January 11, 2021

IRS Issues Final Regulations Providing Guidance on Taxation of Carried Interest from Investment Partnerships under Section 1061

On Thursday, January 7, 2021, the Internal Revenue Service ("IRS") and the Department of the Treasury released final regulations (the "Final Regulations")[1] on the scope and applicability of Section 1061 of the U.S. Internal Revenue Code of 1986, as amended (the "Code").[2] Proposed regulations (the "Proposed Regulations") were released on July 31, 2020 and published in the Federal Register on August 14, 2020.[3]

Key Takeaways

- The Final Regulations confirm that Section 1061 applies only to gains treated as long-term capital gain under Sections 1222(3) & (4) (and not, for example, qualified dividend income, Section 1231 gains or gains from Section 1256 contracts).

- The Final Regulations provide a simpler and more widely applicable definition of capital interests that are not subject to Section 1061(a) than the definition included in the Proposed Regulations.

- The Final Regulations confirm the Proposed Regulations' position that Section 1061 extends to partnership interests held by S corporations and PFICs with respect to which QEF elections are in effect.

- The Final Regulations narrow the scope of the Section 1061(d) transfer rule to transactions that are otherwise taxable for income tax purposes, clarifying, among other things, that the rule is not triggered by transfers that are only transfers for estate or gift tax purposes (e.g., transfers to grantor trusts where the transferor is the grantor and the grantor's family members are trust beneficiaries).

- The Final Regulations provide a more administrable lookthrough rule than the Proposed Regulations, thereby providing taxpayers with more certainty on the treatment of dispositions of partnership interests subject to Section 1061.

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[1] T.D. 9445, 2021-2 I.R.B. 296.

[2] All Section references are to the Code.

[3] We previously issued a client alert discussing the Proposed Regulations, which is available here.

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- Passthrough entities are subject to detailed recordkeeping and reporting requirements, with significant adverse consequences to taxpayer-interest holders for failure to comply.

Section 1061 – Background

In 2017, as part of the Tax Cuts and Jobs Act ("TCJA"), Congress enacted Section 1061, which increases the holding period required to receive long-term capital gain treatment from one year to three years for the gain related to partnership interests (referred to as "Applicable Partnership Interests" or "APIs") held in connection with the performance of certain services, including services that fund managers provide.

Section 1061(c)(1) defines an API as any interest in a partnership transferred to or held by a taxpayer, directly or indirectly, in connection with the taxpayer (or any related person) performing substantial services in an "applicable trade or business" ("ATB") for the partnership. Section 1061(c)(2), in turn, defines ATB as any activity conducted on a regular, continuous, and substantial basis, through one or more entities that consists of, in whole or in part, (1) raising or returning capital and (2) investing in or disposing of "specified assets," identifying such assets for investment or disposition, or developing such assets. And Section 1061(c)(3) defines "specified asset" as securities, commodities, real estate held for rental or investment, cash or cash equivalents, options or derivatives contracts with respect to any of the foregoing, and an interest in a partnership to the extent of such partnership's proportionate interest in any of the foregoing.

Section 1061(c)(4) carves out two exceptions from the definition of API for (1) partnership interests directly or indirectly held by a corporation (the "Corporate Exception") and (2) capital interests in partnerships that give the taxpayer a right to share in partnership capital based on (i) the amount of capital contributed or (ii) the value of such interest subject to Section 83 when the interest is received or vests (the "Capital Interest Exception").

Finally, Section 1061(d) provides a special rule for taxpayers who transfer an API directly or indirectly to certain members of their family or to a person who in the current year or the prior three years performed a service in any ATB in which or for which the taxpayer performed a service. Such a taxpayer must include as short-term capital gain the excess of (1) deemed Section 1061(d) net long-term capital gain with respect to their API attributable to the sale or exchange of any asset held for not more than three years over (2) the amount treated as short-term capital gain under the standard Section 1061(a) rules.

The Final Regulations

The Final Regulations generally clarify and elaborate on the applicability and operation of Section 1061. In addition, they simplify several significant components of the Proposed Regulations. Particularly notable aspects of the Final Regulations are:

1. **Section 1061 Applies Only to Section 1222 Capital Gains**. Section 1061(a) refers to a taxpayer's "net long-term capital gain" and calculates the amount subject to tax by changing the holding periods in Section 1222. The Proposed Regulations provided that Section 1061(a) applies only capital gains that would be treated as long-term capital gains pursuant to Sections 1222(3) & (4). Thus, other forms of tax-favored income, including qualified dividend income, gain on property used in trade or business under Section 1231 and mark-to-market capital gains under Section 1256, are not included in any Section 1061 reporting or calculations. The Final Regulations retain that exclusion and, in addition, explicitly confirm that the Section 1061(d) recharacterization rule and the Distributed API Property rules (each discussed below) also do not include such items.

2. **S Corporations and PFICs with QEF Elections Excluded from Corporate Exception**. Shortly after Section 1061 was enacted, taxpayers considered whether they could use the Corporate Exception to avoid Section 1061 by using a corporation not subject to U.S. federal income tax to hold an API. In Notice 2018-18, the IRS announced that the Section 1061 regulations would provide that partnership interests held by S Corporations would not fall within the Corporate Exception. The Proposed Regulations included that rule and also specified that Passive Foreign Investment Corporations ("PFICs") with respect to which a shareholder has made a QEF election are not "corporations" within the meaning of Section 1061(c)(4)(A). The Final Regulations retain that rule and reiterate that it is necessary to avoid circumvention of Section 1061 and is, therefore, authorized under Section 1061(f)'s grant of regulatory authority. Others disagree, however, and taxpayers may challenge this exclusion.[4]

3. **A Simplified Capital Interest Exception**. The Proposed Regulations implemented the Capital Interest Exception with a rigid rule based on capital accounts that would have likely prevented most investment fund sponsors from qualifying for it. The Final Regulations take a different, more flexible approach that will likely result in the Capital Interest Exception being available to many sponsors.

[4] *See, e.g.*, Thomas D. Sykes, *The 'Corporation' Exception to Carried Interest: A Litigator's View*, 169 Tax Notes Federal 769, 776 (Nov. 2, 2020) ("The argument against the IRS's position that section 1061(c)(4)(A)'s corporation exception does not encompass S corporations is powerful in view of the opinions published in recent years by five federal courts of appeals; in view of the positions that the Justice Department took during briefing of those cases; and in view of the long-standing definitional Treasury regulation."); Bruce Lemons and Richard Blau, *Are S Corporations 'Corporations' Under the Carried Interest Rules?*, 164 Tax Notes Federal 1567, 1573 (Sept. 2, 2019) ("Based on the code itself defining an S corporation as a corporation, and on the uniformly decided case law, it is highly likely that a court examining the issue would conclude that the term 'corporation' used in section 1061(c)(4)(A) has an unambiguous meaning and therefore includes an S corporation.").

- The Final Regulations provide that allocations made to capital interests[5] will qualify for the Capital Interest Exception if (i) they are calculated "in a similar manner" to the allocations for unrelated non-service partners that have made "significant aggregate capital contributions" (at least 5% of aggregate capital contributed at the time of the allocation) and (ii) the distribution rights for such capital interests and the interests held by such unrelated non-service partners are reasonably consistent with each other. The "in a similar manner" analysis can be done on a class-by-class or deal-by-deal basis.

- The Final Regulations explicitly clarify that capital interests can qualify for the exception even if they are not subject to management fees, carry or incentive allocations or are entitled to tax distributions.

- The Final Regulations specify that allocations qualify for the Capital Interest Exception retain their character through tiered structures.

- The Final Regulations clarify that allocations of realized gain made with respect to an API (i.e., that are included in the Section 1061(a) calculation) that are retained by the partnership and reinvested rather than being distributed thereafter qualify for the Capital Interest Exception. However, because this rule does not extend to unrealized gains (and by extension the gains on such gains), sponsors of hedge funds (whose incentive allocations often include both realized and unrealized gains) may not find this clarification particularly useful.

- While the Proposed Regulations categorically excluded interests financed by loans from qualifying for the Capital Interest Exception, the Final Regulations provide that such interests, if financed with fully recourse debt, generally qualify for the exception.

4. **Carried Interest Waivers**. Following the enactment of the TCJA, fund sponsors have considered using "carry waivers," which are intended to permit sponsors to waive carry distributions (and avoid related income allocations) when Section 1061 would apply in favor of later distributions and allocations not subject to Section 1061. The preamble to the Proposed Regulations warned that the IRS may challenge attempts to "circumvent" Section 1061 through those waivers on audit on a number of grounds, including substantiality and under the substance over form or economic substance doctrines. The Final Regulations and their preamble are silent on carry waivers, but presumably the warning still stands.

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[5] The Final Regulations define capital interest in the same terms as Revenue Procedure 93-27: "an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value at the time the interest was received and the proceeds were then distributed in a complete liquidation of the partnership." Treas. Reg. § 1.1061-3(c)(3)(i).

5. **Profits Interests in Operating Entities**. The Final Regulations declined commentators' requests to provide that a profits interest in a partnership that owns a non-ATB business and is held by the employee manager of such business is per se not an API, even if the partnership operates the non-ATB business through a corporate subsidiary and therefore holds Specified Assets (e.g., corporate stock). The preamble states that, depending on the facts and circumstances of the situation, the ATB test could be met and, by extension, the profits interest would be an API. Accordingly, incentive arrangements for employees in operating businesses should be carefully evaluated to determine whether Specified Assets are present, the ATB test is met and such arrangements create APIs.

6. **Enterprise Value**. Under the Final Regulations, the definition of API includes financial instruments and contracts the value of which is determined by reference to the value of the partnership. Therefore, investment management contracts that entitle service companies to a fee based on a percentage of a fund's assets could be APIs. The preamble declined commentator's requests to carve out management company interests from the definition, despite service fees typically constituting ordinary income and management companies being operating entities that provide services rather than functioning as an investment vehicle. Accordingly, investment professionals who receive interests in management companies and then recognize gain upon disposition of all or a portion of the interests (e.g., though an investment by a fund of funds) within three years of receipt may be subject to recharacterization under Section 1061(a).

7. **A Narrower Section 1061(d) Transfer Rule**. The Proposed Regulations included broadly applicable rules under Section 1061(d) that accelerated the recognition of gain to the transferor of an API even in otherwise non-taxable transactions. The Final Regulations take a narrower approach, limiting Section 1061(d) to sales or exchanges of APIs in which gain is otherwise recognized and, accordingly, making it a recharacterization rule rather than an acceleration rule. Furthermore, the rule is triggered only by completed transfers for income tax purposes, clarifying that many common estate planning techniques that involve transfers for gift or estate tax purposes, but not for income tax purposes, will not result in recharacterization. Under the Final Regulations, the amount recharacterized is the lesser of the long-term capital gain recognized upon the transfer and the net amount of long-term capital gain from assets with a holding period of three years or less that the taxpayer would have recognized and which would have been subject to Section 1061(a) (i.e., excluding Section 1231 gain) had the partnership liquidated in a taxable sale.

8. **Reporting Obligations**. The Final Regulations specify numerous categories of information that passthrough entities must provide to their interest holders, going beyond the requirements laid out in the Proposed Regulations. The time and manner of such reporting is unspecified (delegated to the IRS to impose in its forms, instructions and other guidance), but funds will likely bear additional recordkeeping and reporting costs to comply with these rules. In addition, for tiered structures – which most funds use in some form – the Final Regulations retain the Proposed Regulations' (likely

unworkable) requirement that lower-tier passthrough entities' deadlines for providing relevant information to upper-tier passthrough entities is when the lower-tier entities' returns are due, without providing any de minimis exceptions for non-controlling interests in lower-tier entities or holdings that are only a small portion of the value of an API.

9. **A Simplified Lookthrough Rule for Transfers of APIs**. The Proposed Regulations contained a complex rule whereby some or all gain from the disposition of an API with a direct holding period exceeding three years could be recharacterized under Section 1061(a) based on the underlying assets (looking through as many tiers of passthrough entities as were present). The Final Regulations replace that rule with a more straightforward test where the holding period of the direct owner of transferred property typically determines whether gain from the disposition of such property is recharacterized under Section 1061(a). Specifically, if at the time of disposition the direct holding period in an API exceeds three years but the holding period as measured from the date that unrelated non-service partners legally commit to contribute substantial capital (at least 5% of total capital contributions at time of API disposition) to the partnership with respect to which the API relates does not exceed three years, some or all of the realized gain is recharacterized under Section 1061(a). The lookthrough rule also applies to a transaction or series of transactions that occur with a principal purpose of avoiding potential gain recharacterization under Section 1061(a).

10. **Distributed API Property Asymmetry**. The Final Regulations retain an anti-abuse rule in the Proposed Regulations that applies to property distributed to an API holder by a passthrough entity with respect to such API ("Distributed API Property"). If that property has a three year or shorter holding period (including the pre-distribution passthrough entity's holding period) at the time of its disposition by the API holder, the long-term capital gain recognized on the disposition is recharacterized under Section 1061(a). The Final Regulations provide that once the holding period exceeds three years, the distributed property is no longer Distributed API Property. However, unlike other capital assets held by an API-issuing passthrough entity with holding periods exceeding three years, where Section 1061(a)(2) allows the long-term capital gain recognized upon their disposition to offset capital gain from assets with shorter holding periods (which would have applied to the gain from the Distributed API Property had it not been distributed), the gain from ex-Distributed API Property is simply excluded from the Section 1061(a) calculations.

11. **Additional Rules Retained**. The Final Regulations retain several significant rules laid out in the Proposed Regulations:

    - Once a partnership interest qualifies as an API, it remains an API, regardless of transfers (including gifts), dispositions or the holder no longer providing services (i.e., retirement), unless and until one of the exceptions to API treatment applies.

- Once a bona fide third party (that does not provide services in the relevant trade or business and is unrelated to any such service provider) purchases an API for fair market value, it is no longer an API in the purchaser's hands.
- Persons who are subject to tax under Section 1061(a) (that is, persons who are not passthrough entities) are able to net losses from APIs against gains from other APIs.
- When a person receives a partnership interest in connection with the performance of services by himself or herself or by a related party, the services are presumptively substantial and, accordingly, such interest is presumptively an API.

12. **Effective Date**. With limited exceptions,[6] the Final Regulations are effective for taxable years beginning on or after the date of publication in the Federal Register.

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[6] The rule excluding S Corporations from the Corporate Exception is applicable for tax years beginning after December 31, 2017, Treas. Reg. § 1.1061-3(f)(2), and the rule excluding PFICs with QEF elections from the Corporate Exception is applicable to tax years beginning after August 14, 2020, *id.* § 1.1061-3(f)(3).

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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