January 20, 2021

IRS Issues Final Carry Regulations

On January 7, 2021 Treasury and the IRS released final regulations (the "Final Regulations") on the "three-year carry rule" enacted in 2017 pursuant to Section 1061.[1] The Final Regulations largely retain the rules proposed on July 31, 2020 (the "Proposed Regulations") but with some material, mostly taxpayer-favorable, modifications. *The Final Regulations are generally effective for tax years beginning after their publication on January 19, 2021,*[2] *giving partnerships with December tax year-ends the balance of 2021 to prepare for their application*. Generally, the Final Regulations, like the Proposed Regulations, follow Section 1061 by recharacterizing long-term capital gains as short-term capital gains ("1061 Recharacterization") if the asset generating the gains has a holding period of three years or less and is recognized on or with respect to an "applicable partnership interest" ("API").

An API generally includes any partnership interest transferred or held in connection with the performance of specified investment management services (an "applicable trade or business" or "ATB"), subject to exceptions for capital interests, interests purchased by unrelated third parties and interests held by C corporations. 1061 Recharacterization applies to (i) gains allocated in respect of an API through tiers of partnerships and other pass-through type entities, (ii) gains on dispositions of an API or interests in pass-through type entities that directly or indirectly hold an API and (iii) gains from disposition of assets received as in-kind distributions in respect of an API.

Key Takeaways and Questions

Expansion of Capital Interest Exception. Under the Final Regulations, an allocation generally qualifies for the capital interest exception if it is determined and calculated in a "similar manner" to allocations in respect of capital interests of "similarly situated unrelated non-service partners" that made "significant" capital contributions. By contrast, under the Proposed Regulations, the capital interest exception generally required proper maintenance of capital accounts and allocations to be made pro rata to those capital accounts. While generally helpful, the Final Regulation's expanded exception for capital interests still contains notable constraints.

- Third-Party Capital Requirement. For an unrelated non-service partner's contribution to be adequately significant, the contributions must generally represent at least five percent of the aggregate capital of the partnership (or relevant class of interest). Given this requirement, 1061 Recharacterization arguably could apply to gain from an investment partnership without third-party capital even if all the partnership's allocations are made pro rata to capital contributions, though there may be arguments that in some circumstances this result is not intended. The preamble to the Final Regulations indicate that the IRS is continuing to study whether or how the capital interest exception should be applied to investments in co-invest partnerships and investments by managers.
    - *Planning Consideration*. When possible, GP co-invests should be structured to include third-party capital or should at least be made through aggregators that contain third-party capital.
- "Similar Manner" Requirement. An allocation is treated as made in a "similar manner" if allocations and distribution rights with respect to API holders and unrelated non-service partners are "reasonably consistent" with each other. This may be determined on an investment-by-investment or class-by-class basis. The Final Regulations clarify that, for this purpose, non-pro rata tax distributions (if treated as an advance) and waivers of

[1] Section references are to the Internal Revenue Code of 1986, as amended.

[2] The exclusion of S corporations from the corporate exception discussed below is effective for tax years beginning after 2017, and the exclusion from this exception for passive foreign investment companies with a qualified electing fund election ("Pedigreed PFICs") is effective for tax years beginning after August 14, 2020.

carry and management fees are generally disregarded. It is unclear, however, whether other differences, such as differences in liquidity rights for sponsor capital, which hedge funds commonly permit, violate the "similar manner" requirement.

- Debt-Financed Capital Contributions. A loan from a partner or related person (but not from the partnership) may qualify as a capital interest if (i) the loan is fully recourse, (ii) the individual service provider has no right to reimbursement from any other person and (iii) the loan is not guaranteed by any other person. By contrast, the Proposed Regulation effectively excluded from the capital interest exception all contributed capital funded by loans from or guaranteed by related parties.

    - *Planning Consideration.* Although third-party loans guaranteed by the sponsor appear problematic, the Final Regulations appear to permit back-to-back loans whereby the sponsor borrows from a third-party lender and then lends the proceeds to the individual service provider making the capital contribution. In addition, while repayment of a loan used to fund a capital contribution cleanses the contributed capital, the treatment of partial repayments of a loan that funds multiple underlying investments is unclear, suggesting that borrowers should consider documenting separate loans for each underlying investment to better support the position that any repayment prior to the realization of an underlying investment can be tied to the capital contributed for that investment. Finally, careful consideration should be given to borrowing by GP vehicles and/or borrowing by fund vehicles disproportionately on behalf of the GP.

- Earnings on Unrealized "Crystalized" Carry. The Final Regulations provide that allocations of realized gain made with respect to an API that are either (i) retained by the partnership or (ii) distributed and recontributed into the partnership will be treated as reinvested into the partnership and may qualify for the capital interest exemption. By negative implication, and contrary to the implication of the Proposed Regulations, the Final Regulations appear not to treat unrealized API gain allocated to an API holder's capital account as a capital interest for purposes of future allocations on that portion of the holder's capital account. Future allocations on the portion of a capital account consisting of such unrealized API gains appear to remain subject to Section 1061 Recharacterization.

    - *Planning Consideration.* Because the Final Regulations do not appear to restrict the reinvestment of cash distributions in respect of unrealized crystalized carry, by making such distributions of cash and reinvesting the cash, hedge fund sponsors may be able to protect earnings on unrealized crystalized carry from 1061 Recharacterization, provided that such distributions and reinvestments are otherwise respected as being separate for tax purposes. Care should be taken to avoid triggering gain from the distribution, and when commercially feasible, consideration given to making the reinvestment into a different fund from the fund paying the carry.

- Clear Identification. The Final Regulations provide that reliance on the capital interest exception requires that allocations on the capital interest must be made separate and apart from allocations on a carried interest and that both the partnership agreement and contemporaneous books and records demonstrate this. The Final Regulations do not grandfather existing partnership agreements or provide transition relief for compliance with this requirement.

    - *Planning Consideration.* Consideration should be given to eliminating "self-paid carry" in partnership agreements if doing so would have no economic consequence, since treating self-paid carry as eligible for the capital interest exception appears to violate this "clear identification" requirement. In addition, while an example in the Final Regulations suggests that distribution-based fund agreements do not require particular allocation language to satisfy this "clear identification" requirement, updating agreements to include protective allocation language in these agreements should be considered.

More Administrable Lookthrough Rule for API Dispositions. Section 1061 Recharacterization of gain from the disposition of an API interest is generally determined based on the holding period of the API interest, subject to a "lookthrough rule." The "lookthrough rule" generally applies 1061 Recharacterization to gain on API held for longer than three years based on the result that would have occurred if the underlying direct and indirect assets had been sold and gain or loss allocated to the API holder.

- The Final Regulations replaced the Proposed Regulation's "lookthrough rule" with a significantly more administrable rule. Now required lookthrough is limited to dispositions of an API interest held for more than three years only if (i) the holding period of the API interest would be less than three years if that period were deemed to have started on the date that unrelated non-service partners were obligated to contribute substantial capital to the relevant partnership (five percent of total contribution at the time of the disposition) or (ii) there is a principal purpose of avoiding 1061 Recharacterization.

- The Final Regulations also clarify that the same "lookthrough rule" applies to dispositions of stock in S corporations and Pedigreed PFICs for which qualified electing fund elections are in effect if the holding period of the stock is longer than three years (i.e., and the "lookthrough rule" is triggered for either of the two reasons above).

No Regulatory Relief under Section 1061(b). Section 1061(b) provides that, to the extent provided by the Secretary, 1061 Recharacterization shall not apply to income or gain attributable to any asset not held for portfolio investment on behalf of third-party investors. The Proposed Regulations reserved with respect to the application of Section 1061(b). While many comments on the Proposed Regulations described circumstances in which relief under Section 1061(b) would be appropriate (and this seems to have been contemplated by Congress), the Final Regulations continue to reserve on this matter.

- In the absence of guidance implementing Section 1061(b), self-managed funds, GP coinvests, and management companies must rely on the capital interest exception for relief from 1061 Recharacterization. Due to the apparently broad scope of the term "API," it appears that many non-abusive arrangements could inadvertently be subject to 1061 Recharacterization. As above, consider structuring vehicles to include third-party capital, or to invest through aggregators or other partnerships treated as APIs. Alternatively, when possible, consider structuring GP co-invests without use of any partnership entities in the structure, such as by use of S-corps or grantor trusts.

No Gain Acceleration on Related-Party Transfers. The Proposed Regulations provided under Section 1061(d) that, if an API was transferred to a related party, the built-in API gain that would have been subject to 1061 Recharacterization when realized would be accelerated and recognized (calculated generally on the basis of a hypothetical asset sale). The Proposed Regulations applied this rule broadly to transfers, including contributions, distributions, sales and exchanges, and gifts, and accelerated the recognition of gain realized on related-party transfers whether or not the transfer was otherwise a taxable event. The Final Regulations narrow the scope of the Section 1061(d) transfer rule to sales or exchanges of APIs in which gain is otherwise recognized so that it no longer accelerates gain on non-recognition transfers or transactions not treated as transfers for tax purposes. The Related Party transfer rule thus operates effectively as an alternative "lookthrough rule" for Related Party transfers. Note that unlike the ordinary "lookthrough rule" which would generally treat the outside realized gain as being comprised proportionately of lookthrough one- to three-year gain, the Related Party "lookthrough rule" causes outside realized gain to be comprised first of any lookthrough one- to three-year gain to the extent there is any.

Carry Waivers. Many funds permit waivers of carry, including carry otherwise subject to 1061 Recharacterization, and provide for such waived carry to be recovered from subsequent gains, and sometimes only gains not subject to 1061 Recharacterization. While the Proposed Regulations did not specifically attack these "carry waiver" provisions, the

preamble identified potential challenges based on existing anti-abuse rules. Neither the preamble to the Final Regulations nor the Final Regulations themselves address carry waivers.

Noteworthy Retentions from Proposed Regulations. The Final Regulations retain several important rules set forth in the Proposed Regulations:

- Certain income and gains taxed at long-term capital gains rates are excepted from 1061 Recharacterization, including Section 1231 gains, QDI, Section 1256 gains and certain mixed straddles, as well as any other capital gains and losses that are characterized as long-term or short-term without regard to the holding period rules in Section 1222.

- The exemption from API treatment for partnership interests held through "corporations" does not apply to API held through S corporations and Pedigreed PFICs.

- Once a partnership interest is treated as an API with respect to a holder or taxpayer, it remains treated as an API, even if services in respect of the API cease to be performed or the ATB terminates.

- If an unrelated purchaser who is not performing services (and did not perform, and does not anticipate performing services) buys an API, it ceases to be an API with respect to the purchaser. The preamble confirms that this exception applies only on a purchase of an API, not on a contribution to capital of the partnership in exchange for an interest in the API.

- An asset distributed in-kind with respect to an API retains the API taint until the asset meets the three-year holding period. The Final Regulations remain silent on how or whether an in-kind distribution can be treated as in respect of a capital interest when the partner receiving the distribution also holds an API.

- While 1061 Recharacterization applies to net capital gains that would otherwise be long-term capital gains in a year, there is no corresponding recharacterization of net capital loss on assets with a one- to three-year holding period.

- Regulated investment companies ("RICs") and real estate investment trusts ("REITs") may (but are not required to) disclose to their shareholders the amount of capital gain dividends attributable to assets held for more than three years or attributable to assets that are not subject to Section 1061 with their capital gain dividend statements or notices. If such disclosure is not provided, Section 1061 Recharacterization generally applies to capital gains dividends received from a RIC or REIT and allocated in respect of an API.

- The holding period rules in Section 1223 are modified for purposes of determining the holding period of partnership interest consisting in whole or part of a profits interest. Under this rule, the portion of the holding period to which a profits interest relates is determined based on the fair market value of the profits interest at the time of the realization of all or part of the partnership interest (rather than the value of such interest determined at the time that the profits interest is acquired). In adopting this rule, the Final Regulations clarified none of the ambiguity present in the Proposed Regulations.

    - The Final Regulations define profits interest for this purpose as "other than a capital interest" but suggest that the special holding period rule for profits interest does not apply to a right to profits issued for only capital and are extremely unclear in how they should apply to an interest issued for services and capital.

    - The Final Regulations are silent on when a profits interest is treated as issued for purposes of starting its holding period.