MorrisonCohen LLP

> **Client Alert**

IRS Issues Proposed Regulations on Three-Year Holding Period Applicable to Carried Interests

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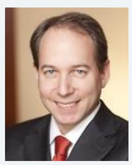

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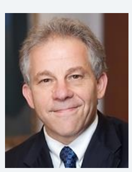

The Internal Revenue Service recently issued proposed regulations on how to apply the Tax Cuts and Jobs Act's three-year holding period to "carried interests." These proposed regulations primarily apply to the gain or loss that private equity, venture capital, real estate, hedge fund, and debt professionals recognize on:

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

The three-year holding period limits the ability of these professionals to be taxed at long-term capital gains rates, which are currently set at 23.8% at maximum (including the 3.8% net investment income tax). The maximum short-term capital gains rate / ordinary income rate is currently set at 40.8% (including the 3.8% net investment income tax).

Although the three-year holding period for carried interests is already in effect, the proposed regulations will generally only apply to tax years beginning on or after publication of the final regulations. However, investment professionals may choose to rely on them now.

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?

A. 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?

A. Carried interests are ownership interests in *passthrough entities* issued to private equity and other investment professionals to compensate them 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 proposed 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 proposed regulations do not disallow such management fee waivers, but warn 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?

A. 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?

A. 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. 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?***

A. 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 <u>types of interests are excluded</u> from the three-year holding period rules?***

A. 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) Capital interests are very narrowly defined and only include interests that permit all partners (including non-investment professionals) to share in capital proportionately based on their respective capital account balances.

  - Capital account balances obtained through contributions attributable to a loan or other advances made or guaranteed by any other partner, the partnership, or their related persons, are not counted until such loans are repaid;
  - Book ups of *capital accounts* that create a positive capital account balance do not count;
  - *Capital interests* do not include any capital gains or losses on *carried interests*;
  - Differences in rights on liquidation due to "side pockets" or follow-on investments may result in *capital interests* not being treated as such under these rules; and
  - Where an investment professional makes a cash investment in a fund 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* does not appear to affect the investment professional's *capital interest.*

(b) Generally, allocations in respect of *capital interests* will not be subject to the three-year holding period if they have the same terms, priority, type and level of risk, rate of return, and rights to cash or property distributions during partnership operations and on liquidation. In addition, these allocations must also be made in the same manner to holders of carried interests and to the unrelated non-service partners.

(c) Generally, gain on the sale of *capital interests* held for one year or more will result in taxation at long-term capital gains rates, except where a portion of the gain is attributable to carried interests subject to the three-year holding period. Helpfully, the proposed regulations provide that an *owner* can dispose of a *capital interest* and use the *capital interest's* basis when determining the gain if the *capital interest* is clearly identified, and the *owner's* basis and holding period (including split holding period) are equitably apportioned between the retained and sold interests.

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

A. 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 proposed 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?

A. 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?

A. ***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?

A. 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 types of capital gains exempt from the three-year holding period rules?

A. 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 not 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 any special rules that alter an otherwise applicable three-year holding period?

A. 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).

However, there is an exception to the shortened holding periods that can result from the *installment sale* and *lookthrough* rules *for* **transition amounts**, which are the long-term capital gains and losses recognized from the disposition of assets held by an *owner* or a *passthrough entity* for more than three years as of January 1, 2018. An irrevocable election must be made in order for any such gains and losses to be treated as *transition amounts*.

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

A. The ***lookthrough rule*** applies where an *owner* has a more-than-three-year holding period in an entity, but the entity has a less-than-three-year holding period in its own underlying assets. The *lookthrough rule* applies in the following circumstances:

- Where an *owner* has both a direct ownership interest and a three-year holding period in an *applicable business* (*e.g.*, a fund), but the fund has a less-than-three-year holding period in enough of its assets (*e.g.*, the portfolio companies) that the fund meets the ***substantially all test***;

or

- Where an *owner* has an indirect ownership interest and a three-year holding period in an *applicable business* (*e.g.*, a fund) through a *passthrough entity* (*e.g.*, a general partner), but either

  (a) The passthrough entity (*e.g.*, the general partner) has a holding period of less than three years in the applicable business (*e.g.*, fund); or

  (b) The passthrough entity (*e.g.*, the general partner) has a holding period of more than three years in the applicable business (*e.g.*, the fund) but the assets of the fund meet the **substantially all test**.

The ***substantially all test*** is met if, in a hypothetical sale, 80% or more of the aggregate fair market value of all of an entity's capital assets (including those indirectly held) would have a holding period of three years or less.

If the *substantially all test* is met, then the *three-year capital gains* is reduced by the percentage of value of the capital assets actually sold that have a holding period of three years or less divided by the value of all capital assets sold.

The 80% threshold in the *substantially all test* will spare many funds the headache of having to calculate holding periods for all the assets held by their general partner and fund.

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

A. 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*, the *owner* may be subject to immediate tax on the transfer at short-term capital gains rates, <u>*even if the transfer otherwise would not be a taxable event*</u>. Here, *related persons* are more narrowly defined than above and include only:

- the *owner's* spouse, children, grandchildren and parents,
- persons who provided services to the relevant *applicable business* during the current or three previous calendar years (generally, the *owner's* colleagues), and
- the *passthrough entity* in which any person described in (i) or (ii) holds a direct or indirect interest.

A 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.

If any tax is paid under the transfer rule, then the related person's basis is increased by the amount of short-term capital gain recognized by the *owner* or a *passthrough entity*.

The transfer rule means that <u>*virtually all estate planning transfers of carried interests will need to be analyzed to see whether (and to what extent) a tax event may have occurred*</u>. Because of the way the three-year holding period rules work (for example the *lookthrough rule*), even a transfer of a carried interest that has been held for more than three years can give rise to a taxable event.

Q16: What are the reporting requirements?

A. 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.