To Our Clients and Friends

Memorandum

January 11, 2021

Treasury Releases Final Carried Interest Regulations

Background

Section 1061 of the Internal Revenue Code was enacted as part of the 2017 Tax Cuts and Jobs Act to create greater parity between the tax treatment of ordinary income and capital gains attributable to carried interest. The basic statutory framework applies by recharacterizing certain long-term capital gain ("LTCG") as short-term capital gain ("STCG"), unless either an extended holding period is satisfied (three years, as compared to one year) or an exception applies. In August, 2020, the Treasury Department and the IRS issued proposed regulations (the "Proposed Regulations") interpreting Section 1061, which were complex and restrictive in many respects, and were the subject of numerous comments from bar associations, trade groups, and other market participants. For a discussion of the Proposed Regulations, please see our Client Memorandum by clicking here.

On January 7, 2021, the Treasury Department and the IRS released final regulations interpreting Section 1061[1] (the "Final Regulations"),[2] which have been submitted for publication in the *Federal Register*. The Final Regulations significantly simplify some of the more technical aspects of the Proposed Regulations and, in many respects, achieve more flexibility and greater certainty for holders of carried interest. However, the Final Regulations continue to apply certain rigid standards from the Proposed Regulations, which will have an adverse effect on some standard market practices. In the preamble to the Final Regulations (the "Preamble"), the Treasury Department and the IRS note that certain areas remain under study and with respect to which they may provide additional guidance, and they request additional comments on certain points. However, the pending change in administration may affect the timing and/or nature of any such review or additional guidance. More broadly, if Congress enacts legislation that reduces or eliminates the difference between the tax rates on ordinary income and LTCG, which may be more likely given the recent election results, the impact of these rules will be limited.

The Final Regulations continue to impose a three-year holding period requirement for capital gains attributable to applicable partnership interests (referred to as "APIs"), generally tested at the level of the direct owner of the asset or interest giving rise to such gains, unless an exception applies, including an exception with respect to interests funded by a carried interest holder's own capital contributions (referred

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[1] References to "Sections" are to sections of the Internal Revenue Code of 1986, as amended, and references to "Regulations Sections" are to sections of the final, temporary, and proposed U.S. Treasury regulations promulgated under the Internal Revenue Code of 1986, as amended.

[2] Capitalized terms used but not defined herein have the meanings ascribed to them in the Final Regulations.

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to as the "Capital Interest Exception"). The Capital Interest Exception, along with the ability to qualify therefor using capital invested with certain loan proceeds, are significant points of change in the Final Regulations, as are the application of certain "lookthrough" rules on dispositions of APIs and transfers of APIs to related persons.

Below is a summary of these and other notable aspects of the Final Regulations.

Notable Changes in Final Regulations

- *Capital Interest Exception*. The Final Regulations provide that an allocation to an API Holder will qualify as a Capital Interest Allocation that is not subject to recharacterization under Section 1061 if the allocation is made "in a similar manner" with respect to an API Holder and unrelated investors[3] based on their capital contributions to the partnership (or, as described below, the investment or class of partnership interest, as applicable), provided such unrelated investors in the aggregate hold 5% or more of the capital contributions to the partnership (or investment or class of partnership interest, as applicable), and certain other requirements are met. The "in a similar manner" requirement will be met if the allocation and distribution rights associated with an API Holder's contributed capital are reasonably consistent with the rights associated with capital contributed by unrelated investors. The Proposed Regulations had set forth a more rigid rule that would have required allocations to be based on capital account balances to qualify as a Capital Interest Allocation, which was inconsistent with how many private investment funds determine their allocations and required that unrelated investors in the aggregate own 5% or more of total balance of the partnership's capital accounts in order to establish equivalence.

  As noted below under "*Employee Co-Investments*," certain factors (including the fact that API Holders do not bear "cost of services" or benefit from tax distributions) are disregarded in determining whether the rights with respect to an API Holder's capital contribution and that of unrelated investors are reasonably consistent; however, preferential withdrawal terms (which may be relevant for hedge funds) are not specifically addressed. The Final Regulations also provide that whether an allocation to an API holder is made "in a similar manner" may be evaluated on an investment-by-investment or class-by-class basis if the allocation and distribution rights of an API Holder are determined with respect to capital invested in a particular investment or are limited with respect to a particular class of interests. The Final Regulations also simplify the application of the Capital Interest Exception to allocations that flow through multiple tiers of partnerships or other pass-through entities.

  While the focus on contributed capital, as opposed to capital accounts, will be a welcome change for many private investment funds, it may raise questions for certain private equity-style funds that make initial allocations between partners based on their relative capital commitments (although in many instances the two allocation methods will produce equivalent results). Furthermore, because the reference to allocations in the Final Regulations presumably means tax allocations as opposed to "book" allocations, the Capital Interest Exception may not be compatible with so-called "stuffing" allocations that specially allocate gain or loss to a withdrawing partner, which are commonly used by hedge funds and other open-ended private funds.

[3] The Final Regulations use the technical term "Unrelated Non-Service Partners."

If API Gain that is allocated to an API Holder in respect of its API is then reinvested in the same partnership, either because there is no corresponding distribution (*e.g.*, as a result of an annual crystallization of carry in a standard hedge fund structure) or as a result of an actual distribution and contribution, the Final Regulations clarify that future allocations in respect of such reinvested API Gain may be eligible for the Capital Interest Exception if all of the other requirements are met. Note, however, that the reinvestment rule applies only to API Gain that is actually realized for U.S. federal income tax purposes and allocated to the API Holder; a mere "book-up" of unrealized gain in respect of an API will not create an investment that may be eligible for the Capital Interest Exception. API Gain is limited to LTCG, and it is not clear whether the allocation of other types of income (*e.g.*, interest, dividends and STCG) may also be reinvested in a manner that is eligible for the Capital Interest Exception.

The Final Regulations also stipulate that the Capital Interest Exception applies to allocations to an API Holder in respect of its capital contributions only if those allocations are made "separate and apart from" the allocations made with respect to the API Holder's API. Both the partnership agreement and the partnership's books and records must clearly demonstrate that this requirement has been met. Sponsors (and, in particular, hedge fund sponsors) will want to evaluate their existing fund agreements and other record keeping to ensure compliance with this requirement and may consider including tailored language as amendments are made or new funds are formed.

In the Preamble, the Treasury Department and the IRS request additional comments on the application of the Capital Interest Exception.

- *Employee Co-Investments*. Under the Proposed Regulations, it was not clear whether the carry-free component of a typical employee co-investment was covered by the "cost of services" principle in the Capital Interest Exception. The Final Regulations helpfully provide a definition for "cost of services" which includes management fees and "API allocations" (which, based on the context and the thrust of the comments to which this change is responsive, appears to be intended to encompass carried interest allocations generally). Moreover, the Final Regulations also helpfully provide that an interest will not fail to qualify for the Capital Interest Exception because an API Holder has a right to receive tax distributions (which are treated as an advance on future distributions) while unrelated investors do not. Additionally, as discussed further below, the Final Regulations make helpful changes to the rules on related party transfers, which reverse the Proposed Regulations' requirement of gain acceleration on certain forfeitures (*e.g.*, forfeiture of an interest upon a departure prior to vesting, which is a common feature in many employee co-invest (and carry) contexts).

  However, by continuing to impose a 5% threshold requirement for unrelated investors in order to qualify for the Capital Interest Exception, the Final Regulations do not specifically address the application of the Capital Interest Exception to many standard employee co-invest arrangements, including cases in which employee capital is invested alongside, rather than directly or indirectly in, a partnership with unrelated investors, although one of the examples in the Final Regulations suggests that the Capital Interest Exception may apply to certain employee co-invest arrangements. The Preamble notes that the application of the Capital Interest Exception to co-invest vehicles remains under continued study by the Treasury Department and the IRS and requests additional comments on the application of the Capital Interest Exception in the Final Regulations.

- *Loan Proceeds*. Under the Proposed Regulations, returns on amounts invested with proceeds borrowed from, or guaranteed by, the partnership, another partner in the partnership, or any related person did not qualify for the Capital Interest Exception. The Final Regulations allow investments made with borrowed funds to qualify for the Capital Interest Exception so long as the borrowing is fully recourse to the individual borrower, and is not guaranteed, or subject to reimbursement by, any other person. Certain ordinary course arrangements would appear to fall outside the scope of the Capital Interest Exception, including borrowings that are recourse only to the borrower's investment in the partnership and borrowings made pursuant to individually underwritten employee loan programs that are guaranteed by an employer.

- *Third-Party Purchasers*. The Proposed Regulations provided that a third-party purchaser of an API is not subject to Section 1061 if various conditions are met. The Final Regulations confirm that this third-party purchaser exception is very limited in scope. The exception is limited to taxable secondary purchases, but does not apply to any APIs acquired in a primary transaction. The exception also does not override the rules otherwise applicable to indirectly held APIs, which continue to be subject to Section 1061 and its three-year holding period with respect to the third-party purchaser of an upper-tier API. In this regard, the Preamble notes that the Treasury Department and the IRS did not adopt comments to broaden the scope of the third-party exception due to "the complexity of administering" the exception in tiered partnership structures. As a result, it may be challenging for many common seed and stake deal structures to fully benefit from the third-party purchaser exception.

- *Lookthrough Rule on Sales of APIs*. When an API Holder sells an API that has been held for more than three years, the gain generally is LTCG regardless of the holding period of the underlying assets unless a "lookthrough" rule applies to recharacterize a portion of the API Holder's gain as STCG based on the underlying assets held by the entity that issued the API. The lookthrough rule in the Proposed Regulations would have generally applied to the sale of an interest in (i) a partnership that has a shorter holding period in 80% or more of its assets or (ii) a partnership that owns any lower-tier API held for three years or less. Instead, the Final Regulations provide that the lookthrough rule applies to an API if the API Holder's holding period in the API would be three years or less if the API Holder's holding period is determined by not including any portion of the holding period before the date that an unrelated investor is legally obligated to make a contribution that constitutes at least 5% of the value of the partnership's total capital contributions as of the time of the API disposition.[4] Although the Preamble notes that the lookthrough rule is intended to discourage funds from "establishing partnerships and leaving them inactive for three years before attracting investment from limited partners, thereby circumventing Section 1061," the lookthrough rule may apply in other situations, such as co-investment vehicles or interests in upper-tier partnerships that own carried interests and which themselves do not

[4] It should be noted that for purposes of the lookthrough rule, the text of the Final Regulations and one part of the Preamble refer to a single 5% unrelated investor, but another part of the Preamble refers to 5% unrelated investors in the aggregate; by comparison, the 5% unrelated investor requirement applicable to the Capital Interest Exception refers to 5% unrelated investors in the aggregate in both the text of the Final Regulations and the discussion in the Preamble.

have unrelated investors.[5] The Final Regulations provide that the lookthrough rule also applies to any transaction or series of transactions with a principal purpose of avoiding potential gain recharacterization under Section 1061. If the lookthrough rule applies, gain that would otherwise be exempt from Section 1061 in connection with a sale of assets (such as Section 1231 gains, gains from Section 1256 contracts, and certain capital gains characterized under the mixed straddle rules) may be recharacterized as STCG under the lookthrough rule. The lookthrough rule is noted as an area for further study by the Treasury Department and the IRS.

- *Related Party Transfers*. The Proposed Regulations adopted an expansive interpretation of the related party transfer rule of Section 1061(d), requiring the acceleration of gain in the case of otherwise tax-free transfers (such as gifts), and in certain cases triggering more gain than was actually realized. The Final Regulations limit Section 1061(d) to a recharacterization rule (rather than a recognition rule), and, accordingly, gifts, estate planning transactions, and forfeitures of APIs are generally not subject to Section 1061(d). Any LTCG otherwise recognized on a transfer to a related party generally is recharacterized as STCG to the extent of the transferred API's share of the partnership's unrealized LTCG in its assets with a holding period of three years or less. In addition, the Final Regulations clarify that certain exceptions under the general rule of Section 1061(a), including with respect to Section 1231 gain, also apply with respect to related party transfers.

- *REITs and Operating Partnerships*. The Final Regulations did not address certain issues for real estate investment trusts (REITs). Publicly traded REITs typically own all of their assets through an "operating partnership," which may issue profits interests (*e.g.*, long-term incentive plan or "LTIP" units) to employees and directors. The LTIP units may be converted to common units, which then may be exchanged for REIT stock in a taxable transaction. The exchange for REIT stock is subject to Section 1061 and results in STCG gain if the employee held the LTIP units (or the common units into which the LTIP units were converted) for three years or less at the time of the exchange. Taxpayer unfavorable rules apply in determining the holding period when LTIP units are issued over time. The exchange may be subject to Section 1061(d) even if the LTIP units (or the common units converted from LTIP units) have been held for more than three years, which may cause the employee to recognize STCG to the extent that the operating partnership owns lower-tier partnership interests, REIT stock, or other capital assets (*i.e.*, not Section 1231 property) held for three years or less.

- *Securities Partnerships*. Under existing Regulations Section 1.704-3(e)(3)(i), a securities partnership (such as a typical hedge fund) may aggregate gains and losses from financial assets using any reasonable approach that is consistent with the purpose of Section 704(c). The Proposed Regulations would have amended these rules to require that, in order to be considered reasonable, the aggregation of gains and losses by a securities partnership must take into account the application of Section 1061 and required complex tracking arrangements. The Final Regulations simplify the approach and merely require that a securities partnership take into

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[5] It is also possible that the lookthrough rule could apply in a case where additional commitments or subscriptions to the partnership are made between the time when the unrelated investor or investors made initial commitments or subscriptions and the time of the API disposition, potentially with surprising results if the 5% test is measured on an individual, rather than an aggregate, basis.

account the application of Section 1061 "in an appropriate manner," but do not provide guidance on a specific method to do so. The Preamble notes that this area remains under consideration and may be subject to additional guidance.

- *Distributed API Property*. The Final Regulations generally continue to treat Distributed API Property as subject to the general recharacterization rule of Section 1061. Distributed API Property is defined as "property distributed by a Passthrough Entity to an API Holder with respect to an API if the holding period in the API Holder's hands is three years or less" when the API Holder disposes of the property. The Final Regulations clarify that there is no recharacterization of gain that would otherwise be exempt if the Distributed API Property were sold by the partnership (including Section 1231 gains, gains from Section 1256 contracts, qualified dividend income, and certain capital gains characterized under the mixed straddle rules). The Treasury Department and the IRS are studying how the Distributed API Property rules apply when an API Holder holds both a profits interest and a capital interest in a partnership.

- *Section 1231 Gains*. The Final Regulations reaffirm that Section 1061 does not apply to gains from the sale or exchange of Section 1231 property (*i.e.*, depreciable or amortizable personal property or real property used in a trade or business and held for more than one year). As a result, an API Holder of a real estate fund generally is not subject to Section 1061 if the real estate fund sells its trade or business real properties after a year. Section 1061 can apply if the real estate fund sells partnership interests or REIT stock, or if the API Holder directly or indirectly sells or otherwise recognizes taxable gain with respect to its carried interest in the fund. The Preamble also confirms that self-created goodwill is not Section 1231 property and therefore may be subject to Section 1061 upon a disposition, even though, subject to the application of the anti-churning rules, purchased goodwill (which is amortizable under Section 197) typically is Section 1231 property and, therefore, would be exempt from the application of Section 1061. The Final Regulations also corrected a few technical glitches, concerning distributed properties and Section 1061(d) related party transactions, to ensure that Section 1231 gains are not subject to Section 1061.

- *Section 1061(b) and Gain Attributable to Enterprise Value*. Commentators had questioned whether Section 1061 is intended to apply to profits interests that entitle recipients to income or gains attributable to increases in the enterprise value of the partnership granting the profits interest, including with respect to the grant of a profits interest in a fund management company that receives management fees from the funds organized by it. Commentators have pointed to Section 1061(b), which provides that "[t]o the extent provided by the Secretary, [Section 1061(a)] shall not apply to income or gain attributable to any asset not held for portfolio investment on behalf of third party investors," as justifying a clear regulatory exception. The Final Regulations do not address this issue (other than to provide an exception from certain aspects of the lookthrough rule), but the Treasury Department and the IRS have identified it as an area for additional study and requested additional comments.

- *Applicability Dates*. The Final Regulations are generally applicable for taxable years (of both Owner Taxpayers and Passthrough Entities) beginning on or after the date the Final Regulations

are published in the *Federal Register*.[6] The Final Regulations will therefore not take effect for most taxpayers until 2022. After the Final Regulations are published in the *Federal Register*, taxpayers may elect to apply the Final Regulations with respect to any taxable year beginning after December 31, 2017, provided that they apply the Final Regulations in their entirety and do so consistently for the year with respect to which such election is made and each subsequent year. In the event the Final Regulations provide taxpayers with a more favorable result in their 2018 - 2021 taxable years than they previously had reported or would be required to report (as applicable), taxpayers should consider electing to apply the Final Regulations (once published) to such years and filing returns or amending returns based on the Final Regulations.

In the event the Final Regulations are not published in the *Federal Register* prior to January 20, 2021 and the Biden administration determines not to publish them, they would not become effective and taxpayers may be unable to rely on them with respect to any taxable year; in that case, taxpayers could rely on the Proposed Regulations in the manner set forth therein.

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[6] Earlier effective dates apply to the rules providing that (i) S corporations and (ii) passive foreign investment companies (“PFICs”) with respect to which a shareholder has made a qualified electing fund (“QEF”) election will not be treated as “corporations” for purposes of the rule that an API does not include any interest held directly or indirectly by a corporation. As relates to S corporations, the rules are effective for taxable years beginning after December 31, 2017 and, as relates to PFICs with respect to which a QEF election has been made, the rules are effective for taxable years beginning after August 14, 2020.

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its contents. If you have any questions about the contents of this memorandum, please call your regular Fried Frank contact or an attorney listed below:

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*_Ms. Gänsler is not admitted to practice law._