MorrisonCohen LLP

> Client Alert

Private Equity and Hedge Fund Professionals Need to Heed Final IRS Rules on Three-Year Holding Period Applicable to Carried Interests

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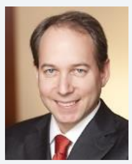

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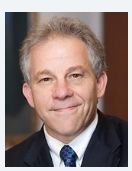

The Tax Cuts and Jobs Act imposed a three-year holding period on "carried interests," which limits the ability of private equity, hedge fund and other investment professionals to be taxed at long-term capital gains rates generally on the sale of the portfolio assets that their funds invest in.

Long-term capital gains rates are currently taxed at a maximum rate of 23.8% (including the 3.8% net investment income tax), with the maximum short-term capital gains rate / ordinary income rate currently set at 40.8% (including the 3.8% net investment income tax).

The Internal Revenue Service recently issued final regulations on how to apply the three-year holding period. Proposed regulations were issued in July 2020 (please see our prior alert here), and private equity and hedge fund professional need to be mindful that the new three-year holding period primarily applies to the gain or loss on:

- sales of their carried interests; and
- distributions or allocations of gain they receive from the sale of a fund's portfolio assets.

Although the three-year holding period for carried interests has been in effect for several years, the final regulations will generally only apply to tax years beginning on or after January 19, 2021. However, investment professionals may choose to rely on them for tax years beginning after 2017, as long as they do so consistently.

Questions and Answers Covered

Q&A-1 to Q&A-7: In *what situations* does the three-year holding period apply?

Q&A-8: *Who* does the three-year holding period apply to?

Q&A-9 to Q&A16: *How* to apply the three-year holding period.

Q1: What does the three-year holding period potentially apply to?

The three-year holding period potentially applies to:

- capital gains and losses attributable to ***carried interests*** (see Q&A 2);
- that are issued to an ***owner*** or ***passthrough entity*** (see Q&A 3);
- in exchange for substantial services (see Q&A 4) by the *owner, the passthrough entity,* or a ***related person*** (see Q&A 5); and
- that are rendered to an ***applicable business*** (see Q&A 6).

Once a carried interest is "tainted" by the three-year holding period rules, it is subject to them until an exception removes that taint (see Q&A 7).

Q2: What are carried interests?

Carried interests are ownership interests in *passthrough entities* issued to private equity and other investment professionals to compensate them for when the fund they manage sells a portfolio company (or other asset) at a gain. Carried interests almost always take the form of profits interests in a *passthrough entity* that is taxed as a partnership. Carried interests are not taxable to the recipient on grant, a result unchanged by the final regulations.

Some private equity sponsors elect to waive a portion of their fund management fees (which would be taxed at ordinary income rates when received) in order to receive additional profits interests in the fund instead. The final regulations do not disallow such management fee waivers. However, the proposed regulations warned that these mechanisms may be challenged and not respected by the IRS. The IRS also has other regulatory projects addressing management fee waivers. See "Treasury Department Issues Proposed Regulations on Management Fee Waiver Arrangements."

Q3: What is an owner or a passthrough entity?

An ***owner*** is any individual, estate or trust who is subject to federal income taxes and receives and directly holds carried interests issued in exchange for *substantial services* rendered to an *applicable business*.

However, because *owners* often hold carried interests indirectly through other entities that do not themselves constitute an *applicable business*, for example, the general partner in a private equity fund, the three-year holding period also applies to those ***passthrough entities*** by "looking through" those entities to the *applicable business*. In addition to partnerships, *passthrough entities* also include S corporations, and PFICs (passive foreign investment company) that have elected to be a QEF (qualified electing fund).

Q4: What are substantial services?

If carried interests are issued to an *owner, passthrough entity*, or *related person* in connection with the performance of services, the *owner, passthrough*, or *related person* is presumed to have provided substantial services.

Q5: What is a related person?

A *related person* is defined very broadly, and is considered related to an *owner* or a *passthrough entity*, for example, where the person:

- is a member of the *owner's* immediate family;

- owns more than 50% of the capital or profits interests of a *passthrough entity or entities*;
- owns more than 50% of the value of the stock of a corporation or corporations that are *passthrough entities*; or
- is a grantor and a fiduciary of any trust that is a *passthrough entity*.

Q6: What is an applicable business?

An ***applicable business*** is effectively an investment fund and is defined as any trade or business involved in (1) ***raising or returning capital*** and (2) ***investing or developing actions***. An *applicable business* can be found even if only one activity is taken during the year, and another activity is taken in a later year. Activities by *related persons* are also taken into account.

Raising or returning capital means actions involving raising or returning capital that are not *investing or developing actions*.

Investing or developing actions means (1) investing in, among other things, securities, options or derivative contracts, or real estate held for rental or investment, or (2) representing to investors, lenders, regulators or other persons that the value, price or yield of a portfolio business will increase in connection with actions of the investment professional. This latter test does not include merely exercising voting rights or managing working capital.

Q7: What types of interests are excluded from the three-year holding period rules?

Excluded interests include those interests:

- issued to executives and employees at portfolio companies (*i.e.*, an operating business that is owned by, but is not itself, an *applicable business*);
- issued to a C corporation or a PFIC that has not elected to be a QEF;
- purchased by third-party purchasers for fair market value in a taxable sale, *e.g.*, secondary sales;
- that are treated as ***capital interests***.

    (a) For investment professionals, "*capital interests*" only include interests arising from capital contributed to a fund where the associated allocation and distribution rights are "*reasonably consistent*" with those that apply to non-investment professionals who have contributed 5% or more of the fund's capital. This rule can be applied on a fund-wide basis, or on the basis of different classes of interests in, or individual investments by, a fund as long as the 5% threshold is met for the particular investment or class of interest.

    - Factors used to determine whether allocations and distribution rights with respect to *capital interests* are "reasonably consistent" include the amount and timing of capital contributed, the rate of return, the terms, priority, type and level of risk, and the rights to cash or property distributions during the fund's operations and on liquidation.

    (b) Capital account balances obtained through contributions attributable to a loan or other advances are counted if the loan is fully recourse, and there is no right to reimbursement or guarantee by any third party.

    (c) Where an investment professional makes a cash investment in exchange for a *capital interest*, the fact that the investment professional (unlike third-party investors) does not have to pay management fees or carried interest on the investment professional's *capital* *interests* will not affect the investment professional's *capital interest.*

(d) Gains from carried interests that are reinvested on an after-tax basis also qualify for *capital interest* treatment.

Q8: If the interests are covered by the final regulations and an exclusion does not apply, who does the three-year holding period ultimately apply to?

The *owner* (and not any *passthrough entity*) must ultimately pay taxes at short-term capital gains rates on any capital gains that have not met the three-year holding period. Any *passthrough entity* will "flow up" any capital gains (whether short-term or long-term) through to the *owner* so that the *owner* can calculate and pay its taxes.

Even though the *owner* is the ultimate taxpayer, (1) the *owner's* holding period is used to determine whether the three-year holding period is met if the carried interest in the applicable fund is held directly by the *owner*, and (2) the *passthrough entity's* holding period is used if the carried interest in the applicable fund is held indirectly by the *owner*, through the *passthrough entity*.

Importantly, the final regulations do not supersede the unitary basis rules applicable to partnerships. As a result, where carried interests and/or capital interests are acquired at different times and are later sold, it is likely that a "slice" of each interest will be deemed to be sold, resulting in a sale of some interests that have shorter holding periods than others.

Q9: If the three-year holding period applies, how much capital gain is subject to short-term capital gains rates?

The amount that is subject to short-term capital gains rates is equal to the ***aggregate capital gains*** less the ***three-year capital gains***.

Q10: How are aggregate capital gains determined if the owner directly holds the carried interest in the fund?

Aggregate capital gains (whether one-year or three-year) are essentially the *owner's* share of capital gains:

- allocated by the fund on the sale of its portfolio companies (or the portfolio companies' assets);
- on the sale of assets by the fund;
- from taxable distributions by the fund (such as distributions of cash in excess of the *owner*'s basis in the fund);
- from distributions of "hot assets" held by the fund (*e.g.*, unrealized receivables or substantially appreciated inventory) in exchange for all or a part of the *owner's* carried interest in the fund; and
- on the *owner's* sale of its carried interest in the fund.

Q11: How are three-year capital gains determined if the owner directly holds the carried interest in the fund?

Subject to the special "*lookthrough*" or "*installment sale*" rules (see Q&A 13 and 14), ***three-year capital gains*** are essentially the owner's share of capital gains:

- allocated by the fund on the sale of its portfolio companies (or the portfolio companies' assets) held for more than three years by the fund;
- on the sale of assets distributed by the fund where the owner has a holding period of more than three years;

- from disposing of an interest in the fund where the owner has held the carried interest for more than three years;
- from deemed exchanges of "hot assets" held by the fund for more than three years (*e.g.*, unrealized receivables or substantially appreciated inventory) that would otherwise result in long-term capital gains; and
- the owner's gain on the sale of its carried interest in the fund held for more than three years.

The same exclusions apply to *three-year capital gains* as they do to *aggregate capital gains*.

Q12: Are any <u>types of capital gains</u> exempt from the three-year holding period rules?

Some special kinds of "capital gains-type" income are exempt from the three-year holding period rules, even if associated with carried interests:

- qualified dividend income – because of this exclusion, dividend recapitalizations from portfolio companies that are C corporations may become even more important in unlocking value that is <u>not</u> subject to the three-year holding period. For funds with foreign investors, this approach may trigger withholding issues for them;
- gains from the sale of real property and depreciable personal property used in a trade or business and held for over one year (Section 1231 property);
- mixed straddle gains (Section 1092 gains); and
- "mark-to-market gains" from certain futures and options contracts (Section 1256 gains).

Q13: Are there <u>any special rules that alter</u> an otherwise applicable three-year holding period?

Yes. Carried interest gain recognized on an ***installment sale*** is classified as one-year gain or three-year gain based on the year the sale took place, no matter when paid.

Where an *owner* holds its carried interest in a fund through another entity – like the typical general partner/fund structure that is commonly used by private equity partnerships – then a special ***lookthrough rule*** applies that can reduce ***three-year capital gains*** (see Q&A 14).

Q14: What is the lookthrough rule and how does it apply?

The ***lookthrough rule*** applies where an *owner* has a more-than-three-year holding period, but the entity has a less than three year holding period in its assets. To prevent investment professionals from gaming the holding period rules by transferring assets to or issuing interests in "old and cold" fund entities, the *lookthrough rule* cuts off the investment professional's holding period in the fund before the first date the fund's non-investment professionals who meet the five percent contribution threshold are legally obligated to contribute capital to the fund (*e.g*. before the fund's subscription documents are signed). There is also a generic anti-abuse rule that allows the IRS to impose the lookthrough rule if a principal purpose of the transaction was avoiding the three-year holding period rules.

Q15: What if an owner transfers its carried interests to a related person?

If an *owner* or a *passthrough entity* transfers all or a portion of a carried interest that would not be treated as having a three-year holding period to a *related person* in a taxable transaction, the *owner* or *passthrough entity* must recognize a proportional amount of any gain as short-term capital gain. For this purpose, "*related persons"* are defined more narrowly than in the general definition in Q&A 5 and include *only*:

(i) the *owner's* spouse, children, grandchildren, and parents,

(ii) persons who provided services to the relevant *applicable business* during the current or three previous calendar years (generally, the *owner's* colleagues), and

(iii) the *passthrough entity* in which any person described in (i) or (ii) holds a direct or indirect interest.

A non-taxable contribution by an *owner* or a *passthrough entity* of a carried interest to a partnership that would itself be subject to the three-year holding period rule is not considered a transfer for this purpose. In addition, a transfer to a disregarded entity – such as a grantor trust – would not be considered a "transfer" for this purpose.

Q16: What are the reporting requirements?

Generally, *owners* will need to file the information the IRS requires to ensure compliance with the proposed regulations. *Passthrough entities* must do the same, as well as provide to their *owners* sufficient information to enable them to comply with their own reporting requirements. In tiered structures, upper-tier *passthrough entities* must request the information from lower-tier *passthrough entities*. The information has to be provided by the lower-tier *passthrough entity* within 30 days after the end of the taxable year and 14 days after the upper-tier passthrough entity's request, whichever is later. *Passthrough entities* that fail to provide the required information to an upper-tier *passthrough entity* will be subject to penalty.