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3-Year Holding Period Rule for 'Carried Interests' Addressed in IRS Final Regulations

On Jan 7, 2021, the Department of Treasury and IRS issued final regulations (the Regulations) that provide guidance to the "carried interest" rules under Section 1061 of the Internal Revenue Code. The Regulations finalize proposed regulations that were issued by the Department of Treasury and IRS on July 31, 2020 (the Proposed Regulations) (*see* August 2020 GT Alert on the Proposed Regulations).

Background of Section 1061

Long-term capital gains derived by individuals are subject to a preferential 20% U.S. federal income tax rate (plus 3.8% "net investment income" tax after certain income thresholds are met). At the same time, individuals are subject to U.S. federal income tax on short-term capital gains at the graduated ordinary income tax rates with a maximum tax rate of 37% (plus 3.8% "net investment income" tax after certain income thresholds are met).

In typical fund and other joint-venture structures, the fund or other joint venture is structured as a partnership (or an entity treated as a partnership for U.S. federal income tax purposes), and the fund sponsors and other service providers typically structure their incentive compensation in the fund or other joint venture as an interest in the partnership, entitling them to a percentage of the partnership's future income and gains, if any (so-called "carried interest"). This way, if the partnership derives long-term capital gain, such gain that is allocated to the "carried interest" holder will be taxed to him or her as a long-term capital gain rather than as ordinary fee income.

Prior to the enactment of Section 1061, capital gain allocated to a "carried interest" holder was generally treated as long-term capital gain (to the "carried interest" holder), if the gain was derived from a sale or other disposition of a capital asset after a holding period of more than one year. Section 1061, which was added to the Code as part of the 2017 Tax Cuts and Jobs Act, provides that capital gain allocated to a "carried interest" holder will only be treated as long-term capital gain (to the "carried interest" holder) if the gain is derived from a sale or other disposition of a capital asset after a holding period of more than three years.

Carried Interest Definition

Section 1061 refers to a "carried interest" as an "applicable partnership interest."

An "applicable partnership interest" is defined as a partnership interest held by, or transferred to, a taxpayer, directly or indirectly, in connection with the performance of substantial services by the taxpayer, or by any other related person, in any "applicable trade or business." In other words, an "applicable partnership interest" is an interest in a partnership's profits that is transferred or held in connection with the performance of services.

An "applicable trade or business" is any activity conducted on a regular, continuous, and substantial basis which consists of (i) raising or returning capital, and (ii) either investing in specified assets or developing specified assets.

The term "specified assets" means certain securities, certain commodities, real estate held for rental or investment, cash or cash equivalents, options or derivative contracts with respect to any of the foregoing, and an interest in a partnership to the extent of the partnership's proportionate interest in any of the foregoing.

An applicable partnership interest (i.e., a "carried interest") does not include for purposes of Section 1061 (i) a partnership interest held by a corporation, or (ii) a capital interest in a partnership, i.e., an interest received in exchange for a capital contribution rather than for services.

Effective Date of the Regulations

Section 1061 itself applies to taxable years beginning after Dec. 31, 2017. The Regulations are generally effective for taxable years beginning on or after Jan. 1, 2022, but taxpayers may choose to apply the Regulations to a taxable year beginning after Dec. 31, 2017, if they apply them in their entirety and in a consistent manner.

Highlights of the Regulations

1. **Gains to Which Section 1061 Applies**. The Regulations confirm, consistent with the Proposed Regulations, that Section 1061 generally applies to capital gains and losses allocated to a "carried interest" as determined under Section 1222 of the Code.

   The Regulations, consistent with the Proposed Regulations, also clarify that Section 1061 **does not apply** to certain other types of income taxed as capital gains under other provisions of the Code, such as:

   (i) Qualified dividend income, i.e., dividend income from U.S. corporations or certain "qualified foreign corporations" (provided that certain requirements are met);

(ii) Gains subject to Section 1231 of the Code, i.e., gains from the sale of depreciable property used in a trade or business (note that this exception is important for real estate funds and ventures because rental real property is generally treated as Section 1231 property);

(iii) Gains under Section 1256 of the Code, i.e., certain gains from derivatives or other financial instruments that are marked to market;

(iv) Capital gains characterized under the identified mixed straddle rules described in section 1092(b) of the Code.

Capital gains and losses (both one-year and three-year) are netted across all "applicable partnership interests" held by the taxpayer, with one result: losses with respect to one interest may offset gains with respect to another.

2. **S Corporations That Hold a Carried Interest**. Section 1061 provides that the three-year holding period requirement **does not apply** to carried interests held by a corporation. Consistent with the Proposed Regulations and prior guidance by the IRS, the Regulations provide that S corporations are not considered "corporations" for purposes of Section 1061. Accordingly, gain allocated to a "carried interest" held by an S corporation is subject to the three-year holding period requirement.

3. **PFICs That Hold a Carried Interest**. Section 1061 provides that the three-year holding period requirement **does not apply** to carried interests held by a corporation. While passive foreign investment companies (PFICs) are considered "corporations" for purposes of Section 1061, the Regulations, consistent with the Proposed Regulations, provide that PFICs with respect to which the U.S. shareholder made a Qualified Electing Fund election under section 1295 of the Code (QEF election) are **not** considered "corporations" for purposes of Section 1061. Accordingly, gain allocated to a "carried interest" held by a PFIC with respect to which the U.S. shareholder made a QEF election is subject to the three-year holding period requirement.

4. **Tiered Structures**. Under the Regulations (consistent with the Proposed Regulations), generally, if an interest in a partnership is issued (or transferred) to a passthrough entity (such as another partnership or an S corporation) in connection with the performance of its own services, the services of its owners, or the services of persons related to either the passthrough entity or its owners, the interest is an "applicable partnership interest" as to the passthrough entity that received the interest, even if such entity is not by itself subject to U.S. federal income tax.

   Each such passthrough entity in a tiered structure, as well as the ultimate taxpayer, is treated as holding an "applicable partnership interest" for purposes of Section 1061 and the tainted Section 1061 capital gain retains its character as such as it is allocated through tiered passthrough entities.

   A carried interest in one entity (e.g., a fund) issued to a person employed by and performing services for another entity not conducting an "applicable trade of business" (e.g., a portfolio company) is not treated as an "applicable partnership interest."

5. **Once an "applicable partnership interest," Always an "applicable partnership interest."** The Regulations, consistent with the Proposed Regulations, provide that once a partnership interest is an "applicable partnership interest," it remains an "applicable partnership interest" and never loses that character (e.g., even if the holder no longer provides services to the partnership or the partnership is no longer engaged in an "applicable trade or business"), unless one of the exceptions to the definition of an "applicable partnership interest" applies (e.g., after the "applicable partnership interest" is transferred to a corporation as defined for Section 1061 purposes).

The Regulations retain the exception to this rule that was proposed in the Proposed Regulations for an "applicable partnership interest" acquired for fair market value by a bona fide unrelated purchaser who does not provide (and has never provided) services to the partnership that issued the "applicable partnership interest" provided that certain other conditions are met. In determining whether a particular profits interest is an "applicable partnership interest," activities of the holder and related persons are aggregated across all entities.

6. **Relevant Holding Period for Gain Allocable to a Carried Interest**. While Section 1061 applies to characterize "carried interest" gain with a holding period of three years or less as short-term capital gain at the taxpayer's level, the Regulations, consistent with the Proposed Regulations, provide that Section 1061's three-year holding period is measured with respect to the specific property that is sold and the holding period of the person (including a partnership) that sold the property.

   For example, if a partnership sells property and allocates the gain to the "carried interest" holder, the partnership's holding period in the disposed property is the relevant measure. Therefore, if the partnership has held the property for more than three years, the gain will be long-term capital gain to the "carried interest" holder, regardless of how long the "carried interest" holder has held the "carried interest."

7. **Relevant Holding Period for Sale of a Carried Interest**. Section 1061's three-year holding period rule also applies to gain derived by a partner from the sale of the partner's "carried interest" in a partnership. If a partner sells its "carried interest" in a partnership, the gain will generally be long-term capital gain only if the partner has held the "carried interest" for more than three years, regardless of how long the partnership has held its assets.

   Nevertheless, under a limited look-through rule set forth in the Regulations, even if the partner has held the "carried interest" for more than three years before selling it, all or a portion (based on specified rules) of the partner's gain from the sale of its carried interest will still be treated as short-term capital gain under Section 1061 if either:

   (i) the holding period of the "carried interest" would be three years or less if such holding period were determined by excluding any period before the date that any unrelated non-service partner was legally obligated to contribute "substantial" money or property (i.e., 5% or more of the total capital, determined as the time of the transfer), directly or indirectly to the partnership; or

   (ii) the transaction or series of transactions has taken place with a "principal purpose" of avoiding Section 1061.

   - The Regulations in effect limit the circumstances in which such look-through rule applies compared with the Proposed Regulations, which proposed to apply such look-through rule if 80% or more of the fair market value of the partnership's assets have been held by the partnership itself for three years or less.
   - The look-through rule in the Regulations does **not** exclude assets that, if sold, would not generate gains subject to recharacterization under Section 1061 (e.g., the rule can apply even if the underlying assets are limited to those that generate Section 1231 gains).

8. **Nonrecognition Transfers of Carried Interests**. Section 1061(d) requires the recognition of short-term capital gain on a direct or indirect transfer of a "carried interest" to a related person that would not otherwise be a taxable event if the partnership owns assets with built-in gain that it held for less than three years. Addressing comments received on the Proposed Regulations in this respect, the

IRS reversed course in the Regulations, which provide that the Section 1061(d) will only apply to recharacterize as short-term capital gains, gains, if any, recognized in a transaction (including a non-taxable transaction where gain has to be recognized). The Regulations clarify that Section 1061 will not operate as a recognition provision in transactions with related parties that do not otherwise require recognition of gain, such as, for example, gifts of a "carried interest."

- The Proposed Regulations, on the other hand, provided for the acceleration of gain in connection with a transfer of a "carried interest" to certain persons related to the taxpayer under circumstances that otherwise would not have been taxable (including, but not limited to, in the case of otherwise non-taxable contributions, distributions, sales and exchanges, and gifts of a "carried interest" to a related person), arguably expanding the reach of Section 1061(d) beyond the scope of Congressional intent.

9. **Exclusion of Gain Allocable to Capital Interests**. When a "carried interest" holder also holds a capital interest in the partnership, the Section 1061 three-year holding period requirement does not apply to capital gain that is allocated to the capital interest, i.e., the right to share in partnership capital commensurate with the amount of capital contributed (determined at the time of receipt of such partnership interest). Addressing comments received on the Proposed Regulations in this respect, the Regulations provide a somewhat broader and more flexible approach than proposed in the Proposed Regulations for determining when (and what) gain can be treated as allocable to a capital interest (as opposed to the "carried interest"), potentially making it easier than under the Proposed Regulations to qualify for this exception. In summary, under the Regulations:

   (i) Allocations of gain made with respect to a capital interest of a partner who also holds a "carried interest" in the partnership will qualify as being excluded from the application of Section 1061 if such allocations are determined and calculated in a "similar manner" as allocations in respect of contributed capital by unrelated non-service partners who have made capital contributions to the partnership representing at least 5% of the aggregate capital contributed to the partnership at the time the allocations are made.

   - To satisfy this test, the allocations and distribution rights with respect to the capital contributed by the "carried interest" holder are reasonably consistent with allocation and distribution rights with respect to the capital contributed by such unrelated non-service partners (for example, in respect of amount and timing of capital contributed, the rate of return on capital contributed, the terms, priority and certain other not exclusive factors specified in the Regulations).
     - This is a deviation from the Proposed Regulations, which proposed to test and determine eligible allocations to a capital interest held by a "carried interest" holder based on Section 704(b) principles and capital accounts.
   - To satisfy this test, allocations and distribution rights with respect to the capital contributed by the "carried interest" holder must be clearly identified in the partnership agreement and the partnership's books and records as separate from the allocations and distribution rights with respect to the "carried interest" itself.
   - Where allocation and distribution rights to a "carried interest" holder are limited to a particular class of capital interests or a particular investment, this determination has to be made on a class-by-class or investment-by-investment basis, as applicable.
   - The Regulations clarify that this capital interest exception may apply even if (i) the allocations and distributions in respect of the capital contributed by the "carried interest" holder are not

reduced by (i.e., the "carried interest" holder does not bear the economic cost of) management fees, "carried interest" payments, or other fees payable by the partnership for services performed to the partnership, (ii) the "carried interest" holder's right to receive allocations and distributions is subordinated to rights of other unrelated non-service partners, and/or (iii) the "carried interest" holder has a special right to receive tax distributions, provided such tax distributions are treated as advances against future distributions.

- The Regulations clarify that an amount of gain recognized by the partnership and allocated to a "carried interest" that is reinvested in the partnership (either by way of an actual distribution and recontribution of the gain amount or the retention of the gain amount by the partnership) may be treated as a capital interest of the "carried interest" holder for purposes of applying the capital interest exception (subject to its requirements) to gain allocation with respect to such reinvested amount.
  - The Regulations clarify that this applies only to a reinvestment of recognized gain and not to unrealized gain that may be allocated to the "carried interest" holder and treated as reinvested by the "carried interest" holder in the partnership for purposes of determining allocations and distributions under the partnership agreement.
- The Regulations provide that the capital interest exception may not be applied to an allocation of gain to a "carried interest" holder in respect of an amount contributed by such partner to the partnership that, directly or indirectly, results from, or is attributable to, any loan or other advance made or guaranteed, directly or indirectly, by the partnership, a partner in the partnership, or any person related to the partnership or a partner in the partnership, except to the extent that the "carried interest" holder is personally liable for repayment of such loan or advance in a manner described in the Regulations.
  - Where such loans or advances by the partnership or a partner in the partnership (or a related person) to the "carried interest" holder are not personally guaranteed by the "carried interest" holder, the Regulations clarify that full or partial repayments of such loans by the "carried interest" holder may free up amounts contributed to the partnership by the "carried interest" holder to qualify for the capital interest exception (subject to its requirements).
- The Regulations also provide rules for determining whether and how to apply the capital interest exception with respect to gain from a sale of a partnership interest by a "carried interest" holder.

10. **Carried Interest Waiver**. Some funds utilize a carried interest waiver provision whereby the carried interest holder waives its right to receive capital gain from assets that have been held for less than three years in return for future allocations of capital gain from assets that have been held for more than three years. The Proposed Regulations did not directly address carried interest waivers, but the Preamble to the Proposed Regulations provided that such waivers may not be respected and may be challenged under the principles set forth in the Treasury regulations governing management fee waiver, and/or the substance over form or economic substance doctrines. The Regulations (including the Preamble to the Regulations) do not further address carry waivers, so the Preamble to the Proposed Regulations remains (for now) the only authority on this subject.

    - The Treasury regulations governing management fee waivers do not disallow management fee waivers but list a number of factors the IRS will consider in determining whether a management fee waiver will be respected. These factors include, among others, that the

manager is subject to entrepreneurial risk, that the waiver occurs before the management fee is earned, and that the waiver is irrevocable. The IRS has indicated (in the Preamble to the Proposed Regulations) that it will look to similar factors when determining whether a carried interest waiver will be respected. In other words, carried interest waivers may be respected if properly structured.

11. **In-Kind Distributions with Respect to a Partner's Carried Interest**. If a partnership distributes property (e.g., stock of a portfolio company) with respect to a partner's "carried interest," any gain from a subsequent sale of such property by the partner (or the partnership or other pass-through entity that received the property) will be treated as long-term capital gain only if the holding period in the property is longer than three years.

    For purposes of this determination, the partner or the partnership (or other pass-through entity that received the property) may add the holding period in the property of the distributing partnership to its own holding period. For example, if a partnership holds a capital asset for two years and nine months and distributes the asset to a "carried interest" holder, and the "carried interest" holder holds the asset for six months prior to disposition, the partner's holding period in the asset will be over three years, and the gain will be long-term capital gain to the "carried interest" holder.

    – In effect, by receiving an in-kind distribution of property in respect of a "carried interest" allocation from a partnership, the "carried interest" holder may avoid being subject to Section 1061 with respect to such allocation at the time of such in-kind distribution. Instead, the determination of whether Section 1061 applies would be postponed to the time at which such property is ultimately sold (at which point, the three-year holding period requirement may have already been satisfied).

12. **Capital Gain Dividends from REITs and RICs**. If a partnership receives a capital gain dividend from a real estate investment trust (REIT) or regulated investment companies (RIC), the "carried interest" holder's share of such capital gain dividend will only be long-term capital gain to the extent the REIT or RIC held the underlying property for more than three years.

    For example, if a partner has held a "carried interest" in a partnership for more than three years, the partnership has held an interest in a REIT for more than three years, and the REIT makes a capital gain dividend to the partnership that is allocated to the "carried interest" holder, the capital gain dividend will only be long-term capital gain to the "carried interest" holder if the REIT informs the partnership that it held the underlying capital asset that gave rise to the capital gain dividend for longer than three years.

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