GOLENBOCK EISEMAN
ASSOR BELL & PESKOE LLP

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ATTORNEYS AT LAW | 711 THIRD AVENUE | NEW YORK, NY 10017 | 212 907 7300 | WWW.GOLENBOCK.COM

Carried Interest Regulations Finalized

January 25, 2021

Section 1061 of the Internal Revenue Code generally recharacterizes long-term capital gains attributable to certain carried interests ("applicable partnership interests" or "APIs") as short-term capital gains, unless an extended, three-year holding period is satisfied. The IRS released proposed regulations on July 31, 2020 regarding the application of Section 1061. On January 7, 2021, the IRS released final regulations that included some significant changes from the proposed regulations.

These final regulations will have a far-reaching impact on many private equity and other investment funds and partnerships. After a brief overview of Section 1061, we Illustrate below some notable observations regarding these new rules.

1. Overview

An applicable partnership interest ("API") is defined as an interest in a partnership which, directly or indirectly, is transferred to (or held by) a taxpayer or pass-through entity[1] in connection with the performance of substantial services by the taxpayer or pass-through entity, or by a related person, in an applicable trade or business ("ATB") of the partnership. An ATB is defined generally as any activity conducted on a regular, continuous and substantial basis consisting, in whole or part of (i) raising or returning capital and (ii) investing in or developing certain specified assets. (ATBs are discussed further below.) "Specified assets" include certain securities, commodities, real estate held for rental or investment, cash or cash equivalents, and options or derivative contracts with respect to any of the foregoing. The final regulations contain a presumption that when a partnership interest is transferred in connection with the performance of services, the services were substantial.

Section 1061 generally does not apply to interests in a partnership held directly or indirectly by or through a corporation, other than subchapter S corporations and passive foreign investment

[1] In a typical PE structure, there are generally one or more tiers of pass-through entities between the partnership that originally issued the API and the pass-through entity in which the taxpayer holds its indirect interest in the API. Each pass-through entity in the tiered structure is treated as holding an API under the regulations. Accordingly, an API holder may be an individual or a pass-through entity which, as defined in the regulations, may be a partnership, trust, estate, S corporation, or a passive foreign investment company with respect to which the shareholder has a qualified electing fund election in effect.

companies ("PFICs") with respect to which the shareholder has a qualifying electing fund ("QEF") election in effect. In addition, APIs do not include interests in partnerships to the extent they are issued for contributed capital, provided allocations to these capital interest holders are commensurate with the capital contributed and are determined in a similar manner as allocations to unrelated non-service partners who also contributed significant capital. In applying this exception, the fact that a partner is not charged management fees or subject to a sponsor's carry, or is entitled to tax distributions, will not prevent such partner from being eligible for the capital interest exception.

2. Once an API, Always an API

The final regulations provide that once a partnership interest qualifies as an API, it remains an API unless and until certain exceptions apply.

> Example 2-1.
>
> Partnership P transfers a profits interest that is an API to individual A in connection with A's performance of services for P. After 6 years, A retires and is no longer performing any services. However, A retains the API in P, and P continues to acquire new capital assets and to allocate gain to A from the disposition of those assets.
>
> *Under the final regulations, A's interest in P continues to be treated as an API after A retires.*

3. Related Party Transfers

Under the proposed regulations, the transfer of an API to certain related persons (including non-taxable transfers) would generally cause an acceleration of gain recognition to the transferor. The final regulations take more restricted approach, under which non-taxable transfers of APIs (e.g., gifts or capital contributions to partnerships) to related persons would not accelerate gain recognition, but the transferred interest would remain an API in the hands of the related transferee under the "Once an API, Always an API" rule. The final regulations also make clear that only completed transfers for income tax purposes are subject to recharacterization under Section 1061.[2] Taxable transfers of APIs to related persons would be subject to short-term gain recharacterization under the final regulations, with the amount of gain recharacterized as short-term generally equal to the lesser of (i) the amount of net long-term gain recognized by the transferor and (ii) the portion of the partnership's net long-term capital gain that would have been allocated to the transferor in respect of the transferred API had the partnership sold all of its assets held for three years or less in a fully taxable transaction for cash equal to their fair market value immediately prior to the API transfer.

> Example 3-1.
>
> Individuals A and B each contribute an API in partnership P to new partnership X in a tax-free exchange for a partnership interest in X.
>
> *The API classification of the P interest will remain in the hands of X. Notably, here both A's and B's interests in X will also be subject to the 3-year holding requirement for long-term capital gain treatment.*
>
> *On the other hand, if the transferee is a C corporation, it appears that under the final regulations the transfer may cleanse the API characterization.*
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> Example 3-2.
>
> Individual A transfers an API in partnership P to A's daughter as a gift.
>
> *Even though the gift is not subject to income tax, the API remains an API in the hands of A's daughter.*
>
> Example 3-3.

[2] Entities disregarded for tax purposes such as grantor trusts, qualified subchapter S subsidiaries and single member LLCs are not treated as related persons under Section 1061(d).

Individual A has held an API in partnership P for more than three years. A sells the API for $100x cash to a related person in a taxable transaction, resulting in A recognizing $100x of long-term capital gain. If, immediately prior to A's transfer of the API, P had sold all of its assets in a fully taxable transaction for cash equal of the fair market value of the assets, A's share of the net long-term capital gain from assets held for three years or less would have been $120.

A's sale is subject to short-term capital gain treatment under Section 1061(d) generally equal to the lesser of (i) the long-term capital gain realized by A on the transfer ($100x) and (ii) A's share of the net long-term capital gain that would have been realized by P had P sold all of its assets held for 3 years or less in a taxable transaction ($120x). Thus, A's $100 long-term capital gain is recharacterized as short-term capital gain under the final regulations. In addition, the API in the hands the transferee will still remain an API.

On the other hand, if an unrelated person acquires the API by a taxable purchase, and the acquirer is not a service provider for the partnership directly or indirectly, then the API taint could potentially be purged under the final regulations.

4. Short-Term Capital Gain Treatment After Having Held API For More Than Three Years – The "Lookthrough Rule"

One potential impact of the "Once an API, Always an API" rule is the possibility of short-term capital gain treatment under the "Lookthrough Rule", if it's applicable. Under that rule, long-term capital gain treatment may not apply to the sale of an API that has been held for more than three years, to the extent the gain is attributable to the partnership's assets that the partnership has held for not more than three years.

<u>Example 4-1.</u>

In Year 1, individual A receives an API in partnership P. In Year 5, A sells its API in P for $100x. If P had sold all of its assets immediately prior to A's sale of the API, the gains that would have been allocable to A would have included $80x that are attributable to assets which P has held more than three years, and $20x attributable to assets that P has held for not more than 3 years.

If the Lookthrough Rule applies, $20x of the gain that A recognizes on the sale of the API would be taxable to A as short-term capital gain, even though A has held the API for more than three years.

The Lookthrough Rule applies under the final regulations if, subject to certain exceptions, the API holder sells the API within three years after an unrelated investor becomes legally obligated to contribute substantial money or property to the partnership. The final regulations define "substantial" for this purpose to mean at least 5 percent of the total capital contributions determined at the time of the sale of the API. Thus, it appears that a relatively large subsequent funding round could cause the three-year holding period to restart for the purpose of the Lookthrough Rule.

<u>Example 4-2.</u>

On July 1, 2021, individuals A and B form partnership P. At the time of P's formation, A agrees to provide substantial services to P in exchange for a 20% profits interest in P. B, a partner that is an unrelated person who is not providing services to P (an "Unrelated Non-Service Partner"), contributes $1 million in exchange for an interest in P and P immediately uses the capital to purchase marketable securities. On July 1, 2023, individual C, another Unrelated Non-Service Partner, becomes legally obligated to contribute $75 million to P and on July 3, 2023, after C makes a contribution of $75 million, P uses this capital to acquire stock in a portfolio

company. On July 1, 2025, when the value of all of P's assets had appreciated, A sells its API to an unrelated third party.

Under the final regulations, the Lookthrough Rule applies because, at the time of A's sale of its API, B's contribution was non-substantial after taking into account C's contribution, and A's sale took place within three years after C's contribution which was substantial within the meaning of the final regulations. Accordingly, the portion of A's gain attributable to the appreciation in value of the portfolio company acquired by P with C's contribution will be recharacterized as short-term capital gain.

5. Applicable Trade or Business ("ATB") Tested On a Combined Basis

A partnership interest qualifies as an API only if the interest is issued by the partnership for services to be performed in an applicable trade or business (the "ATB Activity Test"). Under the final regulations, an applicable trade or business ("ATB") includes two parts, both of which must be present, but do not have to be undertaken in the same year, or even by the same entity. These two parts for the ATB Activity Test are (1) raising or returning capital ("Raising or Returning Capital Actions") and (2) investing in (or disposing of) specified assets or developing specified assets ("Investing or Developing Actions"). To qualify as an ATB, the total level of these activities must be sufficient to constitute a "trade or business" under Section 162 of the Code. The existence of an ATB is determined based on the combined activities of certain related parties, including activities occurring in separate partnership tiers or entities. As illustrated below, the scope of ATB is significantly broad.

Example 5-1.

During the taxable year, a partnership takes a small number of actions to raise capital for new investments, but takes numerous actions to develop specified assets.

The partnership's actions with respect to raising capital and actions with respect to developing specified assets are combined for purpose of determining the ATB Activity Test. If these actions cumulatively rise to the level required to establish a trade or business, then the ATB Activity Test is satisfied.

Example 5-2.

GP, a partnership, conducts Raising or Returning Capital Actions. Management Company, a partnership that is related to GP, conducts Investing or Developing Actions.

If the ATB Activity Test is satisfied when GP's and Management Company's activities are combined, then both GP and Management Company will be treated as engaged in an ATB, and services performed by either GP or Management Company will be treated as performed in an ATB.

Example 5-3.

In year 1, a partnership engaged in Raising or Returning Capital Actions to fund its investment in specified assets, but did not satisfy the level of activity required to establish a trade or business. In year 2, the partnership engaged in significant Investing or Developing Actions that rise to the level required to establish a trade or business, but did not engage in any Raising or Returning Capital Actions.

In such case, the partnership is treated as engaged in an ATB, not in year 1, but in year 2.

Example 5-4.

In year 1, a partnership only conducted Raising or Returning Capital Actions that rise to the level of activity required to establish a trade or business. These Raising or Returning Capital Actions were taken with the goal of increasing the value of specified assets through Investing or Developing Actions.

Although the partnership did not take Investing or Developing Actions during the

taxable year, its Raising or Returning Capital Actions can satisfy the ATB Activity Test in year 1, since they were undertaken in anticipation of also engaging in Investing or Developing Actions. It appears irrelevant under the final regulations as to when the partnership would actually conduct any Investing or Developing Actions in such case.

Example 5-5.

GP is the general partner of a partnership, and is responsible for providing management services to the partnership. GP contracts with an unrelated Management Company to provide such management services on GP's behalf.

Under the final regulations, the management services provided by Management Company are attributed to GP for purposes of the ATB Activity Test because Management Company is operating as a delegate of GP.

Additionally, those actions are also taken into account by Management Company for purposes of the ATB Activity Test and whether Management Company is engaged in an ATB.

6. Reporting Requirements

As mandated by Section 1061, the final regulations set forth certain reporting requirements and include rules for providing information required in connection with tiered structures.

The final regulations are generally applicable for taxable years beginning on or after the date the final regulations are published in the Federal Register. Therefore, for many taxpayers the final regulations may not be effective until 2022. However, interested taxpayers should discuss with their tax advisors as soon as possible the impact and the actions that should be taken in light of these new rules.

For further assistance please contact your primary GEABP attorney or either of the attorneys listed below:

Jeffrey Berger (212) 907-7393
Email: jberger@golenbock.com
Kuang-Chu Chiang (212) 907-7335
Email: kchiang@golenbock.com

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