CLARITY ON RECHARACTERIZATION OF CARRIED INTEREST

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INTRODUCTION

On January 7, 2021, the I.R.S. issued final regulations ("the Final Regulations")[1] that provide guidance under §1061 of the Internal Revenue Code of 1986, as currently in effect ("the Code"). Code §1061 recharacterizes certain long-term capital gains as short-term gains for holders of partnership interests entitled to carried interests. It was enacted as part of the Tax Cuts and Jobs Act (T.C.J.A.) in 2017.[2]

The guidance particularly impacts fund managers of alternative investments, such as private equity and hedge funds, who receive carried interests in exchange for the substantial services provided to investment funds. Notwithstanding the relatively recent enactment of Code §1061, there is strong debate over whether long-term capital gains treatment should apply to gains derived through carried interests. Critics seek to treat the income as compensation subject to ordinary income tax rather than a return on investment deserving the preferred long-term capital gains rate.

Carried interests are a significant incentive for general partners to manage alternative funds as the return on performance is substantial. In addition to the administrative fee, investment managers are compensated by way of partnership interests in the fund. A carried interest allows general partners of hedge funds and private equity funds to retain a fixed percentage (usually 20% or more) of the fund's profits and to enjoy favorable long-term capital gains tax rates (under Code §1061) instead of the much higher ordinary income tax rate to the extent of the general partner's share of long-term capital gains.[3] This performance compensation is contingent on the fund's success under their management.

RECHARACTERIZATION OF LONG-TERM CAPITAL GAINS

<u>Applicable Partnership Interest</u>

An applicable partnership interest ("an A.P.I.") is 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, in any applicable trade or business. Code §1061(c)(2) provides that an applicable trade or business is any activity conducted on a regular, continuous, and substantial basis which consists, in whole or in part, of raising or returning capital, and either investing in or disposing of specified assets or developing specified assets. The

[1] T.D. 9945.

[2] §13309 of Public Law 115-97, 131 Stat. 2054 (2017).

[3] Andrew Needham, *Hedge Funds*, 736-2nd TAX MGMT. PORT. (BNA).

activity may be conducted in one or more entities. It also applies to businesses involved in identifying specified assets for investment or disposition.

The Final Regulations provide that if an interest in a partnership is transferred to or held by a taxpayer, pass-through entity, or any related person for the performance of services, a presumption exists that such holder or transferee provided substantial services.[4]

The Final Regulations confirm that Code §1061 applies to long-term capital gains as defined in Code §1222. Generally, a taxpayer's capital assets held for at least 12 months and one day are taxed as long-term capital gains. However, Code §1061 increases the required holding period for A.P.I.'s from 12 months and one day to 36 months and one day.

An A.P.I. held by a corporation is not covered by Code §1061. The Final Regulations clarify that the term "corporation" refers only to a C-corporation,[5] which presumably includes an eligible entity treated as a C-corporation under the entity characterization rules.[6] An A.P.I. held by or through an S-Corporation or a P.F.I.C.'s where shareholders have Q.E.F. elections in effect are subject to Code §1061 recharacterization rules because they are passthrough entities.

Thus, a passthrough entity may be a partnership, trust, estate, S-corporation, or P.F.I.C. with respect to which the shareholder has a Q.E.F. election. Many investment managers have converted from partnership entity to C-corporation already. This is partly due to the lower corporate tax rates on income from administrative fees. Others may consider restructuring by weighing any advantages of avoiding recharacterization of long-term gains against the cons of double taxation.

Additionally, gains and losses from capital interest are excluded from Code §1061. Final Regulations set forth rules for bifurcating and calculating capital interest allocations.[7] These include that the allocation of the A.P.I. holder's capital interest must be determined in a similar manner as those held by similarly situated unrelated non-service partners.

Lookthrough Rule

The Final Regulations include a lookthrough rule that will cause the holding period of a partner with a carried interest to be treated as being three years or less.[8]

The lookthrough rule applies in two circumstances. One circumstance is that the partner holding the carried interest enters into a transaction or a series of transactions having as a principal purpose the circumvention of the three- year holding requirement for long-term capital gains under Code §1061(a).[9] Here, all gain not attributable to A.P.I. held for more than three years is subject to recharacterization under Code §1061(a). The second circumstance involves the sale or disposition of an A.P.I. held for more than three years where the partnership owns assets with a

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[4] Treas. Reg. §1.1061-2.

[5] Treas. Reg. §1.1061-3(b)(2).

[6] Treas. Reg. §301.7701-3.

[7] Treas. Reg. §1.1061-3(c)(3).

[8] Treas. Reg. §1.1061-4(b)(9).

[9] Treas. Reg. §1.1061-4(b)(9)(i)(A)(2).

holding period of less than three years and that asset was acquired with a capital contribution from an unrelated non-service provider. The service partner's holding period for the carried interest is deemed to begin not sooner than the date on which the unrelated non-service partner is legally obligated to contribute substantial money or property directly or indirectly to the partnership.[10] Here, the gain from the disposition of the A.P.I. is traced to two pools of assets – the first is the holding period of assets held for more than three years by the partnership. The second is the holding period of assets held for three years or less by the partnership.[11]

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TAX POLICY DEBATE

On February 15, 2021, U.S. legislators introduced the Carried Interest Fairness Act of 2021.[12] The bill seeks to tax carried interest at ordinary income rates.

Critics of the preferential tax rate contend that it provides an unfair advantage to investment managers because carried interests are merely a salary and bonus to a taxpayer for services. This is viewed as no different from a salary and bonus paid to a broker for meeting a firm's periodic performance goals.

They argue that investments warranting long-term gains should have some risk of loss associated. Such risk is born by the non-service partners who fund the capital investments of the fund. The investment manager does not bear the same burden. Embedded in the criticism is hostility towards service providers who share in the gains of a partnership, thereby exploiting a "loophole" not typically available to employees receiving a bonus based on performance.

Although similar legislation was introduced in 2015, the recent change in control of Congress may influence the passing of the 2021 legislation. There has been bipartisan support in favor of changing the tax treatment.[13] President Joe Biden has expressed support for eliminating the preferred tax rate for long-term capital gains completely for taxpayers having income in excess of $1 million.[14]

On the other hand, proponents of the long-term capital gains rate view the approach as consistent with the treatment of profits from partnership interests generally. They equate the investment manager's substantial sweat equity with the investor's capital contribution to the fund. A fund's profits should be treated as a return on investment whether in the hands of a manager as A.P.I. or an investor as capital interest. According to one commentator:

> Some people argue that if you do not put up dollars for your ownership, you must be working for a bonus or a salary, and that carried interest means you are just an investment banker working for a fee.

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10 Treas. Reg. §1.1061-4(b)(9)(i)(A)(1).

11 See Treas Reg. § 1.1061-4(c)(2)(i), Example 1.

12 H.R. 1068 was preceded by H.R. 2889, the "Carried Interest Fairness Act of 2015," but died in the Ways and Means Committee.

13 "Broad Support for Closing the Carried Interest Loophole," Ways and Means Committee Democratic Staff.

14 Cumming, Chris. "A Biden Win Could Mean a Tax Rewrite for Private Equity," *Wall Street Journal* (November 3, 2020).

> However, private equity firms are not transaction bankers; rather, [the firms] own and control entire companies over many years.[15]

CONCLUSION

The Final Regulations clarify several concerns, including

- limiting the Code §1061 exception for corporations as applying solely to C-Corporations,
- guidance on calculating the recharacterization amount,
- imposing a lookthrough rule when the A.P.I. is sold by the service partner rather than a sale of the underlying capital assets by a partnership that ultimately lead to long-term capital gains for the holder of the carried interest, and
- tracing the holding period of gains upon the sale of an A.P.I. to the holding period of the underlying assets at the level of the partnership.

Given the intense debate and legislative momentum around carried interests and preferred tax rates generally, the guidance may need to be revisited sooner than later.

15 Klinsky, Steven. "The Carried Interest Loophole? What Loophole?" *New York Times* (July 15, 2016).

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