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Proposed Regulations Issued Under Section 1061 for Carried Interests

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The proposed regulations answer a lot of questions regarding the application of Section 1061 ; however, the rules are complex and not always intuitive and taxpayers should be mindful of them at the outset of structuring any carried interest arrangement and throughout the life of the partnership.

On July 31, 2020, Treasury and the IRS issued proposed regulations under Section 1061 . Enacted in 2017 by the Tax Cuts and Jobs Act (TCJA), Section 1061 requires a three-year holding period for a "carried interest" partner to receive the benefit of the long-term capital gains rate. The proposed regulations provide some needed clarity with respect to several operative provisions under Section 1061 , including what interests and arrangements are subject to the rules, how to interpret certain exceptions to the rules, and what the information reporting requirements are for the various taxpayers affected by the implementation of Section 1061 . Mechanically, the provision recharacterizes as short-term capital gain the difference between a taxpayer's net long-term capital gain with respect to one or more "applicable partnership interests" ("APIs") using the standard one-year holding period and such gain using a three-year holding period. The proposed regulations refer to this difference as the "Recharacterization Amount" and the holder of an API as the "API Holder."

What Is an API?

An API is an interest in a partnership's profits that is transferred or held in connection with the performance of substantial services by the taxpayer, or any other related person, in any applicable trade or business ("ATB"). The proposed regulations expand the definition of a partnership interest for purposes of Section 1061 to also include any financial instrument or contract, the value of which is determined, in whole or in part, by reference to the partnership. [1]

In order for a profits interest to constitute an API, Section 1061 requires that the interest be transferred or held in connection with the performance of *substantial* services. Rather than expanding upon the definition of "substantial" by providing a facts-and-circumstances determination or bright-line rule, the proposed regulations simply presume that if a partnership interest is transferred in connection with the performance of services, the services performed are substantial. Treasury and the IRS rationalize this presumption "because the parties to the arrangement have economically equated the potential value of the interest granted with the value of the services performed." [2]

In addition to the requirement that services be substantial to fall within the definition of an API, such services must also be rendered to an ATB. Under Section 1061 , the term ATB encompasses a range of financial service activities relating to "Specified Assets" (*i.e.*, certain securities, certain commodities, real estate held for rental or investment, cash or cash equivalents, options or derivative contracts with respect to any of the foregoing, and an interest in a partnership to the extent of the partnership's proportionate interest in any of the foregoing). Specifically, an ATB is any activity conducted on a regular, continuous, and substantial basis which consists, in whole or in part, of raising or returning capital, and either (i) investing in (or disposing of) Specified Assets (or identifying Specified Assets for such investing or disposition), or (ii) developing Specified Assets. The proposed regulations refer to these actions, respectively, as "Raising or Returning Capital Actions" and "Investing or Developing Actions."

An activity is conducted on a regular, continuous, and substantial basis under the proposed regulations if it meets the "ATB Activity Test" (*i.e.*, the total level of activity (conducted in one or more entities) meets the level of activity required to establish a trade or business for purposes of Section 162). In applying the ATB Activity Test, the proposed regulations provide that, in some cases, it is not necessary for both Raising or Returning Capital Actions and Investing or Developing Actions to occur in a single year for an ATB to exist in that year. For instance, the ATB Activity Test is met if Investing or Developing Actions alone satisfy the ATB Activity Test in the current

year and Raising or Returning Capital Actions have been taken in prior years. Conversely, the test is satisfied if Raising or Returning Capital Actions during the year satisfy the ATB Activity Test and Investing or Developing Actions are anticipated but not yet taken. The proposed regulations further provide that in applying the ATB Activity Test, the actions of one or more related persons are taken into account, regardless of whether an entity conducts only Raising or Returning Capital Actions or only Investing or Developing Actions.

The preamble to the proposed regulations discusses the interaction of Section 1061 with Revenue Procedures 93-27 and 2001-43, which provide a safe harbor under which the IRS will not treat the receipt of a profits interest as a taxable event for the partner or the partnership if certain requirements are met. As clarified in the preamble, " Section 1061 applies to all partnership interests that meet the definition of an API, regardless of whether the receipt of the interest is treated as a taxable event under Revenue Procedure 93-27 ." [3] Also, an election under Section 83(b) does not prevent an interest from being an API. Conversely, just because an interest meets the definition of an API does not mean the safe harbor requirements of Revenue Procedure 93-27 are satisfied.

The proposed regulations also clarify that once a partnership interest becomes an API, the partnership interest remains an API unless and until an exception to Section 1061 applies, regardless of whether the taxpayer or a related person continues to provide services in an ATB. Therefore, even after a partner retires and provides no further services, if the retired partner continues to hold the partnership interest, the interest remains an API. Similarly, if the partner provides services, but the ATB Activity Test is not met in a later year, the interest will continue to be an API. Further, an API remains an API if it is contributed to another passthrough entity or a trust or is held by an estate.

Corporate Exception to Section 1061

An API does not include "any interest in a partnership directly or indirectly held by a corporation." Treasury and the IRS notified taxpayers in 2018 that the regulations under Section 1061 would provide that the term "corporation" for purposes of this exception does not include an S corporation. [4] True to form, the proposed regulations provide that a partnership interest held by an S corporation is treated as an API if the interest otherwise meets the API definition. Likewise, the proposed regulations clarify that a PFIC with respect to which the shareholder has a QEF election in effect will be treated as an API if the interest otherwise meets the API definition. [5] Treasury and the IRS are concerned that, absent this rule, taxpayers may use PFICs with respect to which they have made QEF elections to avoid the application of Section 1061 .

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