

August 3, 2022

## Proposed Senate Legislation Would Limit Capital Gain Treatment for Carried Interests

On July 27, 2022, Senate Democrats announced proposed legislation, the Inflation Reduction Act of 2022 (the “Act”), that includes a proposal (the “Proposal”) to expand the special holding period rules applicable to carried interest under Section 1061 of the Internal Revenue Code of 1986, as amended (the “Code”). The proposed legislation also adds a 15% minimum tax for certain large corporations and increases funding for the IRS.

Section 1061, added to the Code in 2017 as part of the Tax Cuts and Jobs Act, generally extended the holding period required to be satisfied in order to obtain capital gain treatment from one to three years for gain that is realized with respect to an “applicable partnership interest” (“API”), which generally includes carried interests held by individuals performing services for investment partnerships.

The Proposal, which would apply to taxable years beginning after December 31, 2022, would significantly modify Section 1061 by generally recharacterizing income that would otherwise qualify as long-term capital gain as short-term capital gain, subject to a limited exception for gain realized five years after both “substantially all” of the carried interest is acquired and the partnership has acquired “substantially all” of its assets, with a look-through rule for underlying partnerships. The five-year period is modified to three years in the case of taxpayers with an adjusted gross income of less than \$400,000 or income with respect to any API that is attributable to a real property trade or business.

If applied literally and broadly, this five-year “holding period” exception would rarely be satisfied. Depending on the facts, it may be that the exception would not be satisfied even if all assets held by a partnership were held for longer than five years (as assets are acquired and disposed of over time and at any one time, “substantially all” of the partnership’s assets may not yet have been acquired). Evergreen funds that turn over their portfolio consistently over any five-year period would seemingly never qualify. The look-through rule for underlying partnerships also applies regardless of the size of the interest in such underlying partnership.

The Proposal contains numerous other uncertainties, in particular regarding how to determine when an asset is “acquired,” whether the “tacking” of holding periods under general tax principles for non-recognition transactions would be disregarded, and whether a change in or increased interest in profits may be treated as the “acquisition” of a new API or part of the same API (and therefore when “substantially all” of an API may be treated as having been acquired).

The Proposal is identical to proposed legislation known as the “Build Back Better Act” that was released by the House Ways and Means Committee on September 13, 2021, other than a change to the proposed effective date. Many of these uncertainties were commented upon after the release of the proposed legislation last year, but they were not addressed in the Proposal.

Other aspects of the Proposal include the following:

- The application of Section 1061 would apply to any income eligible for long-term capital gains rates, such as qualified dividend income, gain from Section 1256 contracts, and Section 1231 gain, whereas Section 1061 currently applies only to income attributable to assets the sale or exchange of which would give rise to long-term capital gain or loss under Section 1222.

- The Proposal would require gain recognition on any transfer of an API, whether or not the transfer would otherwise qualify for non-recognition treatment under applicable tax rules and whether or not the API has been held for five years.
- The Proposal clarifies that the exception for APIs held by “corporations” only applies to “C corporations.”
- Broad regulatory authority is granted to close “loopholes,” including specifically the use of carry waivers and in-kind distributions.

The Act also proposes to impose a 15% minimum tax on the financial statement income of corporations with over \$1 billion in financial statement income, subject to a lower threshold for corporations owned by a foreign parent. This proposal is substantially similar to a proposal included in the Senate Finance Committee’s version of the Build Back Better Act released on December 11, 2021.

The Act further provides for additional IRS funding over ten years for taxpayer services, enforcement, operations support and business systems modernization.