partner capital contributions in the same class or investment to test against. At least 5% of the capital in the tested class or investment must be held by non-service partners. The service partner's capital interest must be held directly with non-service partners in the same class or investment, which may not be the standard structure for many funds. The final regulations also provide that the amount and timing of capital contributions, rate of return on capital, priority of distribution, risk associated with the capital contributed, and rights to operating and liquidating distributions are factors considered.

The regulations make it clear that the following factors will not cause an interest to fail the capital interest exception: (1) the fact that a service partner's allocations are subordinate to non-service partners; (2) the fact that service partners receive tax allocations when non-service partners do not, and; (3) the fact that a service partner's capital interest is not subject to an allocation reduction for management fees or API allocations while a non-service partner's interest is subject to such reduction. Under the final regulations, any common economic arrangements will be respected if the other requirements are met.

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The final regulations require that in order to take advantage of the capital interest exception, the partnership's governing agreement and books and records must distinguish between allocations made with respect to the capital interest from those made with respect to the carried interest subject to Section 1061. Governing agreements should be amended to satisfy this requirement and sale transactions should be planned and structured with Section 1061's rules in mind.

The capital interest exception presents several planning opportunities:

Partner loans to purchase capital interests

While the proposed regulations excluded interests funded with loan proceeds from the partnership or any partner or related party, the final regulations provide an exception to this rule for loans from partners (or related entities to the partners) to service providers where the service partner is personally liable for repayment of the loan, the service provider has no right to reimbursements from any other person and the loan is not guaranteed by any other person. So, a service partner could receive a loan from a current partner or a related party to fund capital contributions. The terms of any loan must be carefully structured to meet the final regulations' requirements.

Reinvestment of API gain

The final regulations provide that any API gain that is reinvested in the partnership by the API holder will be treated as a contribution that may produce a capital interest allocation as long as the other capital interest requirements are met. However, it is important to note such gain must be realized for tax purposes, a book up of unrealized gain will not produce a capital interest. Planning strategies may include automatic reinvestments of allocated gain, preferably related to gain from assets not subject to Section 1061, as a means of increasing a carried interest holder's excluded capital interest.

Employee Co-investments

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Common in large real estate and private equity funds, co-investments are lines of credit from banks or financial institutions offered to partners and employees of a fund's general partner, affiliated management company or sponsor, the proceeds of which are used to purchase interests in the funds managed by the general partner, affiliated management company or sponsor. Generally, these loans are secured by the interest and distributions from the purchased interest. As the loans are made from unrelated financial institutions, they are not subject to the related party loan rules. Based on the final regulations, capital contributions through co-investments should meet the capital interest exception if the other capital interest requirements discussed above are met. Common co-investment terms may need to be revisited in order to comply with the capital interest exception.

Carry Waivers

A planning idea often discussed when the Section 1061 rules were first enacted is the use of a waiver of a service partner's right to current allocations of gain subject to Section 1061 granted in exchange for future allocations of gains held for more than three years (i.e., gains outside of the scope of Section 1061). The preamble to Section 1061's proposed regulations warned that carry waivers "may not be respected and may be challenged under section 707(a)(2)(A), reg. sections 1.701-2 and 1.704-1(b)(2)(iii) and/or the substance over form or economic substance doctrines."

The final regulations did not address carry waivers, but they are likely to be closely scrutinized by the IRS. There are several options available to challenge carry waivers. The IRS could treat any allocation related to a carry waiver as compensation paid to a service provider under Section 707(a)(2)(A), which is taxed as ordinary income from services rather than a partnership allocation. The IRS could assert the application of the general partnership tax abuse rules which permit the IRS to recast a transaction if the principal purpose of the transaction is the substantial reduction of federal tax. Treasury Regulation Section 1.704-1(b)(2)(iii) requires any allocation to have substantial economic effect to be respected. [2] Additionally, the IRS could attempt to apply legal doctrines related to tax avoidance strategies such as the Step Transaction

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Doctrine, the Sham Transaction Doctrine, the Business Purpose Test, the Substance Over Form Doctrine or the Economic Substance Doctrine. For a carry waiver to avoid falling prey to these doctrines, there must be an economic purpose other than tax avoidance and both an upside and downside risk to the future allocation being more or less than the current allocation waived by the service provider. Allocations related to a carry waiver that don't satisfy these requirements are likely to fall victim to one of the several IRS recharacterization options described above.

Corporations

Carried interests held by a C corporation fall outside of the scope of Section 1061. The final regulations make clear that holding a carried interest through an S corporation does not fall under the Section 1061(c)(4) exclusion for interests held by a "corporation." However, the statute has not been amended to make this distinction. Some practitioners argue that the definition of "corporation" in the Internal Revenue Code is unambiguous and includes both C corporations and S corporations. Courts have regularly held that the IRS cannot contradict unambiguous language of the statute it is interpreting. A previous article deals with this issue in more detail. It is likely that this issue may be litigated in the future, however, it is clear that the IRS' view is that Section 1061 does not exclude APIs held by S corporations.

C corporation compensation arrangements such as bonus and equity compensation, including options and stock grants, fall outside of the scope of Section 1061. Given the reduction in the corporate tax rate from 35% to 21% in 2017 (still applicable as of March, 2021) and the potential availability of the tax benefits of Section 1202 ($10 million per shareholder gain exclusion for certain stock held more than five years), many business owners and investors are considering the benefits of operating through a C corporation, even though such investments are subject to two layers of tax.

Transferring carried interests to unrelated parties

Prior to the final regulations, it appeared that a sale of an API to a party that was not defined as a "related party" for purposes of the

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Section 1061(d) related party rules, but was otherwise controlled by the API owner, could remove the interest from Section 1061. If a carried interest is sold to a "related party," Section 1061(d) mandates short-term capital gain treatment for the portion of the assets that does not have a three-year holding period. But the definition of related parties for Section 1061(d) encompasses only direct family members and fund management colleagues. The attribution rules for corporations, partnerships, trusts and estates are omitted. As a result, it appeared 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 Section 1061.

While this planning may work to bypass the Section 1061(d) rules, the final regulations provide that once a partnership interest attains API status, it does not lose such status unless the API is sold at arm's length and the purchaser (1) is unrelated (under the broader related party rules applicable outside of Section 1061(d)) to the seller or any other service partner to the partnership or related entity and (2) the person has never provided nor anticipates providing services directly or indirectly (e.g., through a related entity) to the partnership.[3] As such, unless this exception is met, any allocation of gain to the API from assets held by the partnership for less than three years would still be subject to Section 1061.

Distribution of appreciated assets to API holders

As drafted, Section 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 Section 1061. However, the final regulations require the calculation of the recharacterization amount to include any long-term capital gain from assets distributed from the partnership that have a holding period of more than one year but less than three years, significantly limiting this strategy. Nevertheless, despite the fact that any asset distributed to API holder will be tainted for three years, a distribution of assets to interest holders versus a sale at the partnership level may afford

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more flexibility to capital interest holders who want to sell assets immediately and API holders who would rather wait to sell the asset until after the holding period exceeds three years to avoid short term capital gains treatment.

Structuring investments by partnerships to avoid establishing new holding periods subject to Section 1061

Gains subject to short-term gain reclassification for API holders include API holder's share of gain from the partnership's sale of assets with a holding period of less than three years. The goal for these assets 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, which would cause new partnership holding periods for Section 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 operating business. If additional funding for an add-on investment at the operating business 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 operating business, with no additional stock issued by the corporation. Under this scenario, the stock of the operating business would be eventually sold and there would be no issues with respect to multiple holding periods, so as long as the operating business stock is held by the partnership for three years, the gain from such sale would pass through the LLC/LP to its owners, including API holders, and Section 1061 would not come into play.

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

If the operating business is taxed as a partnership (usually an LLC or LP), then the contribution of additional cash with respect to a

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partnership interest (including the carried interest) starts a new holding period attributable to the additional cash. 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 Sections 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 to avoid new holding periods.

Beware of the look-through rule

The final regulations seek to limit the use of dormant funds and other planning opportunities aimed at increasing the holding period of service partners APIs. Before regulations were finalized, it appeared that entities could be created before the investment of capital from non-service partners, thereby allowing service partners to start the clock on their holding period before the entity became active. Such planning would allow service partners to sell their API three years after receiving an interest, but less than three years after any asset was acquired. As such, the sale of the API interest would receive long-term capital gain treatment under Section 1061. However, the final regulations provide that the IRS will look through to holding period of the assets of the partnership rather than the holding period of service partner's API to determine if Section 1061 applies to the gain if the API would have a holding period of three years or less if the holding period of such API were determined by not including any period prior to the date that non-service partners were legally obligated to make substantial contributions (at least 5 percent of the partnership's total capital either directly or indirectly) to the entity to which the API relates. This look-through rule significantly impacts the ability to use dormant funds to extend the holding period of APIs.

The final regulations also provide that the look-through rule applies in the sale of an API held for more than three years when any transaction or series of transactions has taken place with a principal purpose of avoiding potential gain recharacterization under Section

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1061(a). While the final regulations do not provide specific guidance on the meaning of "a transaction or series of transactions with a principal purpose of avoiding Sectios 1061", the concept of a transaction with the principal purpose of avoiding tax is used in other Sections of the Internal Revenue Code and Treasury Regulations. Additionally, this topic has been heavily litigated in the courts and several judicial doctrines allow courts to recharacterize a transaction based the economic substance of the transaction rather than its legal form.

For example, Section 269 disallows the benefit of any deduction, credit, or other allowance when the principal purpose of an acquisition is the evasion or avoidance of tax. Section 357(b) treats an assumption of debt as money if the principal purpose of an acquisition is the avoidance of tax. Similarly, Treasury Regulation Section 1.304-4(b) disregards the structure of a transaction if the principal purpose of the transaction is to avoid the dividend rules of Section 304. Relevant legal doctrines related to tax avoidance strategies include, but are not limited to, the Step Transaction Doctrine, Sham Transaction Doctrine, Business Purpose Test, Substance Over Form Doctrine and Economic Substance Doctrine. Generally, in determining whether to reclassify a transaction under the aforementioned statutes, regulations and judicial doctrines, courts consider whether there is any economic significance or business purpose to the transaction other than the avoidance of tax. Treasury Regulation Section 1.269-3(a) states "[i]f the purpose to evade or avoid Federal income tax exceeds in importance any other purpose, it is the principal purpose." As such, it is important that other economic or business purposes exist when structuring transactions to bypass Section 1061 in order to avoid the look-through rule.

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 Section 1061 should be interpreted

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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 expertise assisting business clients with respect to tax planning and equity and bonus compensation arrangements. If you need assistance or would like additional information, contact any other member of the Tax Law Practice Group for Tax Law Defined™.

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[1] "Specified assets" also include an interest in a partnership to the extent of the partnership's proportionate interest in any of the listed assets.

[2] 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. 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. Treasury Regulation Section 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.

[3] Treasury Regulation Section 1.1061-3(d).

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