IRS Finalizes Its Section 1061 Carried Interest Regulations

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On January 13, 2021, the IRS posted final Treasury Regulations for Section 1061 of the Internal Revenue Code. Section 1061 increases the holding period required for long-term capital gains treatment from more than one year to more than three years for partnership interests deemed to be "applicable partnership interests" ("API").[1] Basically, the goal of Congress in enacting Section 1061 was to make it somewhat more difficult to reap the benefits of holding carried interests (referred to as "promotes" in the real estate industry) without destroying the benefits by taxing income received as compensation. The final regulations provided much needed guidance and some clarity with respect to issues raised by practitioners in response to the proposed regulations.

Key guidance included in the final regulations and discussed below include:

- the definition of an API, including treatment of profits interests held by an S corporation or passive foreign investment company ("PFIC");
- exceptions for capital interests, including capital contributions funded with loans;
- determination of the holding period of an API interest, including a look-through rule for related party and tax avoidance transactions; and
- the calculation of Section 1061 recharacterization amounts and reporting requirements.

How Section 1061 Works

Section 1061(a) increases the holding period required for long-term capital gains treatment from more than one year to more than three years for capital gain related to an API. Real estate, private equity and hedge fund professionals who receive profits interests for services generally are treated as holding an API under Section 1061 and its regulations.

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Prior to the enactment of Section 1061, an investment fund holding long-term capital assets could issue a carried interest to a sponsor, and the sponsor might immediately qualify for the pass-through of long-term capital gains if the partnership sold capital assets with a one-year holding period. Additionally, the sponsor could sell (or have redeemed) their carried interests after one year and potentially claim long-term capital gains treatment on the proceeds.[2] Under Section 1061, the 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 sponsor's carried interest was sold prior to achieving a three-year holding period.

Definition of an Applicable Partnership Interest (API)

Section 1061(c)(1) defines an API as "any interest in a partnership which, directly or indirectly, is transferred to (or is held by) the taxpayer in connection with the performance of substantial services by the taxpayer, or any other related person,[3] in any applicable trade or business." The final regulations provide a presumption that if a partnership interest is transferred in connection with the performance of services, the person is presumed to have provided substantial services for Section 1061 purposes.[4]

An "applicable trade or business" (ATB) is defined in Section 1061(c)(2) as any activity conducted on a regular, continuous, and substantial basis consisting, in whole or in part, of raising or returning capital, and either (i) investing in (or disposing of) specified assets (or identifying specified assets for such investment or disposition), or (ii) developing specified assets. The statute defines "specified assets" as securities, commodities, real estate held for rental or investment, cash or cash equivalents, or any option or derivative of any of those assets.

The final regulations state that the total level of specified activities (raising or returning capital and investing in or developing specified assets), including the activities of any related persons, must reach the level of activity that would be required to establish a trade or business under Code Section 162 to meet the applicable trade or business definition.

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The final regulations also provide that it is not necessary for activities related to raising or returning capital and investing/disposing or developing in specified assets to both occur in a single year, if it is anticipated that such activities will occur in a later year. So, an ATB is being conducted if either raising/returning capital or developing specific assets rises to a regular, continuous and substantial level in a particular year and it is anticipated that the other activity will be performed in a later year.[5] The final regulations further provide that all ATB activities are aggregated to determine if such activities are conducted on a regular, continuous, and substantial basis.[6]

Based on the API definition, unless an exception applies, most carried interests (profits interests) held by service partners working for private equity ("PE") sponsors, venture capital funds, hedge funds and real estate funds, fall within the API definition. Before the final regulations were issued, many questions remained as to how broadly the ATB definition would be applied. For example, would activities carried on by family offices or limited joint ventures be considered an ATB? Unfortunately, the final regulations did not provide complete clarity on many issues. Nor did the final regulations establish much needed de minimis exceptions to their application.

Exceptions to API Classification

Section 1061 explicitly excludes the following from its rules: (1) income or gain attributable to any asset not held for portfolio investment on behalf of third-party investors; (2) interests held by a person performing services under the employment of another business that is not an applicable trade or business; (3) interest in a partnership held by a corporation[7]; (4) any interests commensurate to the capital contributed; and (5) if the interest is taxable under Code Section 83, the taxable value (i.e., the taxable value would be treated as capital contributed). The final regulations also provide an additional exception for unrelated purchasers of APIs.

Assets not held for portfolio investment on behalf of third-party investors

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Section 1061(b) provides that the Treasury Secretary shall provide rules to exclude "income or gain attributable to any asset not held for portfolio investment on behalf of third party investors." Comments on the proposed regulations suggested additional guidance was needed for family offices, management companies, and other partnerships that do not hold assets for portfolio investment on behalf of third-party investors. These comments also asked for guidance confirming that Section 1061(a) does not apply to recharacterize income or gain attributable to the value of intangibles, including goodwill, created or used in an ATB. Unfortunately, the final regulations did not provide any clarity on these issues.

Interests held by person performing services as employee of non-ATB

Section 1061(c)(1) provides that an API does not include "an interest 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." Here again the final regulations failed to provide clarity on this exception. We assume that the exception is intended to exclude from the scope of Section 1061 service providers who are issued profits interests for services provided to an operating company. For example, if a PE firm owns a company that operates restaurants, a profits interest issued by the restaurant company to its senior management or restaurant managers would not be an API, but a profits interest issued to the PE sponsor entity or its employees could well be an API if no other exception applies.

Interests held by a corporation

Following the enactment of Section 1061, the plain language of the statute appeared to exclude interests held by any corporation (including S corporations) from API treatment. In 2018, the Department of Treasury issued Notice 2018-18, indicating that the IRS intended future regulations to provide that the term "corporation" for purposes of the exclusion of interests held by a corporation does not include an S corporation. The final regulations fulfil that promise, declaring that a corporation does not include an entity for which an election was made to treat the entity as a

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"passthrough entity." In addition to S corporations, the final regulations' definition of passthrough entity includes partnerships, trusts, estates and passive foreign investment companies (PFIC) that shareholders have made a qualified electing fund election.

Capital interests

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 Code Section 83. However, in determining if this exclusion applies, the proposed regulations did not focus on the capital contribution or the Code Section 83 income exclusion, but instead required that allocations be made to all partners in the same manner based on capital account balances. Practitioners questioned whether partnerships using targeted allocations and waterfall distributions would be excluded from the capital interest exception. Practitioners were concerned if that was the case, many common business arrangements in the real estate, venture capital, private equity and hedge fund industries would cause such partnerships to fall outside this exception, regardless of whether the interest holder contributed capital in exchange for their interest. Fortunately, the final regulations provide a more simplified rule that is more in line with the text of the statute.

The final regulations provide that gain allocated to or derived by a service partner is generally eligible for the capital interest exclusion if the following requirements are met: (1) the gain allocated to the service partner is determined in a manner similar to allocation on capital interests held by unrelated non-service partners that have made significant capital contributions to the pass-thru entity, and (2) allocations on the capital interest are clearly identified as separate and apart from allocation on the carried interest in the partnership agreement and in contemporaneous books and records of the partnership. In other words, the allocations must be proportionate with the amount of capital invested (property or taxable service) and clearly identified in the partnership's books and records. The final regulations provide further clarification with respect to these requirements.

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- Commensurate with capital requirement
  The final regulations provide that allocations are made in a similar manner to unrelated non-service partners (e.g., investors)[8] if they are "reasonably consistent" with allocations to non-service partners. Factors considered in determining consistency include, but are not limited to, timing of contributions, rate of return, priority of returns, and the particular rights of each class of equity. While the final regulations indicate that these factors are considered, the regulations also provide that when multiple classes of interests exist and both service and non-service partners hold a particular class of interest, only the consistency within that class of interest is considered. Additionally, the final regulations provide that an allocation will not fail this requirement solely because a service partner's allocation is subordinate to non-service partners, because such allocation is not reduced by management fees or the costs of other services performed by the service partner, or because only the service partner has a right to receive tax distributions. As a result of how the final regulations handle these issues, many common business arrangements for service partners will not cause a partnership to fail this requirement.[9]
- Clear identification requirement
  The final regulations provide that capital interest allocations must be separately identified from carried interest allocations in the partnership agreements and books and records when determining partnership allocations. Separate classes of interests/units that clearly separate a service partner's capital interests from its carried interests are commonly used and may allow funds to already meet this requirement. However, taking into account the final regulations' requirements, it is important to review current operating agreements and record-keeping practices to ensure that allocations and distributions separately break out amounts for capital interests and carried interests held by service partners.

Unrelated purchaser exception

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Once an API is designated as such, the final regulations provide that the interest does not lose API status, even after transfer to another party.[10] As such, if a person unrelated to the seller that provides no services to the partnership purchases an API, any gain allocated to the API would still be subject to Section 1061. The final regulations provide that an API sold at arm's length is exempt from Section 1061 if the purchaser (1) is unrelated 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 to the partnership.[11]

Capital interests purchased with proceeds of partnership or partner loans

The proposed regulations provided that a capital interest did not include service partner interests acquired with funds attributable to a loan, advance or debt guarantee from any other partner, the partnership, or a related person until repayments on the debt were made from sources other than similar loans or advances. While this language is included in the final regulations, the final regulations also provide an exception to this rule when the service partner is personally liable for repayment of the loan (so long as there isn't a third-party guarantee or reimbursement arrangement) and the funds are not loaned by the partnership.[12]

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 so 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.

Determination of Holding Period: Look-Through Rules

The final regulations provide new rules for determining what holding period applies when gain is recognized on disposition of a carried interest. The general rule is that the holding period is the direct owner's holding period in the asset sold (i.e., the owner's holding

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period in the interest or the partnership's holding period in the asset). However, the final regulations include exceptions to this rule, causing long-term gain to be recast as short-term gain in certain situations by looking through to the holding period of the assets allocable to the API.

Related party transfers

When an API is transferred directly or indirectly to a related party [13], Section 1061(d) requires the seller to report as short-term capital gain the amount of such gain attributable to any asset of the partnership not held for more than three years that is in excess of the amount of gain recharacterized as short-term gain under Section 1061(a). In other words, for transfers of carried interest to related parties, you look through to the holding period of the assets of the partnership and recharacterize as short-term capital gain any amount attributable to an asset with a partnership holding period of less than three years.

The final regulations limit the look-through rule to any transaction (direct or indirect) where gain is recognized. This is a taxpayer friendly departure from the proposed regulations, which accelerated income recognition in related party non-recognition transactions, including Code Section 1231 gains. Wealth planning arrangements structured to avoid gain recognition (e.g., lifetime gifts to trusts, sales to grantor trusts, and transfers at death) will not trigger gain under the final regulations. However, it is important to note that the final regulations related party rules do cover redemptions of APIs and will subject such transactions to the look-through rule.

Look-through rule if principal purpose is avoiding Section 1061

The final regulations also 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

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after any asset was acquired by the partnership. As such, the sale of the API interest would receive long-term capital gain treatment under Section 1061. However, the final regulations seek to disallow such planning opportunity and also state that, if the principal purpose of a transaction is to avoid the three-year holding period requirement, the IRS will look through to the assets allocable to the API to determine if Section 1061(a) applies.

Under the proposed regulations, if 80% or more of the assets of the partnership in which the API was held, based on fair market value, had a holding period of less than three years, the look-through rule applied. The final regulations did not include the bright line 80% test and instead applied the look-through rule in situations where, at the time of disposition of an API held for more than three years: (1) 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% of the partnership's total capital either directly or indirectly) to the entity to which the API relates; or (2) a transaction or series of transactions had taken place with a principal purpose of avoiding potential gain recharacterization under Section 1061(a).

The first situation applies to holding period planning involving the formation of an entity for the purposes of beginning the holding period clock for API holders before the entity becomes active.

The second situation relates to any other transaction where the principal purpose is to avoid Section 1061 recharacterization. While the final regulations did not provide specific guidance on a transaction or series of transactions with a principal purpose of avoiding Section 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.

Transactions falling within the scope of the preceding paragraph have been heavily litigated in the courts, and several judicial doctrines allow courts to recharacterize a transaction based on the economic substance of the transaction rather than its legal form. For example, Section 269 disallows the benefit of any deduction,

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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, Treas. Reg. 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 the Step Transaction Doctrine, the Sham Transaction Doctrine, the Business Purpose Test, the Substance Over Form Doctrine and the 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. Treas. Reg. 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." Obviously, 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.

Determination of Section 1061 Recharacterization Amount

The amount recharacterized as capital gain under Section 1061 is equal to the amount that the taxpayer's "One Year Gain Amount" exceeds its "Three Year Gain Amount." The One Year Gain Amount is computed by adding (1) taxpayer's net gain or loss from the sale of an API held for more than one year and (2) the taxpayer's share of all net partnership capital gain and loss items that would be long-term capital gain or loss items but for the application of Section 1061, and reducing such amount by the capital gain items not subject to Section 1061, discussed below, and items excluded as gains from capital interests, discussed in the "Exceptions to API classification" section above. The Three Year Gain Amount is the taxpayer's share of partnership net capital gain or loss included in the One Year Gain Amount that has been held for more than three years and any net capital gain or loss from the sales of an API interest held for more than three years to which the look-through

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either doesn't apply or doesn't recharacterize as short-term capital gain. Special rules apply for installment sales, dividends from RICs, REITs and foreign investment companies with QEF elections in place.

Capital gain items not subject to Section 1061

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 a 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-terms and long-terms gain without regard to the holding period rules of Section 1222 (e.g., gains and losses under the mixed straddle rules).

Reporting Requirements

If a pass-through entity does not furnish the information that an API owner (i.e., the individual that ultimately pays the tax) needs to determine the Section 1061 recharacterization amount (e.g., items required to compute the One Year Gain Amount and Three Year Gain Amount) and the owner cannot otherwise substantiate these amounts, the amount reclassified as short-term capital gains under Section 1061 must be calculated without reducing the One Year Gain Amount by capital gain items not subject to Section 1061 (e.g., Section 1231 gain, qualified dividends) or gains from capital interests, and the Three Year Gain Amount will be calculated as if all of the taxpayer's share of partnership long-term capital gain items are held for less than three years. The result would increase the One Year Gain Amount and reduce the Three Year Gain Amount, leading to a substantial Section 1061 recharacterization amount increase for the API holder.

The final regulations also provide information request requirements. If a pass-through entity that holds an interest in a lower-tiered entity needs information from the lower-tiered entity to meet its reporting obligations, such information must be requested within 30 days from the close of the taxable year or within 14 days after the

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date of the request of information from an upper-tier entity, and if a request is timely made, the lower-tier entity must respond by the Schedule K-1 due date for the taxable year or be subject to penalties to be determined by the Treasury Secretary. Despite requests to exempt small partnerships from the reporting rules, the final regulations made no such exemption. As such, it will be important that all partnerships with service partners and relevant organizational documents follow the information reporting and request rules to avoid increased Section 1061 recharacterization amounts and penalties.

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 any member of the Tax Law Practice Group for Tax Law Defined™.

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[1] Many consider Section 1061 as applying generally to profits interests, carried interests and promotes, but the statute really only applies to these partnership interests if they fall within the statute's definition of an "applicable partnership interest" (API).

[2] Subject to the "hot assets" rules of Code Section 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] A related person for purposes of Section 1061, other than Section 1061(d)(2), includes a person or entity treated as a related person or entity under Section 707(b) or 267(b). A related person for purposes of Section 1061(d) is defined more narrowly and includes only members of the taxpayer's family within the meaning of Section 318(a)(1), the taxpayer's colleagues (those who provided services in the ATB during certain time periods) and, under the

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regulations, a passthrough entity to the extent that a member of the taxpayer's family or a colleague is an owner.

[4] Treas. Reg. 1.1061-2(a)(1)(iv).

[5] Treas. Reg. 1.1061-2(a)(2) Example 4.

[6] Id., Examples 1-3.

[7] As discussed in this article, "corporation" for this purpose excludes an S corporation.

[8] Unrelated non-service partners must hold in aggregate 5 percent or more of the capital contributions related to the particular class or investment to test for consistency for this exception.

[9] It is presumed that the allocations discussed in the final regulations refer to tax allocations. A common business arrangement used in hedge funds is to replace unrealized gains with realized gains for partners exiting the fund to make up the difference between the exiting partners' book basis and tax basis, referred to as "stuffing" allocations. As these allocations differ from tax allocations made to other partners, they may run afoul of the commensurate with capital requirement.

[10] Treas. Reg. 1.1061-2(a).

[11] Treas. Reg. 1.1061-3(d)(1).

[12] Treas. Reg. 1.1061-3(c)(3)(v).

[13] A related person for purposes of section 1061(d)(2) (a Section 1061(d) related person) is defined more narrowly than a related person for purposes of section 1061(c)(1) and includes only members of the taxpayer's family within the meaning of section 318(a)(1), the taxpayer's colleagues (those who provided services in the ATB during certain time periods) and, under the regulations, a Passthrough Entity to the extent that a member of the taxpayer's family or a colleague is an owner.

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