On July 31, 2020, the Internal Revenue Service (the "**IRS**") and U.S. Department of the Treasury released proposed regulations under Section 1061 of the Internal Revenue Code (REG-107213-18) (the "**Proposed Regulations**"). Section 1061 was added to the Code as part of the Tax Cuts and Jobs Act of 2017, significantly altering the tax treatment of "carried interests" issued by tax partnerships. The Proposed Regulations represent the IRS' initial regulatory guidance and will not be finalized until the public has had a chance to review and comment on them. They do, however, represent a significant step in the rule making process and may generally be relied upon now as the IRS' interpretation of the law. Those holding or issuing carried interests should understand how the Proposed Regulations may affect them.

Basic Rules of §1061 Recharacterization

Carried interests are often issued to investment fund managers in exchange for their services to the fund and require little or no capital investment from the recipient. When properly structured, the issuance of a carried interest does not cause immediate taxation to the recipient. It instead represents a disproportionate interest in the fund's future income, including long term capital gains, in relation to the capital invested by a carried interest partner. Section 1061 does not change these results, but instead imposes an additional holding period requirement for capital gains associated with a carried interest.

Carried interests are referred to in Section 1061 and the Proposed Regulations as "**Applicable Partnership Interests**," or "**APIs**." APIs can only be issued by partnerships that are engaged in "**Applicable Trades or Businesses**," or "**ATBs**," which generally cover the businesses of most investment funds (i.e. hedge, private equity, venture and real estate funds). Ordinarily, capital gains are taxed at preferential long term capital gains rates if a capital asset is held for more than one year. However, if a person holds an API, long term capital gains will be recharacterized as short term capital gains unless these gains are from assets that were held for more than three years.

Notably, if a partner holds an API and also invests capital in the partnership as a bona fide investor, that capital interest is not treated as an API. To be respected by the IRS as a capital investment, it must have the same rights and preferences as other third party investors. The Proposed Regulations provide further detail on acceptable capital investments that will not be grouped with a partner's API.

Effect on Carried Interests Issued to Corporations

Under Section 1061 if a carried interest is issued to a corporation it will not be treated as an API. After Section 1061's initial passage many practitioners noted that the statutory definition exempts all corporations, which technically includes C corporation, S corporations and any foreign corporations. S corporations and certain foreign corporations (e.g. a passive foreign investment company ("**PFIC**") that is taxed as qualified electing fund ("**QEF**")) are generally taxed as passthrough entities. Holding a carried interest in one of these specific corporate structures ostensibly would have prevented a carried interest from being characterized as an API, avoided a corporate level tax, and escaped the three year holding period of Section 1061.

The Proposed Regulations state that APIs held by corporations that are generally taxed as passthroughs (e.g. S Corporations and QEFs) will still be treated as APIs. Whether the IRS has the power to do this remains a matter of some debate and resolution might require further legislative or judicial action. Any person attempting to implement a structure that is counter to regulatory guidance should discuss it with their tax advisors to understand the risks.

The Applicable Holding Period

Consistent with past IRS guidance the holding period for Section 1061 is measured at the level of the partnership selling a capital asset. This allows newly admitted partners holding APIs to obtain long-term capital gains as long as a fund sells capital assets held for more than three years. Additionally, the holding period for property distributed in kind to partners will include the holding period of both the fund and the partner. That distributed property must be held for a combined holding period of more than three years to avoid the gain recharacterization of Section 1061 on a sale. Therefore, a fund may distribute securities to a partner that have been held for one year, but that partner would then need to hold such securities for more than two years for any gains to be taxed as long term capital gains.

Unlike the gains from assets held by or distributed from partnerships, gains from dispositions of APIs themselves are generally characterized by the holding period of the partner. Although there are limited lookthrough rules on the sales of APIs that can recharacterize some gains to the extent the underlying partnership's does not have a three year holding period in its assets.

Assets Exempt from 1061

Significantly, Section 1061 applies only to capital gain that is characterized under the standard holding period rules. This category of common capital assets generally includes corporate stock and certain partnership interests. Long term capital gains determined outside of the standard holding period rules are exempt from the

three year holding period requirement of Section 1061. This category of exempt assets and income includes: §1231 property (depreciable property used in a trade or business, like most real estate), §1256 contracts (certain publicly traded derivatives), and qualified dividends (C corporation dividends eligible for capital gain rates).

Stuffing Allocations and Accounting

Throughout the Proposed Regulations, special rules conform the guidance to common fund structures. For example, rules address multitier entity structures, using familiar partnership mechanisms to ensure gain from an API is allocated to the intended holders. One particular change is aimed at modifying the "stuffing" allocation method commonly used by hedge funds. Partnerships that use stuffing allocations must now ensure that they take into account the application of Section 1061. The Proposed Regulations do not go so far as to provide a safe harbor application of Section 1061 principals to stuffing allocations. The preamble, however, suggests that securities partnerships should consider establishing unrealized API gain and loss accounts for this purpose, or identifying another reasonable method.

Transfers to Related Parties

If a person transfers an API to a related party (e.g. family members, persons engaged in the same ATB and related passthroughs), in an otherwise nontaxable transfer, Section 1061 recharacterizes that transfer as taxable. Specifically, this will trigger short-term capital gains equivalent to what would have been allocated to such transferred API if the subject partnership sold all of its assets with a holding period of more than one but not more than three years.

The rule thus adds hazards when APIs are transferred as part of estate planning or in restructuring multitier structures. Fortunately, the rules provide that gifts to grantor trusts, as well as contributions to partnerships, will not cause this gain to trigger.

For More Information

The Proposed Regulations are substantial and complex. This client alert is only a high level overview of a certain portion of these provisions. It is not intended to provide legal advice, and no legal or business decision should be based on its contents. For further information please contact any member of the Shartsis Tax group.

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For information on the potential outcomes and assistance with the numerous challenges of transferring carried interests to family members, please contact any member of the Shartsis Family Wealth Planning group.

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