IRS ISSUES SECTION 1061 PROPOSED REGULATIONS

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Corporate Tax Alert

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Prior to 2017 Tax Cuts and Jobs Act (TCJA), private equity fund, hedge fund, and other investment fund or asset managers that received an interest in an entity taxed as a partnership for U.S. federal income tax purposes (a so-called "carried interest") in exchange for providing investment advisory services to such vehicle were generally taxed at preferential long-term capital gains rates on their allocable share of income attributable to such carried interest so long as the underlying investment vehicle held the assets giving rise to such income for more than a year. In addition, the recipient of a carried interest is generally not subject to U.S. federal income tax in connection with the receipt thereof. The TCJA aimed to curtail such preferential tax treatment afforded to carried interest holders through the enactment of Code Section 1061. Section 1061 increases the holding period necessary to achieve long-term capital gain treatment from one year to three years for gains allocated or otherwise recognized with respect to certain carried interests. On 31 July 2020, the Treasury Department and the IRS released eagerly anticipated proposed regulations clarifying several aspects of Code Section 1061 (the Proposed Regulations). The Proposed Regulations answer many questions regarding the scope and applicability of Section 1061, and taxpayers (especially fund sponsors receiving carried interest distributions) should understand how the Proposed Regulations impact the tax treatment of those carried interests.

BACKGROUND OF CODE SECTION 1061

Code Section 1061 recharacterizes certain long-term capital gain with respect to applicable partnership interests (APIs) as short-term capital gain if the capital gain arises from the sale or exchange of property held for less than three years.[1] An API is an interest in a partnership that is transferred to or held by a taxpayer in connection with the performance of substantial services by the taxpayer in an applicable trade or business (ATB).[2]

An ATB is defined as an activity conducted on a regular, continuous, and substantial basis that consists, 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 investing or disposition) or (ii) developing specified assets (collectively, "specified actions").[3] "Specified assets" include securities, real estate held for rental or investment, cash or cash equivalents, an interest in a partnership or a beneficial ownership interest in a trust if it is a security, an interest in a partnership to the extent that the partnership itself holds specified assets, and options or derivative contracts with respect to any of the foregoing.[4]

HIGHLIGHTS OF THE PROPOSED REGULATIONS AND PLANNING OPPORTUNITIES

API Exceptions. The Proposed Regulations clarify that once a partnership interest is an API, it generally remains an API and never loses that character.[5] However, the Proposed Regulations introduce a new exception for bona fide purchases of APIs by an unrelated party who is not a service provider (a "bona fide purchaser") and clarify the application of the statutory "capital interest" and "corporate" exceptions from the API rules.[6]

The Proposed Regulations provide that an interest in a partnership that would otherwise be treated as an API but is purchased by a bona fide purchaser for fair market value is not an API with respect to the buyer. In order to qualify as a bona fide purchaser, the buyer must (1) have never provided services in the relevant ATB, (2) not contemplate providing services to the relevant ATB in the future, and (3) not be related to a person who has ever provided services to the ATB.

The exception in Section 1061(c)(4)(A), providing that an API does not include any interest in a partnership directly or indirectly held by a corporation, led some tax advisers to suggest that a service provider holding an API through an S corporation could avoid the application of Section 1061. However, in Notice 2018-18 (the 2018 Notice), the Treasury Department and IRS stated that "corporation" for this purpose does not include an S corporation.[7] Consistent with the 2018 Notice, the Proposed Regulations provide that partnership interests held by S corporations are treated as APIs if the interest otherwise meets the API definition. Similarly, a PFIC that has a qualified electing fund election in place is not treated as a corporation for the purposes of Section 1061.[8]

The Proposed Regulations provide extensive rules on Section 1061(c)(4)(B), which exempts a "capital interest" from being classified as an API. The Proposed Regulations exempt from recharacterization any long-term capital gains and losses that represent a return on an API holder's invested capital. In order for an allocation of gain to qualify for this exemption, the allocation must be based on the API holder's relative capital account balance in the partnership, meaning that it will potentially not apply in situations where partners participate differently in different assets. In addition, the capital interest exception does not apply where the interest is purchased using a loan made or guaranteed by any other partner or the partnership (or any related person).

The Activity Test. The Proposed Regulations adopt a presumption that services are "substantial" with respect to a partnership interest transferred in connection with services.[9] Under the Proposed Regulations, an activity is conducted on a regular, continuous, and substantial basis if it meets the "ATB Activity Test" with respect to specified actions, which is satisfied if the total level of activity would establish a trade or business under Section 162.[10] Under the Proposed Regulations, it is not necessary for a service provider subject to the provision to both raise and return capital and invest in and develop specified assets in a single year for an ATB to exist. Further, related persons performing these actions are aggregated together to determine if the ATB Activity Test is met. For these purposes, "related persons" generally include certain family members and more-than-50-percent-owned entities.[11]

Three-Year Holding Period Requirement. The Proposed Regulations provide that the holding period of a partnership in an asset on which gain is realized, not the holding period of the service provider in an API in the partnership, controls for purposes of determining whether gain from the sale of the asset is subject to the rules of Section 1061. Accordingly, if the partnership held the asset for less than three years, gain or loss with respect to the disposition is characterized as short-term capital gain to the holder of an API, notwithstanding that the API may have been held for more than three years.[12] On the other hand, if the partnership has held the asset for

more than three years, a sale of the asset will result in long-term capital gain treatment to a partner holding an API, even if the partner has held its API for less than three years.

The Proposed Regulations also provide that partners wishing to dispose of their API(s) must hold that interest for more than three years to receive long-term capital gain treatment. In other words, if a taxpayer sells its API before three years have passed, the gain will be short-term capital gain. Even if a taxpayer sells its interest in an API after holding it for three years, a look-through rule may apply to recharacterize some of that long-term capital gain as short-term capital gain. The look-through rule applies if 80 percent or more of the value of the assets held by the partnership are assets held for three years or less that would produce capital gain or loss subject to Section 1061 if the partnership disposed of them.[13]

Treatment of Specific Types of Income Received with Respect to an API. The Proposed Regulations provide that long-term capital gains determined under Section 1231, Section 1256, Section 1(h)(11), and allocated to the holder of an API, are excluded from the Section 1061 regime regardless of the service provider's holding period in the API. However, long-term capital gains from installment sales are subject to the rule regardless of whether the installment sale occurred before the effective date of Section 1061.[14] For capital gain dividends from Regulated Investment Companies (RICs) and Real Estate Investment Trusts (REITs), the underlying asset held by the RIC or REIT must have been held for more than three years.[15] Managers of funds that invest in RICs or REITs may want to determine whether they can obtain holding period information from these entities to ensure they are accurately reporting gain. On the other hand, if the REIT or RIC made investments indirectly through an entity taxed as a partnership, the manager may prefer to receive an API in such entity so that the manager may receive an allocation of income that is excluded from the Section 1061 regime (e.g., Section 1231 gains).

Importantly, gains from property described in Section 1231 that is depreciable property held in a trade or business are not subject to the recharacterization rule of Section 1061. Thus, under the Proposed Regulations, managers of funds investing in or developing depreciable property used in a trade or business would not be subject to Section 1061. In addition, long-term capital gains determined under Section 1256 (the straddle rules) and qualified dividends are not subject to recharacterization under Section 1061.

OPEN ISSUES

Since the enactment of Code Section 1061, funds have increasingly been adopting carried interest waivers that allow managers to waive capital gain from investments held for less than three years in exchange for an equivalent amount of future long-term capital gain on investments held for more than three years. Although the Proposed Regulations do not address carried interest waivers specifically, the preamble warns that these arrangements may not be respected in light of the substance over form and economic substance doctrines. The IRS is concerned with situations where a fund manager waives gain subject to Section 1061 but elects to receive gains from assets held for more than three years even though the gain has already accrued. Notwithstanding the language in the preamble, such arrangements, if properly structured, may still be beneficial to managers.

Please contact the authors of this client alert for further insight with respect to the Proposed Regulations or to discuss potential planning opportunities with respect to Section 1061 matters.

FOOTNOTES

[1]26 U.S.C § 1061(a).

[2]26 U.S.C. § 1061(c)(1); Prop. Reg. § 1.1061-1(a) (2020).

[3]See Prop. Reg. § 1.1061-1(a)(5) (2020); Prop. Reg. § 1.1061-2(b)(1)(ii) (2020).

[4]Prop. Reg. § 1.1061-1(a) (2020).

[5]Prop. Reg. § 1.1061-2(a)(1)(i) (2020).

[6]Prop. Reg. § 1.1061-1(5)(a) (2020); Prop. Reg. § 1.1061-3(d) (2020).

[7]IRB Notice 2018-18 (2018-12 IRB 443, March 19, 2018).

[8]Prop. Reg. § 1.1061-3(b)(2)(i)-(ii) (2020).

[9]Prop. Reg. § 1.1061-2(a)(1)(iv) (2020).

[10]Prop. Reg. § 1.1061-2(b)(1) (2020).

[11]Prop. Reg. § 1.1061-2(b)(1)(i)(A)-(B) (2020); see also §§ 704(b) and 267(b).

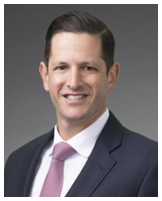
[12]Prop. Reg. § 1.1061-4(b)(8)(i)-(ii) (2020).

[13]Prop. Reg. § 1.1061-4(b)(9)(i)(C) (2020).

[14]Prop. Reg. § 1.1061-4(b)(3) (2020).

[15]Prop. Reg. § 1.1061-4(b)(4) (2020).

KEY CONTACTS



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