The recently proposed Inflation Reduction Act of 2022 (“IRA”) includes a number of tax provisions, the most important of which for our fund and real estate clients involve changing the existing rules targeting carried interests. The changes would (i) make holders of carried interests in hedge funds, private equity funds, and VC funds almost invariably unable to qualify for long-term capital gain rates on income from their carry; and (ii) subject holders of certain profits interests with respect to real estate investments, including real estate funds, to similar rules.

One positive surprise for these clients is that the IRA omitted anticipated changes that would have subjected essentially all management fees (regardless of whether run through a limited partnership or S corporation) to the 3.8% self-employment/net investment income taxes.

The principal carried interest changes are discussed below, and are proposed to be effective for taxable years beginning after December 31, 2022. Overall, the new rules may succeed in making carried interests a less attractive form of compensation for many (but not all) funds after that date. If the revisions are passed, we will work with our fund clients to determine what planning may best be implemented for the remainder of 2022 (such as accelerating gains or making non-taxable transfers of carried interests). We will also work to determine how best to structure compensation from future funds (and even the funds themselves) in light of these changes.

Recharacterizing Carried Interest Income Taxed as Capital Gains as Short-Term Capital Gains

The IRA targets carried interests associated with the asset management industry.

It would generally recharacterize all income taxed at long-term capital gain rates (“LTCG”) earned with respect to a carried interest as short-term capital gain. In contrast, current law only recharacterizes LTCG earned with respect to a carried interest if derived from certain classes of assets. Notably, LTCG from funds with rental/investment real property would become subject to these rules.

Even for funds rarely realizing LTCG on their carried interests (such as active trader funds), sponsors may be unhappy to see the sales of their carried interests fail to produce LTCG. Additionally, sales of interests in sponsors’ entities may often prove subject to the recharacterization rules (apparently even as to gains from goodwill).

Very Limited Holding Period Exception from Short-Term Capital Gain Recharacterization

The new law would offer an exception from short-term-capital-gain recharacterization, but only if a new holding period rule is met. This would revise and replace the more favorable holding period exception under current law.

Absent generous legal guidance from the IRS, this new holding period exception may prove illusory for many fund sponsors. It seems possible that Congress wanted to generally eliminate rate preferences for carried interests but thought that the bill would be more likely to pass by framing the changes as merely lengthening the holding period.

Specifically, after the revisions, the holding period to avoid recharacterization of LTCG income earned with respect to a carried interest would be five years, beginning on the latest of three dates: (1) the date on which the carried interest holder acquired substantially all of the carried interest, (2) the date on which the carried interest-issuing partnership acquired substantially all of its assets, and (3) the date on which the foregoing rules are met for partnerships deemed owned by the carried interest-issuing partnership.

If these new "substantially all" rules and deemed ownership rules are interpreted by the IRS as seemingly intended by Congress, many funds and related entities will have trouble even starting the five-year period. For example, open-end funds may never acquire substantially all of their assets, as they might have general partner entities continuously acquiring new carried interests. Further, closed-end funds raising and acquiring targets over many years may find the five-year period extending past winding down of the fund.

Real estate funds may find themselves better able to meet the holding period requirements, depending on IRS guidance and their business model (e.g., many acquire a single property and hold it for a number of years). If the law passes, promotes issued to developers in many real estate joint ventures could become subject to these recharacterization rules absent guidance issued by the IRS to exempt transactions when the “asset [is] not held for portfolio investment on behalf of third party investors.” Additionally, the period for real estate investments is generally three years (not five) after meeting the “substantially all” requirements.

Taxation of Every Transfer of Carried Interests

The new law would make all transfers of carried interests generate immediate gain. This would occur apparently without regard to the identity of the recipient or even if the transfer is a gift. This would create many problems in attempting to perform transactions with carried interests that are currently tax-free (e.g., dividing existing carried interests over multiple entities or certain estate planning transactions).

Certain common transactions are likely to remain unproblematic, however; for example, converting realized gains from a carried interest into deemed purchases of capital partnership interests is unlikely to constitute a transfer triggering gain.

Bolstering Government Defenses to Workarounds for the Carried Interest Rules, and Room to Lighten Up Application

In numerous places, the revisions provide the IRS great ability to write regulations to adjust the application of the anti-carried-interest rules and to prevent workarounds (including ones involving the distribution of certain assets, carry waivers, and specially designed financial instruments recreating API exposure). Other revisions bolster the validity of existing IRS guidance for the carried interest rules.

More beneficially for fund managers, the IRS would have regulatory power to exclude from recharacterization LTCG attributable to any asset not held for portfolio investment on behalf of third-party investors, which could fix some of the headaches the revisions may cause for partnerships not aimed at third parties, or for non-financial assets (such as goodwill).

* * * * *

We will continue to monitor the legislation and assist clients with any questions and concerns they may have as to these changes.

For further assistance, please contact a member of the Tax group at Shartsis (Rafi Mottahedeh, Dashiell Shapiro or Mark Mullin) or a member of the Investment Funds & Advisers group (John Broadhurst, Carolyn Reiser, Neil Koren, Jim Frolik, Christina Hamilton, David Suozzi, Anthony Caldwell, Jahan Raissi, Joan Grant, Kat Miller or Emma Wolfe).

Previous letters to our investment advisory clients and friends and additional discussions of topics relevant to private fund managers, investment advisers and private investment funds can be found at our insights page: www.sflaw.com/blog/investment-funds-advisers-insights.

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