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Memorandum

IRS Releases Final Regulations Under Section 1061 on Carried Interest

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On January 7, 2021, the Internal Revenue Service ("IRS") released final Treasury Regulations promulgated under Section 1061 of the Internal Revenue Code (the "Code," and such regulations, the "Final Rules"). The Final Rules address a special three-year holding period requirement for investment managers to treat carried interest proceeds as eligible for preferential capital gains tax rates. Although there remain a number of unanswered questions and ambiguities, the Final Rules adopt the basic structure of the Proposed Treasury Regulations (such regulations, the "Proposed Rules"), but modify the Proposed Rules in various ways that will provide more predictable results for taxpayers in many circumstances. Below is a high-level summary of the background giving rise to the Final Rules, along with their key provisions and implications.

Although the rules are expected to become applicable in 2022 for calendar year taxpayers, it has become customary for incoming presidential administrations to order a regulatory freeze on pending regulations. As further discussed below, to the extent that the Final Rules are not published in the Federal Register prior to January 20, the Final Rules may be delayed, withdrawn or revised by the incoming administration.

Background: The Proposed Rules

- The Tax Cuts and Jobs Act of 2017 introduced Section 1061 to the Code, increasing from one year to three years the holding period requirement for preferential capital gains tax rates to apply to investment managers with respect to carried interest (for tax years beginning after 2017). Specifically, Section 1061 applies to an applicable partnership interest ("API"), which is an interest in a partnership transferred to, or held by, a taxpayer in connection with the performance of services in an investment management (or similar) trade or business.
- On July 31, 2020, the IRS issued the Proposed Rules to clarify the application of Section 1061. The Proposed Rules addressed the application of, and exceptions to, Section 1061, and provided technical guidance describing how income falling within the purview of Section 1061 should be calculated and reported. As noted above, the Final Rules were released on January 7, 2021, and have been submitted to the Office of the Federal Register ("OFR") for publication.

Summary of Principal Changes in the Final Rules as Compared With the Proposed Rules

- *Capital Interest Allocation Exception*
  - Section 1061(c)(4)(B) provides that an API does not include a capital interest in a partnership which provides a right to share in capital commensurate with the capital contributed or the value of such interest subject to tax as compensation income (upon receipt or vesting of such interest) (the "Capital Interest Exception"). The Proposed Rules' implementation of this provision would have required (1) that allocations to capital interests be made based on relative Section 704(b) capital account balances of each partner receiving the allocation on generally the same economic terms (*i.e.*, priority, level of risk, etc.) and (2) that such allocations also be made to unrelated investors having at least 5% of aggregate partnership capital account balances.
  - Acknowledging that the methodology that had been proposed was inconsistent with how most private investment funds allocate income, the Final Rules provide that allocations to a capital interest will satisfy the Capital Interest Exception if they are "determined and calculated in a similar manner" as capital interest allocations to significant unrelated investors (representing at least 5% of partnership capital). The Final Rules would therefore permit distribution-driven allocations typically used by private investment funds to satisfy the Capital Interest Exception, so long as the partnership agreement and books and records of the partnership "clearly demonstrate" that allocations are made in a similar manner to the significant unrelated investors. Moreover, the Final Rules confirm that a capital interest held by an API holder will not fail to be treated as "determined and calculated in a similar manner" solely because the interest does not bear a management fee or carried interest imposed on other partners, or is entitled to a tax distribution that is not available to other partners.
  - The Final Rules simplify the application of these rules through tiered structures by providing that such allocations will be respected through such structures as long as the allocations are made at such tiered entities in a manner consistent with Section 704(b) principles.
- *Investments Made With Loan Proceeds*
  - The Proposed Rules would have provided that, despite otherwise meeting the Capital Interest Exception, a capital investment made by an API holder with the proceeds of a loan is ineligible if the loan was guaranteed or made by any partner, the partnership or certain of their related parties.
  - Although the preamble notes that commentators objected to this provision based on both statutory scope and the potential barrier of entry it imposes on employee co-investment, the Final Rules maintain the view that capital investments made with the proceeds of a loan made or guaranteed by another partner, the partnership or a related person could lead to an abuse of the Capital Interest Exception, other than in the context where the investing party is personally liable for the loan (without a right of reimbursement) and there is no guarantee of the loan. Accordingly, the Final Rules provide that a valid capital interest can be obtained if it is funded by the proceeds of a recourse loan made to an

individual by another partner (or a person related to such partner, other than the partnership itself), provided there is no guarantee of the loan by any person (*i.e.*, it appears such person's spouse could not provide a personal guarantee of the loan). These rules, in particular the requirement that any loan not be subject to a guarantee, continue to impose significant impediments to providing employees with the capital necessary to invest and may create uncertainty regarding the scope of certain credit arrangements that are common in the private fund industry.

- *Third Party Investments*
  - The Proposed Rules included an important but limited exception for "stakes" investors in fund general partners, providing that an interest in a partnership is not treated as an API if it was purchased for fair market value by an unrelated non-service provider. Notably, the Proposed Rules excluded from this treatment investments by unrelated persons that are made in the form of a contribution (so-called "primary" investments) to a partnership rather than by a purchase (so-called "secondary" investments). The Preamble to the Final Rules confirms that this omission is intentional and that the exception does not apply to primary investments.
- *Related Party Transfers*
  - Section 1061(d) provides that if an API is transferred to a related person (family members and certain colleagues), directly or indirectly, the taxpayer will be required to include in gross income (as short-term capital gain) an amount equal to the transferee's long-term capital gain for assets held for three years or less, minus the transferee's short-term capital gain with respect to the transfer of such API.
  - The Proposed Rules interpreted Section 1061(d) as both a gain recharacterization and acceleration provision, with the result that many otherwise non-taxable restructurings or transfers could be frustrated. The Final Rules confirm that Section 1061(d) is solely a recharacterization provision that applies in the context of what is otherwise a transaction in which gain or loss is recognized.
  - These changes to Section 1061(d), pursuant to the Final Rules, provide flexibility for fund sponsors to restructure their internal vehicles without triggering tax in transactions that otherwise would be nonrecognition transactions.
  - The Final Rules adopt the Proposed Rules' expansion of Section 1061(d) to apply not only to transfers to family members and certain colleagues, but also to pass-through entities owned by such persons. It remains unclear whether entities other than pass-through entities can be considered related persons for this purpose.
- *Holding Period Lookthrough Rule*
  - The Proposed Rules included a limited "Lookthrough Rule," under which the sale of an API with a holding period of more than three years would nonetheless be subject to Section 1061 if 80% or more of the capital gain-producing assets of partnership had a holding period of three years or less. This rule

was intended to address concerns regarding the avoidance of Section 1061 by taxpayers utilizing existing partnerships to acquire assets to ensure a holding period in the API of more than three years.

  - The Final Rules significantly pare back the Lookthrough Rule so that it only applies when a greater-than-three year API is disposed of and either (1) the holding period would be three years or less if only periods when unrelated investors are required to contribute capital are taken into account or (2) the relevant transaction(s) occur with a "principal purpose" of avoiding Section 1061. Accordingly, the final Lookthrough Rule generally should apply only to prevent taxpayers from establishing APIs in advance of having outside capital in order to artificially extend their holding period in the relevant partnership.

- *Applicable Trade or Business*
  - The Final Rules generally adopt the standard set forth in the Proposed Rules for determining whether a partnership interest is issued in connection with an applicable trade or business, basing the determination on whether the activity (including activities undertaken by related persons) would lead an entity to be considered engaged in a trade or business under Section 162.
- *Transition Rules*
  - The Proposed Rules contained a series of transition rules that have been removed in the Final Rules.

Applicability Date and Regulatory Freeze

- The Final Rules retain the same applicability dates as the Proposed Rules, generally applying to taxpayer API holders' taxable years beginning on or after the date the Final Rules are published. Thus, if the Final Rules are published in 2021, they will become applicable in 2022 for calendar year taxpayers. Taxpayers may choose to apply the Final Rules to a taxable year beginning after December 31, 2017, so long as they are applied consistently and in their entirety.
- President-elect Biden's incoming administration has announced its intent to issue a memorandum enacting a freeze on regulations issued by the Trump administration not yet published or in effect by January 20, 2021. While details of the memorandum are not yet available, it is expected to follow the approach in regulatory freeze memoranda issued by both the Trump and Obama administrations. Those memoranda provided that final regulations sent to the OFR, but not yet published, were withdrawn to be reviewed by the relevant agency under the new administration. Accordingly, it is expected that the Final Rules will be frozen and subject to further review if they are not published by OFR before January 20, 2021.
- The lack of certainty regarding the effective date and applicability date of the Final Rules may cause confusion for taxpayers and tax practitioners.

Considerations for Fund Clients

- Internal Restructurings, Estate Planning—Because the Proposed Rules do not treat Section 1061(d) as an acceleration rule, sponsors should feel comfortable that internal restructurings and estate planning transfers will not result in an immediate tax if they are not otherwise taxable.
- Loan Programs—Sponsors will need to consider whether the benefits of providing credit support to an employee under a loan program outweigh the potential cost of employees being subject to Section 1061 on their capital investment.
- Capital Interests—Sponsors should consider whether their partnership agreements and books and records contain allocation language sufficient to comply with the Final Rules by clearly demonstrating that allocations to an API holder's capital interest is made in a similar manner to that of unrelated non-service partners.
- Stakes Investments—Stakes investors will need to consider the impact of their primary investments being treated as APIs and ensure they qualify for the third party purchaser exception to API treatment.

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