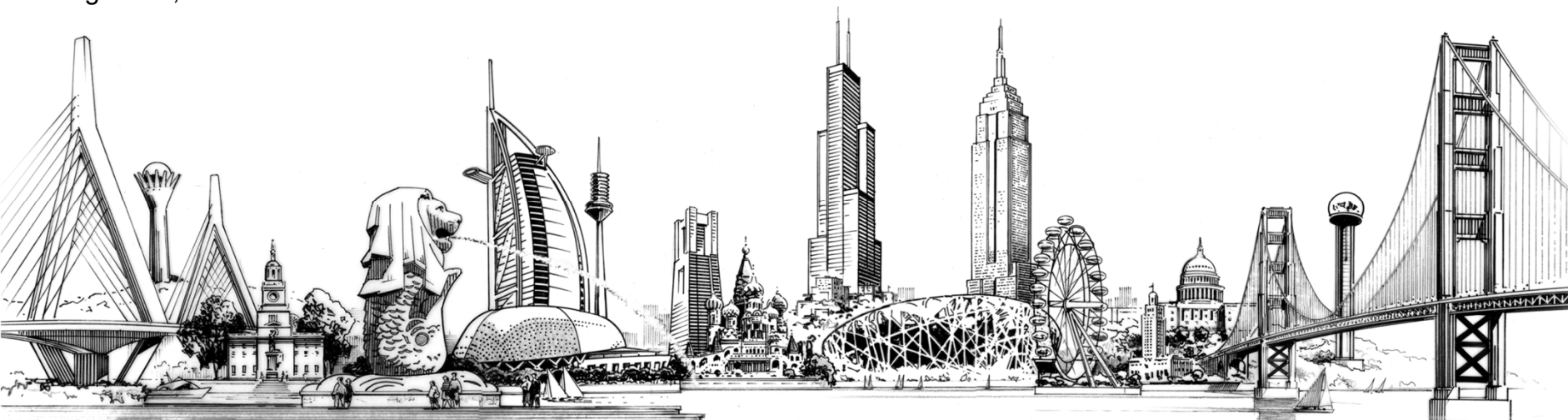


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# THE NEW PROPOSED RULES ON CARRIED INTEREST – ISSUES AND IMPLICATIONS

Speakers: Daniel Carmody, Sarah-Jane Morin, Daniel Nelson, Jason Traue, Richard Zarin, and Meghan McCarthy  
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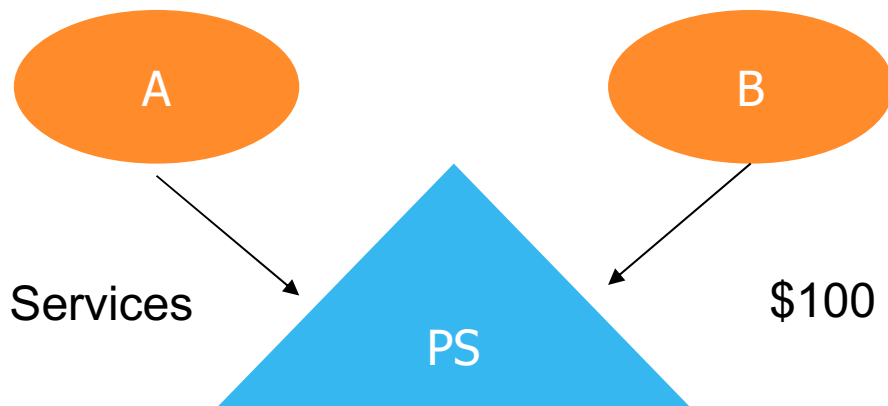
# Agenda

- Carried Interest Background
- The Applicable Partnership Interest (“API”)
- Holding Period and Gain Issues
- Exceptions
- Capital Interest Allocations
- Interaction with Proposed Fee Waiver Regulations
- Tiered Partnership

# **CARRIED INTEREST BACKGROUND**

# Revenue Procedure 93-27

- What is a “profits interest”?
- What is a “capital interest”?
- How are they treated?
- Exceptions?



# The Road to Section 1061

- 2007 Congressional Hearings
- Section 710 proposals
- Section 1061
  - Accepts the premise of Rev. Proc. 93-27
  - Requires a three-year holding period for capital gains “with respect to . . . applicable partnership interests” to qualify for long-term capital gains rates
  - Service providers don’t receive compensation income, but have to deal with holding period challenges

# **THE APPLICABLE PARTNERSHIP INTEREST**

# Substantial Services & Related Person Issues

An API is a partnership interest transferred to (or is held by) the taxpayer in connection with the performance of substantial services by the taxpayer, or any other related person, in any applicable trade or business.

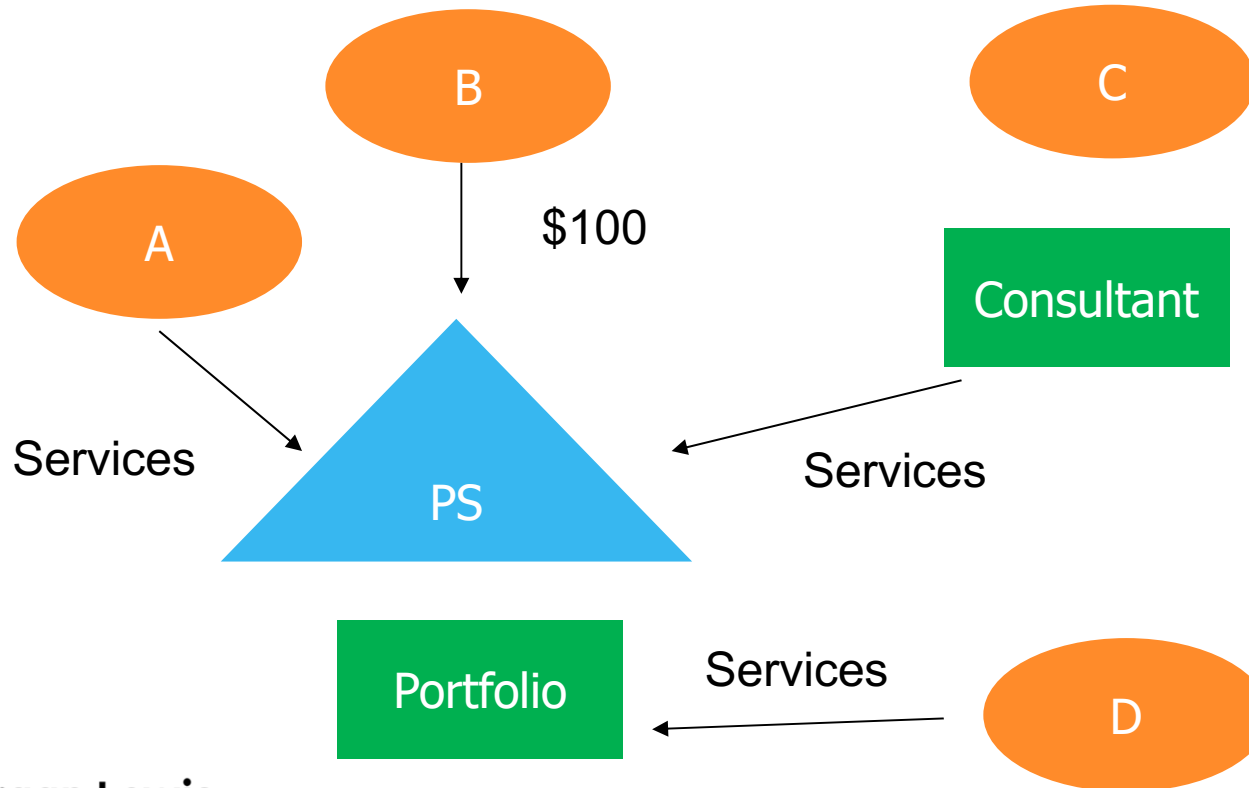
- What are “substantial services”?
- Who is a Related Person?
- Are all carried interests an API?



# Applicable Trade or Business

- Any activity conducted on a regular, continuous, and substantial basis (through one or more entities) which consists of:
  - Raising or returning capital; and
  - Either: (i) investing in (or disposing of) “specified assets”; or (ii) developing “specified assets”
- Specified assets: securities, commodities, real estate held for rental/investment, cash or cash equivalents, options or derivative contracts with respect to foregoing, and an interest in a partnership to the extent of the partnership’s proportionate interest in any of the foregoing.
- Potential issues in holding partnership structures (e.g., for private equity portfolio companies) where services might be viewed as for the benefit of both an underlying entity’s non-applicable trade or business and the holding partnership’s applicable trade or business.

# Example – Who has the API?



# Once an API; Always an API

- PS is formed in Year One, with Partner A receiving an API
- Partner A stops providing services to PS in Year Four
- In Year Ten, PS acquires Blackacre
- In Year Twelve, PS sells Blackacre for a gain. Result to Partner A?
- What if Partner A had sold interest in PS to unrelated third party in Year Eleven?

**GAINS SUBJECT TO 3-YEAR  
RULE**

**TRANSFERS OF AN API**

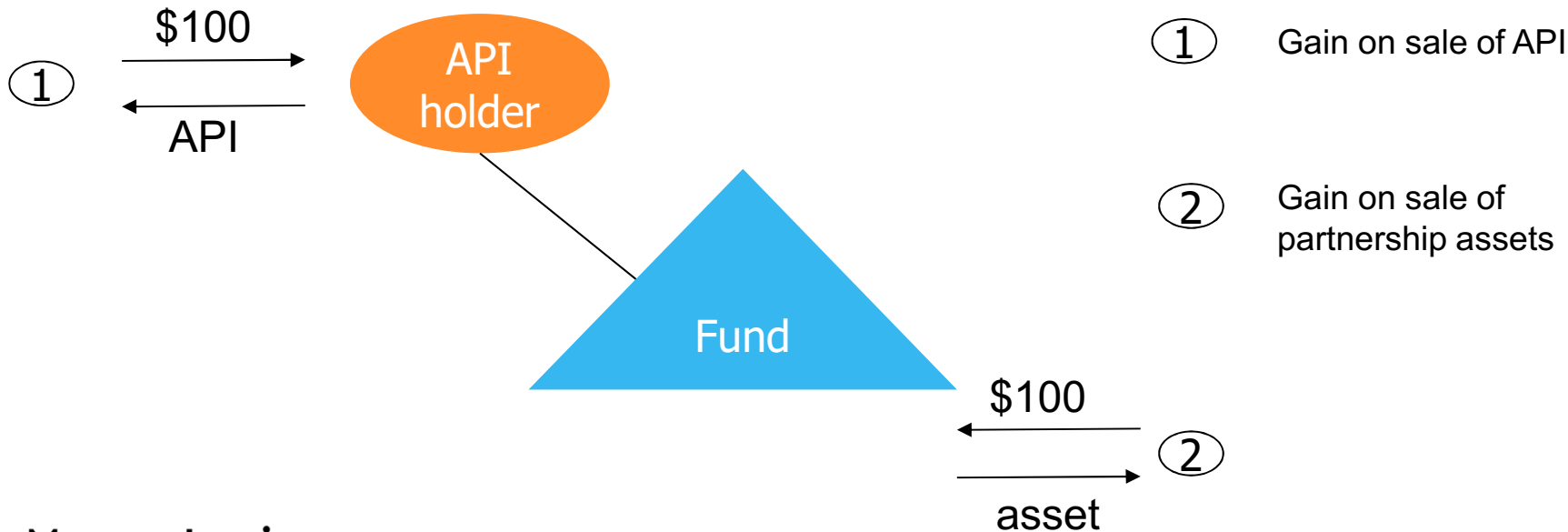
**HOLDING PERIOD ISSUES**

# Gain to which 3-year rule applies

- Section 1061 focuses on net long-term capital gain
- Certain categories of tax-favored income not subject to 3-year rule
  - Section 1231 gains (gains from the sale of property used in a trade or business)
  - Qualified dividend income
  - Mark-to-market gains from “Section 1256 contracts” (certain futures and options contracts)
- Planning implications at portfolio level
  - Asset sales by tax transparent portfolio companies that would generate Section 1231 gains
  - Recapitalizations of portfolio companies that would generate qualified dividend income

# Levels at which holding period is tested

Section 1061 focuses on net-long term capital gain “with respect to” APIs. The holding period used for testing gain can be at different levels (e.g., at the fund level, or at the level of the API holder).



# Distributions in-kind

- If a partnership distributes an asset in-kind to the holder of an API, the subsequent gain from the sale of the asset by the API holder remains subject to the 3-year rule
  - Holding period determined on a combined basis (i.e., the partnership's holding period at the time of distribution plus the API holder's further holding period "outside" the partnership)

# Sales of APIs -- lookthrough rule

- In general, when an API is sold, the 3-year rule is applied by reference to the seller's holding period in the API (and not the holding periods in the underlying portfolio assets)
- A "lookthrough rule" may change the result in two situations:
  - A tiered partnership structure. For example, an individual holds an interest in an upper-tier partnership with a >3 year holding period, and the upper-tier partnership holds an API in a lower-tier partnership with a <3 year holding period. In this situation, the holding period in the API in the lower-tier partnership controls.
  - If 80% or more of the total FMV of non-cash assets of the partnership granting the API have a holding period of 3 years or less, then gain from the sale of the API can be treated as partially short-term.



# Transfers of APIs to Family Members and Colleagues

- Transfers of an API to certain family members and colleagues can trigger gain recognition
  - Results in the recognition, as short-term capital gain, of the excess of (1) the gain that would be recognized on the hypothetical sale of underlying partnership assets with a holding period of 3 years or less, over (2) the amount of short-term capital gain otherwise recognized under Section 1061(a)
  - In essence, a mark-to-market rule
  - Scope of family members and colleagues (different than the related party standard that otherwise applies for Section 1061 purposes)
    - Spouse, children, grandchildren, parents
    - A person who performed services within the current calendar year or the preceding three calendar years in the relevant applicable trade or business to which the transferred API relates
- This rule can apply to a transaction that would otherwise not result in gain recognition
- However, this rule does not apply to the contribution of an API to another partnership (because Section 704(c) will address the built-in gain)

# Amendment to Holding Period Rules

- Existing Treasury Regulations Section 1.1223-3 provides for a bifurcated holding period for partnership interests
  - Existing rules focus on “contributions” and relative fair market values of interests acquired at different times
  - Application of existing rules to grants of additional carried interest is unclear
- The proposed regulations would amend Treasury Regulations Section 1.1223-3 to create a bifurcated holding period for carried interest grants
  - The bifurcation analysis would be performed at the time of disposition
- Because this amendment is not limited to APIs, it has broader implications (e.g., in relation to changes in profits sharing percentages in an operating partnership)

# EXCEPTIONS

# Exception for Corporations

- The statute has an explicit exception that APIs do not include any interest held directly or indirectly by a corporation.
- What about S corporations?
  - Consistent with Notice 2018-18, the Proposed Regulations provide that an S corporation is not considered a corporation for purposes of the corporation exception.
  - The rule related to S corporations applies to tax years beginning after December 31, 2017.
- What about PFICs?
  - The Proposed Regulations exclude PFICs for which a QEF election has been made from the corporation exception.
  - The rule related to PFICs is effective from the date the Proposed Regulations are published in the Federal Register.

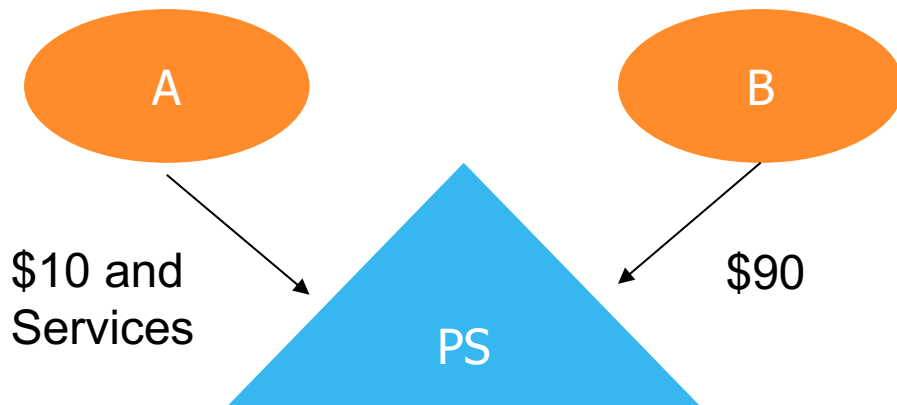
# Additional Exceptions Possible?

- Section 1061(b) – “To the extent provided by the Secretary, subsection (a) shall not apply to income or gain attributable to any asset not held for portfolio investment on behalf of third party investors.”
  - What could this cover?
  - Family Office arrangements?
- Possible exceptions for small partnerships
  - Preamble teaser
  - Extent of regulatory authority?

# CAPITAL INTEREST ALLOCATIONS

# Concept – Example Based on Statutory Language

Section 1061(c)(4)(B) provides that an API will not include any capital interest in the partnership which provides the taxpayer with a right to share in partnership capital commensurate with – (i) the amount of capital contributed (determined at the time of receipt of such partnership interest), or (ii) the value of such interest subject to tax under section 83 upon the receipt or vesting of such interest.



PS waterfall gives A and B a preferred return and a return of capital. Then distributions are made 80% to A and B in proportion to their original capital contributions, then 20% to A.

A's \$10 capital should be treated like B's \$90 capital.

# Focus of Proposed Regulations

- Definition of “Capital Interest Allocations”
- Proposed Regulations focus on allocations that are proportionate to equity value.
  - Is this consistent with statutory focus on “contributions.”
  - What about carry-free allocations to a general partner or special limited partner?
  - Role of capital accounts.
  - Debt-financed contributions may not count. Anything else excluded?
- Even though “once an API, always an API,” a holder of an API can also receive “Capital Interest Allocations.”
- Example for Discussion.



# Distributions/Contributions?

- Potential strategies for creating Capital Interest Allocations
  - Distribution/contribution arrangements
  - Build API Holder's capital account
  - Are "contributions" essential?
  - Circular cash flow? Consider dividend/reinvestment program ideas.
- Treatment of actual or deemed cash or in-kind contributions reflecting hedge fund carried interests
- Are there other approaches to creating Capital Interest Allocations?
- Do "book-ups" create flexibility?

# Disconnect with Practice?

- The proposed regulations assume a traditional capital account based agreement (but don't require it).
- Description of normal private equity partnership economics.
- Description of normal hedge fund partnership economics.
- Can the proposed regulations be reconciled with typical agreements?

# **INTERACTION WITH PROPOSED FEE WAIVER REGULATIONS**

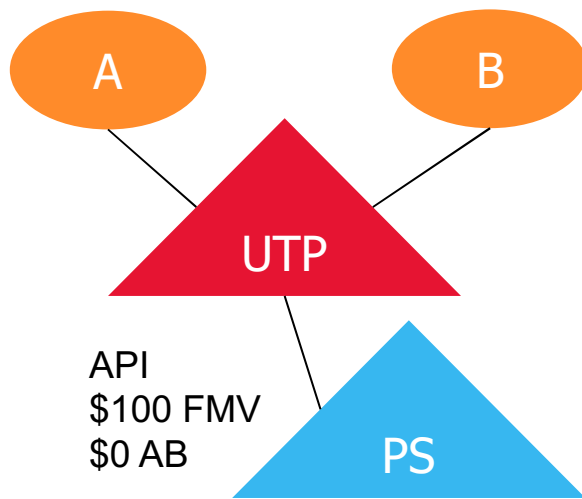
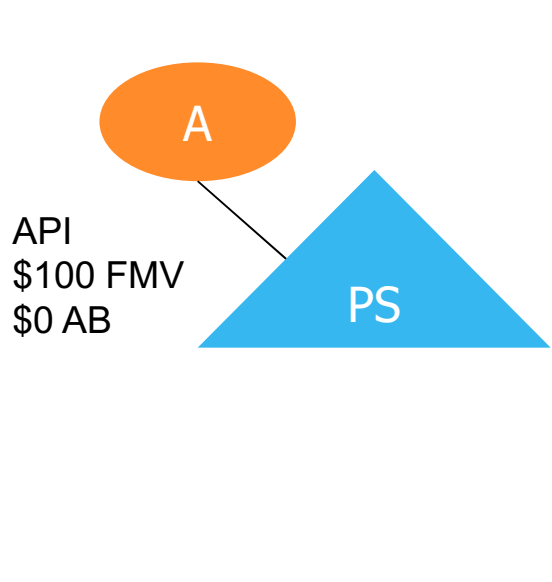
# Proposed Fee Waiver Regulations

- Section 707 disguised compensation rules
- Discussion of traditional fee waiver arrangements.
- 2015 proposed regulations on fee waiver arrangements.
- Interaction with section 1061 concepts?
- Discussion Example.

# TIERED PARTNERSHIPS

# Book-Ups and Section 704(c) Concepts

- Partnerships are not considered related parties for related party transfer rules.
- Anticipation that “book-up” would track API consequences.



What about gain above \$100?

# Information Reporting

- If there are API holders, partnership now needs to track additional holding period to the three year mark.
- What about lower-tier partnerships?
  - What are the obligations if an API is contributed?
  - What are the obligations if an upper-tier partnership might issue an API?
- Additional K-1 statements
- Do partnership agreements need to be amended?

**QUESTIONS?**



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Daniel F. Carmody counsels clients on tax matters involving domestic and international transactions. In particular, his practice focuses on structuring partnerships, limited liability companies, and Subchapter S corporations. He also represents clients in audits and appeals before the Internal Revenue Service.

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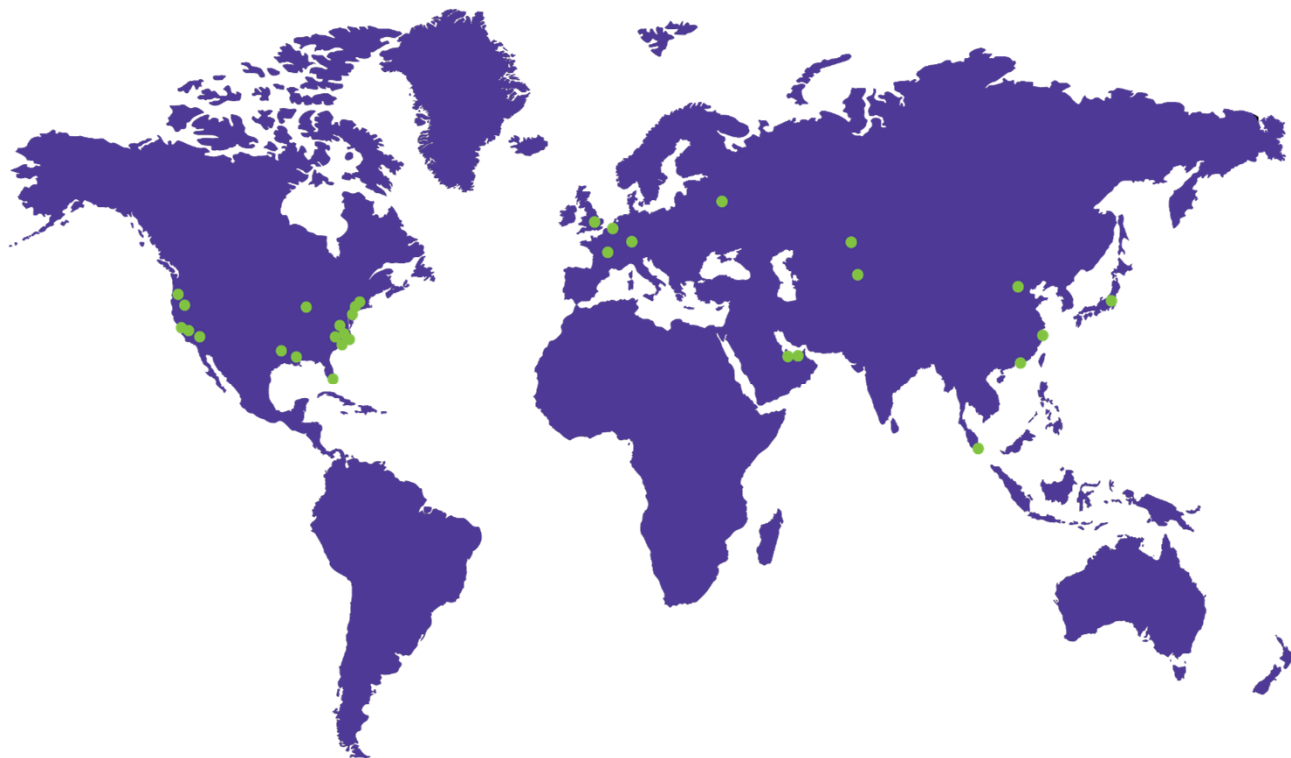
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