August 4, 2020

IRS Issues Proposed Regulations Providing Guidance on Taxation of Carried Interest from Investment Partnerships under Section 1061

On Friday, July 31, 2020, the Internal Revenue Service ("IRS") and the Department of the Treasury released proposed regulations (the "Proposed Regulations") on the scope and applicability of Section 1061 of the U.S. Internal Revenue Code of 1986, as amended (the "Code"),[1] as well as providing several transitional rules.

Key Takeaways

- The Proposed Regulations confirm that tax-favored items, including qualified dividend income and Section 1231 gains, are not subject to Section 1061.
- The IRS warned taxpayers that carry waivers may be challenged on audit.
- The IRS confirmed its view that Section 1061 applied to partnership interests held by S Corporations.
- The Proposed Regulations provide a definition of capital interests not subject to Section 1061, but the requirements may be difficult for fund sponsors to meet.
- Once an interest in a partnership is subject to Section 1061, it remains subject to Section 1061 unless specific exceptions apply, including an arm's-length taxable transfer to an unrelated transferee.

Section 1061 – Background

In 2017, as part of the Tax Cuts and Jobs Act ("TCJA"), Congress enacted Section 1061, which increases the holding period required to receive long-term capital gain treatment from one year to three years for the gain allocated to partnership interests (referred to as "Applicable Partnership Interests" or "API") held in connection with the performance of certain services, including services that fund managers provide.

Section 1061(c)(1) defines an API as any interest in a partnership transferred to or held by a taxpayer, directly or indirectly, in connection with the taxpayer (or any related person) performing substantial services in an "applicable trade or business" ("ATB") for the partnership. Section 1061(c)(2), in turn, defines

[1] All Section references are to the Code.

ATB as any activity conducted on a regular, continuous, and substantial basis, through one or more entities that consists of, in whole or in part, (1) raising or returning capital and (2) investing in or disposing of "specified assets," identifying such assets for investment or disposition, or developing such assets. And Section 1061(c)(3) defines "specified asset" as securities, commodities, real estate held for rental or investment, cash or cash equivalents, options or derivatives contracts with respect to any of the foregoing, and an interest in a partnership to the extent of such partnership's proportionate interest in any of the foregoing.

Section 1061(c)(4) carves out two exceptions from the definition of API for (1) partnership interests directly or indirectly held by a corporation (the "Corporate Exception") and (2) capital interests in partnerships that give the taxpayer a right to share in partnership capital based on (i) the amount of capital contributed or (ii) the value of such interest subject to Section 83 when the interest is received or vests (the "Capital Interest Exception").

Finally, Section 1061(d) provides a special rule for taxpayers who transfer an API directly or indirectly to certain members of their family or to a person who in the current year or the prior three years performed a service in any ATB in which or for which the taxpayer performed a service. Such a taxpayer must include as short-term capital gain the excess of (1) deemed Section 1061(d) net long-term capital gain with respect to their API attributable to the sale or exchange of any asset held for not more than three years over (2) the amount treated as short-term capital gain under the standard Section 1061(a) rules.

The Proposed Regulations

The Proposed Regulations generally clarify and elaborate on the applicability and operation of Section 1061. Particularly notable aspects of the Proposed Regulations are:

1. *Proposed Regulations Confirm That Section 1061 Applies Only to Section 1222 Capital Gains*. Section 1061(a) refers to a taxpayer's "net long-term capital gain" and calculates the amount subject to tax by changing the holding periods in Section 1222. The Proposed Regulations provide that Section 1061 applies only to capital gains that would be treated as long-term capital gains pursuant to Sections 1222(3) & (4).[2] Thus, other forms of tax-favored income, including qualified dividend income, gain on property used in trade or business under Section 1231 and mark-to-market capital gains under Section 1256, are not included in any Section 1061 reporting or calculations. The exclusion of Section 1231 capital gains, in particular, will likely be welcome clarification for fund sponsors, given that many intangible gains come within Section 1231.

2. *Lack of Guidance, and a Warning, on Carried Interest Waivers*. Following the enactment of the TCJA, fund sponsors have considered using "carry waivers," which are intended to permit sponsors to waive

[2] The one exception to this is Section 1061(d), discussed below.

carry distributions (and avoid related income allocations) when Section 1061 would apply in favor of subsequent distributions and allocations not subject to Section 1061. The Proposed Regulations themselves do not include guidance on whether or not such arrangements would be respected under Section 1061, but the preamble warns that attempts to "circumvent" Section 1061 through such waivers may be challenged on audit on a number of grounds, including substantiality and under the substance over form or economic substance doctrines. While not foreclosing carry waivers, this warning puts fund sponsors on notice that the IRS may well argue that a carry waiver should be ignored, resulting in fund sponsors being deemed to have been allocated income subject to Section 1061(a).

3. *S Corporations and PFICs with QEF Elections Excluded from Corporate Exception*. Taxpayers considered whether the Corporate Exception could be used to avoid Section 1061 by having a corporation not subject to U.S. federal income tax hold an API. In Notice 2018-18, the IRS announced that the Section 1061 regulations would provide that partnership interests held by S Corporations would not come within the Corporate Exception. The Proposed Regulations reiterate that S Corporations are not "corporations" within the meaning of Section 1061(c)(4)(A). In addition, the Proposed Regulations specify that Passive Foreign Investment Corporations with respect to which a shareholder has made a QEF election are not "corporations" for the purposes of the Corporate Exception. In doing so, the Proposed Regulations rely on the grant of authority in Section 1061(f) to promulgate regulations to carry out the purposes of Section 1061 and prevent abusive avoidance of its imposition of tax, though not everyone agrees that such authority extends to these exclusions.[3]

4. *Capital Interest Exception*. The Proposed Regulations include detailed requirements that must be met for an interest to be treated as a capital interest rather than an API. These include that (1) allocations must be made in the same manner to all partners, subject to carve outs for preferred returns and cost differences (such as management fee breaks), and on the basis of relative capital account balances and (2) there must be unrelated[4] non-service partners with a "significant aggregate capital account balance," defined to be 5% or more of the aggregate capital account balance of the partnership. Because many funds calculate returns to capital on a deal-by-deal basis (to account, for example, for defaults and exclusions of limited partners), and fund sponsors often do not pay carried interest on their sponsor capital commitment (so their rate of return on such capital interest itself is not the same as the rate of return for limited partners who do pay carried interest), it may be difficult for sponsors to avoid having the allocations they receive as a result of sponsor capital commitments be subject to Section 1061(a).

---

3 *See, e.g.*, Monte A. Jackel, *S Corporations and Carried Interests*, 165 Tax Notes Federal 987 (Nov. 11, 2019); Bruce Lemons and Richard Blau, *Are S Corporations 'Corporations' Under the Carried Interest Rules?*, 164 Tax Notes Federal 1567 (Sept. 2, 2019).

4 The Proposed Regulations specify that relatedness for the purposes of 1061 (other than 1061(d) which has its own statutory definition discussed above) is determined by applying Sections 707(b) and 267(b).

In addition, following the enactment of the TCJA, some fund sponsors have taken the position that a recapitalization of a partnership interest (such as the conversion of an interest held by a general partner into an interest held by a limited partner) would permit what had been an API gain to be eligible for the Capital Interest Exception. The Proposed Regulations firmly reject that position, indicating that such transactions, while they may come within Section 721, do not transform API gains into capital gains not subject to Section 1061(a) under the Capital Interest Exception.

5. *Once an API, Always an API*. The Proposed Regulations emphasize that once a partnership interest qualifies as an API, it remains an API, regardless of transfers (including gifts) or dispositions, unless and until one of the exceptions to API treatment applies. API treatment persists even after the service-provider taxpayer retires or ceases to provide services, the partnership no longer meets the ATB test or the API is contributed to another passthrough entity or trust or is held by an estate. Notably, in addition to the statutory exceptions discussed above, the Proposed Regulations include a new exception for bona fide third-party purchasers. Specifically, if a taxpayer (1) acquires what was an API in a taxable transaction for fair market value, (2) has not, does not, and does not anticipate providing services to the partnership or its subsidiaries and is not related to anyone who provides such services and (3) Section 1061(d) does not apply, then the interest will not be an API in the hands of the buyer. Based on this exception, investors in fund sponsors can acquire a portion of the sponsor's API without having the income received from the investment subject to Section 1061(a).

6. *Tiered Partnerships*. Section 1061 does not specify whether "taxpayer" means the partner or the partnership, creating ambiguity about how to apply Section 1061 to partners who hold interests in upper-tier partnerships that themselves hold APIs in lower-tier partnerships. The Proposed Regulations clarify that all persons are "taxpayers" for the purposes of determining whether an interest is an API, but only persons whose investments are subject to Section 1061(a) (that is, not passthrough entities, such as partnerships or S Corporations) are "taxpayers" for the purposes of the Section 1061(a) calculation ("Owner Taxpayers"). Furthermore, the Proposed Regulations state that gains or losses with regard to an API retain that status as they are allocated from tier to tier, and ultimately to Owner Taxpayers. The IRS explicitly intends that only Owner Taxpayers, and not passthrough entities, aggregate API gains or losses from all their APIs, allowing Owner Taxpayers to offset gain from one API with loss from another API, even if the first API is owned directly and the second is owned through a passthrough entity.

7. *Holding Periods, the Lookthrough Rule and Distributions of Property to API Holders*. Applying Section 1061(a) requires calculating the holding period "with respect to" APIs. The regulations clarify that, subject to the "Lookthrough Rule" described below, the relevant holding period is the direct owner's holding period in the asset sold. Thus, as is typical in the funds context, if the partnership in which the taxpayer holds the API sells an asset, the partnership's holding period in that asset will determine how the taxpayer categorizes the income the taxpayer is allocated from the sale of the asset

for the purposes of applying Section 1061(a). The taxpayer's holding period in its API is relevant only if the API is the asset being sold.

Pursuant to the "Lookthrough Rule," however, if a taxpayer has held an API for more than three years and disposes of it in a taxable transaction in which the taxpayer recognizes capital gain (and to which Section 1061(d) does not apply), there are two situations in which some or all of such capital gain is subject to Section 1061(a). First, if the taxpayer holds the API through intermediate entities, and any of those entities have a holding period in the API of three years or less, all of the capital gain is subject to Section 1061(a). Second, if 80% or more of the aggregate fair market value of all the assets (ignoring cash and cash-equivalents) of the partnership that granted the API both (1) would produce capital gain or loss based on the application of Sections 1222(3) & (4)[5] if sold *and* (2) have a holding period to the partnership of three years or less, then a portion of the taxpayer's capital gain is subject to Section 1061(a). This will generally result in the taxpayer treating some of the capital gain as short-term capital gain rather than long-term capital gain, even though its holding period in its API exceeded three years.

Finally, under the Proposed Regulations it is not possible to avoid Section 1061 by distributing property. Instead, the property distributed by a partnership with respect to an API retains its character as "Distributed API Property" and thus any gain recognized on the disposition of such property is included in the Section 1061(a) calculation. The holding period for the recipient of the property for Section 1061 purposes includes the holding period of the initial API-granting partnership.

8. *Section 1061(d)*. Section 1061(d) as written is somewhat confusing.[6] However, the Proposed Regulations generally track the statute and treat the transfer (including by gift) of an API or any Distributed API Property to a related person (generally, family members or colleagues)[7] as a realization event. Such transferor taxpayers must recognize short-term capital gain on the excess, if any, of (1) all of the net long-term capital gain from assets in which the partnership that granted the API had a holding period of three years or less which the transferor taxpayer would have been allocated had the partnership sold all of its assets over (2) the amount treated as short-term capital gain under Section 1061(a). If the transferee's basis is determined in whole or in part by reference to the transferor's basis, immediately prior to the transfer the basis of the transferred interest is increased by the amount of any short-term capital gain required to be recognized due to Section 1061(d). The interest retains its

5 Accordingly, any assets which produce other forms of tax-favored income, discussed in Paragraph 1 above, including Section 1231 capital gains, would be included in the denominator but not in the numerator for the purposes of this calculation.

6 In fact, the American Bar Association submitted a report to the IRS in advance of the Proposed Regulations urging the IRS to suspend the applicability of Section 1061(d) until Congress amends the provision to clarify its application and purpose. *See* ABA, Comments on the Treatment of Applicable Partnership Interests Under Section 1061 at 30–31 (March 22, 2019).

7 As discussed above, the definition of "related person" for Section 1061(d) is specified in Section 1061(d)(1) and differs from the definition the Proposed Regulations make applicable to the rest of Section 1061.

character as an API in the hands of the transferee. Where it applies, Section 1061(d) is broader than the Lookthrough Rule (because it applies to any transfer and applies regardless of the makeup of the partnership's assets).

9. *Definitions of API and ATB*. For a taxpayer's interest to be an API, the taxpayer must provide "substantial" services in an ATB "on a regular, continuous, and substantial basis." Sections 1061(c)(1) & (2). The Proposed Regulations create a presumption that whenever an individual provides services in an ATB and receives a partnership interest that such services are "substantial" and clarifies that the activity necessary to create an ATB must reach the level required to establish a trade or business under Section 162. Further, the Proposed Regulations provide that the various activities that constitute an ATB may occur in different years and still satisfy the ATB requirements.

10. *Transition Rules*. The Proposed Regulations provide that partnerships that were in existence on January 1, 2018 may irrevocably elect to exclude all long-term capital gains and losses from the disposition of all assets held by the partnership for more than three years as of January 1, 2018 from the scope of Section 1061. The amount excluded, however, is capped for each partner at what they would have been allocated with respect to their partnership interest under the partnership agreement in effect on March 15, 2018, with respect to the calendar year ending December 31, 2017.

Effective Date. With limited exceptions,[8] the Proposed Regulations are proposed to be effective when finalized, but may be relied upon as of the date of publication in the Federal Register, pending the issuance of final regulations, provided taxpayers follow them in their entirety and in a consistent manner.

* * *

[8] The rule excluding S Corporations from the Corporate Exception is applicable for tax years beginning after December 31, 2017, Prop. Reg. § 1.1061-3(f)(2); the rule excluding PFICs with QEF elections from the Corporate Exception is applicable to tax years beginning after date of publication of proposed regulations in Federal Register, Prop. Reg. § 1.1061-3(f)(3); and the partnership transition rules may be relied on for tax years beginning in 2020, Preamble p. 50.

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

Brian S. Grieve
+1-212-373-3768
bgrieve@paulweiss.com

Robert Holo
+1-212-373-3637
rholo@paulweiss.com

David W. Mayo
+1-212-373-3324
dmayo@paulweiss.com

Brad R. Okun
+1-212-373-3727
bokun@paulweiss.com

Lindsay B. Parks
+1-212-373-3792
lparks@paulweiss.com

Jeffrey B. Samuels
+1-212-373-3112
jsamuels@paulweiss.com

Scott M. Sontag
+1-212-373-3015
ssontag@paulweiss.com

Associate Noah H. Marks contributed to this Client Memorandum.