Carry On My Wayward Fund: Final Carried Interest Regulations Provide Flexibility That Recognizes Industry Realities

Tax Alert

01.15.2021

Once, long ago, Mediterranean seafarers would transport or "carry" the cargo of others and earn 20 percent of the profits therefrom as compensation for their services.[1] Fast-forward to the present day and 20 percent "carries" or "carried interests" are commonplace with the captains of professional asset management. The long-time standard for a private equity fund manager's compensation is a "two-and-twenty": an annual management fee equal to two percent of the fund's assets plus a 20 percent profits interest in the fund, which is organized as a partnership for federal tax purposes.

This compensation arrangement gives rise to one of the most gabbed-about "loopholes" in the world of tax. The issuance of the profits interest to the fund manager generally escapes immediate taxation,[2] and the character of the partnership's income passes through to the fund manager (and other partners) as the fund sells off its investment assets, potentially allowing the fund manager to receive an allocation that is taxed as long-term capital gain (23.8 percent) rather than ordinary services income (37 percent), even though the carried interest represents compensation for the fund manager's services as such.

After some false-starts, Congress addressed the tax treatment of carried interests in 2017. Considering the issue, the House Ways & Means Committee stated that "the lower rates that apply to long-term capital gain from the sales or exchanges of capital assets of partnerships should not be available to holders of [carried] interests unless an extended holding period requirement has been met."[3] Hence, new section 1061 as enacted in the Tax Cuts & Jobs Act of 2017 extends the holding period required to receive long-term capital gains treatment from more than one year to more than three years. The recharacterization rule applies generally to gains on assets disposed by the partnership that are allocated to holders of partnership profits interests received in exchange for the provision of investment management services. Such interests are referred to as "applicable partnership interests" or "APIs."

On January 7, 2021 the United States Department of Treasury (Treasury) and the Internal Revenue Service (IRS) issued final regulations (the Final Regulations) under section 1061.[4] The regulations package – likely one of the last ones to be overseen in its entirety by Steve Mnuchin's Treasury – demonstrate significant engagement with stakeholders and in several key areas provides a more flexible approach to implementing section 1061 than the one Treasury and the IRS set forth in proposed regulations published last year (the Proposed Regulations).[5]

Capital Interests That We Can All Live With

An API means any interest in a partnership which, directly or indirectly, is transferred to or held by a taxpayer in connection with the performance of substantial services by him or any related person in an "applicable trade or business."[6] An applicable trade or business is any activity conducted on a regular, continuous, and substantial basis that consists of (1) raising or returning capital *and* (2) either investing in or developing "specified assets," such as securities, real estate, cash and cash equivalents, options, and derivatives.[7]

Excepted from the definition of an API is any capital interest that provides the holder the right to share in partnership capital "commensurate with the amount of capital contributed," the "Capital Interest Exception."[8] In general, this exception was meant to provide relief for any portion of a partner's allocation that was based not on a pure profits interest but rather on capital that had been contributed to, or reinvested in, the partnership. This reflects the economic reality that fund managers are often expected to commit investment capital into the funds they manage, typically in the area of one percent to three percent of the fund's total capital commitments.[9]

The Proposed Regulations provided that to qualify for this exception, two basic requirements must be met. [10] First, allocations to putative API holders must be made in the "same manner" as they are made to unrelated non-service partners. An allocation will be made in the same manner, in general, only if the allocation is based on the relative capital accounts of the partners. Second, the allocations must be clearly identified in the partnership agreement and on the partnership's books and records as separate from the allocations made to the partner on account of its API, *i.e.*, on account of its "pure" profits interest in the partnership.

Commenters noted that the restriction that allocations be based on the relative capital accounts of the partners is too rigid and excludes many common arrangements.[11] Commenters pointed out that the statute's language "commensurate with the amount of capital contributed" does *not* require allocations to be made based on overall capital accounts. Private equity funds, for example, typically do not base allocations on overall capital accounts, rather limited partners typically contribute capital in stages according to specific investment opportunities in the fund, and are allocated proceeds based on the performance of those specific investments to which they contributed. What's more, allocations and distributions are generally subject to "waterfall" provisions, which split distributions between the limited partners and the fund manager into buckets to be recovered in a specific order, typically providing that investor capital is recovered first (either on a deal-by-deal basis or a total basis). On top of that, capital accounts of limited partners are often subject to different terms than those of the general partner fund manager in various respects, including withdrawal and liquidity rights, regulatory allocations (such as minimum gain chargeback under Treas. Reg. § 1.704-2(f)), and distributions for tax payments.

The commenters were successful in getting Treasury and the IRS to revisit their thinking. [12] Accordingly the Final Regulations hew more closely to the statute, and replace the "same manner" requirement with a requirement that an allocation to an API Holder with a fund manager's capital interest must be "determined and calculated in a similar manner as the allocations with respect to capital interests held by similarly situated Unrelated Non-Service Partners who have made significant aggregate capital contributions[.]"[13] "In a similar manner" generally means that the allocations and distribution rights with respect to the fund manager's capital interest are "reasonably consistent with the allocation and distribution rights with respect to capital contributed by Unrelated Non-Service Partners[.]"[14]

The Final Regulations permit this inquiry to be made on an investment by investment basis, rather than on a partnership-wide basis.[15] The inquiry is guided by a non-exclusive list of relevant factors, which include the amount and timing of capital contributed; the rate of return on capital contributed; the terms, priority, type and level of risk associated with capital contributed; and the rights to cash or property distribution during the partnership's operations and on liquidations.[16]

Thus, the Final Regulations provide welcome flexibility with respect to the Capital Interest Exception. But, given the broad, factor-based approach, fund managers (and their advisors) will need to carefully scrutinize the allocation and distribution arrangements in their fund agreements to ensure that their capital interests actually qualify for the Capital Interest Exception.

Brother, Can You Spare Some Capital?

The Proposed Regulations prevented the Capital Interest Exception from applying to any capital contribution funded by any loan from a related party.[17] The concern, it would seem, is that capital accounts would be artificially inflated to take advantage of the Capital Interest Exception, creating an end-run around section 1061. Hence, under the Proposed Regulations, the contribution of related-party debt financed capital could only be taken account when the borrowed funds were repaid.

As commenters noted, it is common for new partners to be required to make substantial capital contributions which are often acquired through loans.[18] For example, where the general partner/fund manager is itself a partnership, as is typical, individual employees of the fund manager are often required to contribute capital to the general partner, and borrow money from a party related to the fund manager to do so. These capital contributions are not tax-motivated, rather, as Treasury and the IRS acknowledge, they are designed "to align the incentives of the [new] general and limited partners[.]"[19]

Accordingly for purposes of the Capital Interest Exception, the Final Regulations generally permit an individual partner's capital contributions to be funded with loan proceeds from related parties so long as he or she is personally liable for the loan.[20] In carving out an important exception to the overbroad rule of the Proposed Regulations, Treasury and the IRS have struck a better balance between preventing tax abuse and designing a regulatory regime that reflects commercial realities.

Transfer Time

Section 1061(d) provides that if a taxpayer transfers an API to a related person, the taxpayer must include in its gross income the excess of any long-term capital gain "attributable to the sale or exchange of any asset held for not more than three years as is allocable to such interest" over any amount of short-term capital gain so allocable. The Proposed Regulations had provided that any transfer of an API to a related person would trigger the provision, even if the transaction were otherwise a tax-free transaction (*e.g.*, a contribution qualifying for section 721 or section 351, or a gift).[21]

The Proposed Regulation's broad rule treated section 1061(d) as an *acceleration* provision in addition to being a *recharacterization* provision: allocable gain would be recognized (as short-term capital gain) on transfers to related persons, even if the transfer were tax-free under general federal tax principles.

This was, arguably, a regulatory overreach. While the plain language of the statute – which does not refer to any nonrecognition provisions – is in some sense ambiguous on this point, it seems odd that Congress intended section 1061 to cause taxpayers to recognize income and pay tax where previously no such recognition was required, as the stated rationale for the provision had to do with the *character* of income that the fund manager would recognize anyway on account of its carried interest, not the *amount* of such gain.[22]

Covering their stance in the Proposed Regulations, the IRS and Treasury stated that while section 1061(d) "can be reasonably be interpreted as an acceleration provision," a better approach in the absence of clear statutory language is to apply section 1061(d) only to transfers in which long-term capital gain otherwise would be recognized.[23] So the Final Regulations do exactly that, following a more narrow interpretation of the statutory language.[24] Needless to say, the commenters' success in getting Treasury and the IRS to back away from their initial position demonstrates the importance of engaging in the regulatory comment process.

* * *

The Final Carried Interest regulations were, on the whole, a thoughtful response to industry concerns. But applying these rules to existing and new funds will take thoughtful analysis and insight. Fortunately, Miller & Chevalier is here to help.

For more information, please contact:

Andrew L. Howlett, ahowlett@milchev.com, 202-626-5821

Anthony G. Provenzano*

**Former Miller & Chevalier attorney*

----

[1]Maxwell Gawley, *Closing the Carried Interest Loophole and the Impacts on Venture Capital* , 68 DePaul L. Rev. 671, 674 (Spring 2019).

[2]*See* Rev. Proc. 2001-43, 2001-34 I.R.B. 191 (Aug. 3, 2001) (Providing that if certain requirements are met, "[when] a person receives a profits interest for the provision of services to or for the benefit of a partnership in a partner capacity or in anticipation of being a partner, the Internal Revenue Service will not treat the receipt of the interest as a taxable event for the partner or the partnership.").

[3]H. Rep. No. 115-409, at 277 (Nov. 13, 2017).

Miller & Chevalier

[4]T.D. 9945, RIN 1545-B081.

[5]*See* 85 Fed. Reg. 49754 (Aug. 14, 2020).

[6]Section 1061(c)(1).

[7]Section 1061(c)(2).

[8]Section 1061(c)(4)(B).

[9]*See* New York State Bar Association Tax Section, *Report No. 1442 – Report on Proposed Regulations under Section 1061* 22 (Oct. 4, 2020) (NYSBA Tax Section Report) citing MJ Hudson, *Private Equity Fund Terms Research* 43 (5th ed. 2019-2020).

[10] *See* Prop. Treas. Reg. § 1.1061-3(c)(3), (4), 85 Fed. Reg. 49754, 49782 (Aug. 14, 2020).

[11]American Institute of CPAs, *Comments on Reg-107213-18, Proposed Regulations Under Section 1061* 9 (Nov. 23, 2020); NYSBA Tax Section Report at 34-35.

[12]The preamble to Final Regulations acknowledged that "it might be difficult for some common business arrangements to meet the capital interest exception[.]" RIN 1545-BO81 at 17.

[13]Treas. Reg. § 1.1061-3(c)(3)(i).

[14]Treas. Reg. § 1.1061-3(c)(3)(ii).

[15] *Id.*

[16]Treas. Reg. § 1.1061-3(c)(3)(ii)(A).

[17]Prop. Treas. Reg. § 1.1061-3(c)(iii)(C), 85 Fed. Reg. at 49782. *See also*, 85 Fed. Reg. at 49672 (preamble stating that "For purposes of section 1061, a capital account does not include the contribution of amounts directly or indirectly attributable to any loan or other advance made or guaranteed, directly or indirectly, by any other partner or the partnership (or any person related to any such other partner or the partnership.)")

[18]*See, e.g.*, American Bar Association Tax Section, *Comments on Applicable Partnership Interests under Section 1061* 22 (October 5, 2020); NYBSA Tax Section Report at 22, 46-48.

[19]RIN 1545-BO81 at 91.

[20] *See* Treas. Reg. § 1.1061-3(c)(3)(v).

[21]Prop. Treas. Reg. § 1.1061-5(a), 85 Fed. Reg. at 49792.

[22]H. Rep. No. 115-409, at 277 (Nov. 13, 2017) ("Because the character of a partnership's income passes through to partners, income from a carried interest may take the form of long-term or short-term capital gain realized by the underlying investment fund as the fund sells off investment assets. Long-term capital gain allocated to individual partners may represent compensation for their services as fund managers. The Committee believes that the lower rates that apply to long-term capital gain from sales or exchanges of capital assets of partnerships should not be available to holders of applicable partnership interests unless an extended holding period requirement has been met.").

[23] *See* RIN 1545-BO81 at 40-41 (describing change from Proposed Regulations).

[24]Treas. Reg. § 1.1061-5(a).
