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IRS Finalizes Carried Interest Regulations

Tax Planning & Structuring

The IRS and Treasury Department released final regulations on January 7, 2021, that govern the tax treatment of partnership and LLC interests related to services, so-called carried interests, a/k/a applicable partnership interests (APIs), under Section 1061.

The newly added Section 1061 under the 2017 Tax Cuts and Jobs Act (TCJA), increase the holding period for APIs to qualify for lower long-term capital gain rate tax treatment from one year to three years, thereby recharacterizing gain from APIs held from one to three years as short-term gain taxed at ordinary income tax rates (37%), rather than lower long-term capital gain tax rates (20%).

Proposed regulations published in July 2020 clarified some, but not all, of the longstanding questions on how the law is applied. Many commenters felt that proposed regulations did not address common industry practices and were overly complex.

The final regulations generally adopt the proposed regulations; however, the IRS and Treasury have made numerous taxpayer-friendly modifications. Most importantly for estate and gift tax purposes, the final regulations make clear that a transfer to a family member will not be an “acceleration event” causing ordinary income unless it is a transaction in which gain would otherwise be recognized. There is no gain or loss recognition on gifts or sales to intentionally defective grantor trusts. The proposed regulations treated the transfer, including the gift within the three-year holding period, of an API or any distributed API property to a related party, such as a family member, as a taxable event.

The final regulations also provide the following highlights:

- Confirmation that the increased holding period does not apply to items of income that are separately entitled to long-term capital gain treatment, such as qualified dividends.
- Unlike the restrictions in the proposed regulations, the final regulations allow loans or advances from another partner in the partnership (or a related person, other than the partnership) to be attributed to the partner as long as the partner is personally liable for the repayment of such loan. This means that any allocations attributable to such loans or any advances will be respected as capital interest allocations excepted from the three-year holding period to qualify for long-term capital gain treatment.
- The final regulations make clear that partnership interests held by S corporations, as well as those held by passive foreign investment companies that have a qualified electing fund election in effect, do not fall within the “corporate exception” under Section1061, which provides that corporations that directly or indirectly own partnership interests are not considered API.
- The final regulations include detailed requirements that must be met for an interest to be treated as a capital interest rather than an API, and they clarify that once an interest is considered an API, it will always be treated as an API unless it meets the capital interest exception or the corporate exception. An API will still be considered an API even after the service-provider taxpayer retires or ceases to provide services to the partnership, and it is not possible to avoid Section 1061 by distributing property.
- There remains a carve-out treating section 1231 and certain real estate gains as long-term capital gain, regardless of the holding period. This is of considerable importance for real estate funds and their managers.
- A carve-out known as the “family office exception” remains reserved in the final regulations. Section 1061(b) provides regulatory authority to establish an exception to the special three-year holding period rule for income or gain attributable to any asset that is not held for investment on behalf of any “third-party investor” that has been seen as intended to apply to family offices. The preamble to the final regulations clarifies that Section 1061 is intended to apply to professional money managers that earn a carried interest for services to family offices. However, this exception is not effective until it is activated through regulations or

other guidance, and therefore remains uncertain.

The final regulations generally apply to tax years beginning on or after the date of publication in the Federal Register (subject to certain exceptions for S corporations and PFICs), and will therefore apply to existing partnership taxpayers with a calendar tax year beginning January 1, 2022. Taxpayers are permitted to apply the final regulations before that date if they are applied consistently. In the case of a new partnership formed after publication of the final regulations in the Federal Register, the final regulations will take effect this year.

Finally, it is worthwhile noting that future planning in this area is uncertain at best. Under the proposed Biden tax plan, ordinary income tax rates for individual taxpayers making more than $400,000 revert to the pre-TCJA level of 39.6% and for individuals with over $1 million in income, capital gains are also taxed at 39.6%. Further, the Biden tax plan eliminates the carried interest benefit in its entirety, meaning all such income gain will be taxed at ordinary income rates.

For additional information, or to discuss the details of the final regulations and how they may apply to your particular circumstances, please contact a member of Gould & Ratner's Tax Planning and Compliance Practice.