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Client Alert
Commentary

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Final Carried Interest Regulations: Key Takeaways for Private Fund Sponsors

While the final regulations simplify key exceptions and contain favorable changes, ambiguity continues for investment fund managers.

On January 7, 2021, the US Treasury Department and Internal Revenue Service (together, Treasury) released final carried interest regulations (the Final Regulations) under Section 1061,[1] which is intended to limit long-term capital gain treatment attributable to "carried interest" arrangements issued to owners and employees of private fund sponsors by imposing a three-year holding period requirement in lieu of a one-year holding period requirement. The Final Regulations make important modifications to the proposed carried interest regulations (the Proposed Regulations) — released by Treasury in July 2020 — that are beneficial to private fund sponsors. (See Latham's *Client Alert* Proposed Carried Interest Regulations Leave Unanswered Questions.)

Key Points:

- The Final Regulations broaden the exception for capital interests, making it easier for gain from invested capital to fall outside of the three-year holding period requirement in Section 1061 for long-term capital gain.
- Many taxpayers will not be subject to the Final Regulations until January 1, 2022, which allows time to assess implications of Final Regulations in uncertain situations.
- Rules regarding transfers of APIs to related persons have been modified to only apply to taxable transactions.

What interests are subject to the three-year holding period requirement?

The three-year holding period requirement applies to applicable partnership interests (APIs), which are generally defined as any interest in a partnership that, directly or indirectly, is transferred to (or held by) a taxpayer in connection with the performance of substantial services by the taxpayer, or a related person, in an applicable trade or business. An applicable trade or business consists of activities relating to both raising and returning capital, and investing in or disposing of specified assets. An applicable trade or business exists if the activities of the taxpayer and all related persons[2] are sufficient (when taken as a whole) to constitute a trade or business under Section 162. Specified assets include securities (i.e., shares of a corporation, interests in publicly traded partnerships, and debt instruments), commodities, real estate held for rental or investment, options, derivative contracts, and partnership interests attributable to the foregoing. If a taxpayer provides any services in an applicable trade or business and a profits interest is transferred in connection with the performance of those services, the services are presumed to be substantial. If a partnership distributes property in-kind to an API holder, the distributed property generally continues to be subject to the three-year holding period requirement upon a subsequent disposition.

Observation: The basic definition of API under the Final Regulations remains broad. As expected, APIs include "carried interest" or "incentive allocations" used in typical private investment fund arrangements, as well as profits interests issued in connection with management fee waiver arrangements. Given how broadly an applicable trade or business is defined and the presumption that services are substantial, APIs may also include many other carried interest and profits interest arrangements granted to other persons, such as managers or developers who provide services to multiple asset-specific joint ventures that own specified assets.

Exceptions to the three-year holding period requirement

Capital invested by a fund sponsor

Gains attributable to capital invested by a fund sponsor are generally not subject to the three-year holding period requirement if certain other requirements are met. Significantly, the Final Regulations broaden the exception for capital interests by eliminating some of the restrictive provisions in the Proposed Regulations that did not reflect the common economic terms of most investment funds. As a result, gains attributable to capital invested by sponsors in many typical private fund arrangements are likely to be exempt from the three-year holding period requirement, but meaningful uncertainties and exceptions remain.

Under the Final Regulations' broad definition of an API, a sponsor holding a partnership interest that includes carried interest and invested capital (potentially even when the carried interest and invested capital are held in separate related entities) would be subject to the three-year holding period requirement on both components absent a specific exception. To qualify for the capital interest exception under the Final Regulations, the terms relating to a sponsor's invested capital must satisfy several requirements, which are discussed below.

Allocations and distribution rights must be similar to those for unrelated investors

Allocation and distribution rights with respect to a sponsor's invested capital must be "reasonably consistent" with the allocation and distribution rights that apply to the capital invested by unrelated non-service providers (such as third-party investors in a fund) who hold at least 5% of the capital contributed to the partnership. Whether allocation and distribution rights are "reasonably consistent" depends on factors such as the amount and timing of the capital contributed; the rate of return on the capital contributed; the terms, priority, type, and level of risk associated with the capital contributed; and the rights to cash or property distributions during the partnership's operations and on liquidation. The capital interest exception applies to allocations made through tiered partnership structures in which an upper-tier partnership holds an API in a lower-tier partnership.

Notably, the capital interest exception applies to the sponsor's capital investment even if the investment is not subject to management fees or carried interest (unlike the investments of third-party investors), or if the sponsor is entitled to typical advance tax distributions while third-party investors are not.

Observation: While capital interests held by most private equity fund sponsors are likely to fit within the requirement that they be "reasonably consistent" with allocations made to third-party investors, it is less clear whether incentive allocations to hedge fund managers would also qualify in light of the preferential redemption rights typically afforded hedge fund sponsors.

Observation: The Final Regulations seemingly require that an unrelated non-service provider hold a similar capital interest in the *same* partnership as the person who owns the API in order for the capital interest exception to apply. Under this interpretation, sponsor capital invested through a "co-invest" vehicle that participates directly in an underlying investment alongside the fund may not qualify for the capital interest exception. An example in the Final Regulations suggests this result may not have been intended, though the preamble to the Final Regulations notes that Treasury is continuing to study the application of the capital interest exception to co-invest vehicles. Unless this requirement is further clarified, sponsors using these types of co-invest arrangements may consider investing their capital directly or indirectly through a fund entity in which third-party investors also participate to mitigate the uncertainty regarding whether their invested capital will qualify for the capital interest exception.

What is a capital interest? Effect of borrowing and reinvested carry/promote

A capital interest is an interest that would entitle the holder to a share of proceeds in a hypothetical liquidation of the partnership for fair market value at the time the interest was received, and generally includes APIs received in exchange for capital contributions.

The Final Regulations provide that the capital interest exception is not available with respect to capital contributed to a partnership that is funded with loans from the partnership or another partner in the partnership or any person related to them. This rule also applies if the partnership, other partner, or a related person directly or indirectly guarantees a loan used to fund a capital contribution. Under the Final Regulations, however, amounts funded by a partner with a fully recourse loan (i.e., for which the partner is personally liable) may still qualify for the capital interest exception, as long as (1) the individual service provider has no right to reimbursement from any other person, and (2) the loan or advance is not guaranteed by any other person. If a loan initially causes a capital contribution to be ineligible for the capital interest exception, the capital interest exception is generally available for any portion of the amount of the loan that has been repaid, provided the loan is not repaid with a similar loan.

Observation: Under this rule, capital invested with amounts borrowed by an investment professional from a sponsor will generally still qualify for the capital interest exception as long as the investment professional is personally liable. However, manager guarantees of loans, including third-party bank loans, will result in the income and gain allocated in respect of the capital funded with the loan being subject to the three-year holding period requirement, as in the Proposed Regulations, until the loan is repaid. Furthermore, the applicability of the capital interest exception may be uncertain in a number of common scenarios involving loans because the scope of an "indirect" guarantee is not entirely clear.

If a sponsor receives an allocation of taxable income or gain (as opposed to unrecognized "book" gain for partnership tax accounting purposes) with respect to its carried interest and the gain is reinvested (either as a result of an actual distribution and recontribution or as a result of the retention of such amount), the allocated gain will generally be treated as a contribution to the partnership that may be eligible for the capital interest exception.

Observation: If a hedge fund sponsor takes an incentive allocation that becomes part of the sponsor's capital account and the sponsor participates in future gains and losses pro rata with investors, the sponsor will not be able to treat the portion of its capital account attributable to a purely "book" (non-taxable) incentive allocation as eligible for the capital interest exception.

Capital interest allocations must be clearly identified in the partnership agreement

Under the Final Regulations, the capital interest exception will only be satisfied if the allocations in respect of the capital interest are "separate and apart" from the allocations with respect to the API/carried interest, and if the partnership agreement and the partnership's "contemporaneous" books and records "clearly demonstrate" that the requirements of the capital interest exception have been met.

Observation: It is not entirely clear how this requirement will apply to most standard private equity funds. The preamble to the Final Regulations indicates that many funds will not need to amend their partnership agreements in response to this requirement and also acknowledges the common use of "targeted" allocations by investment funds, which generally do not designate the specific allocations being made in respect of carried interest versus capital interests in the allocation provisions of the partnership agreement. In addition, an example in the Final Regulations in which the sponsor qualifies for the capital interest exception does not refer to any specific language in the fund agreement other than the distribution provisions.

Given that the fund distribution waterfalls in most fund agreements readily distinguish the carried interest from the return on invested capital, a strong argument can be made that the clear identification requirement is satisfied in many cases without having to amend the allocation provisions. However, the distinction between a carried interest and capital interest may depend on how the agreement is drafted. An example in the Final Regulations treats the sponsor's invested capital as subject to a 20% carried interest (which is subject to the three-year holding period requirement) based on the language of the partnership agreement, even though the Final Regulations clarify that all of the profits on the sponsor's invested capital are potentially eligible for the capital interest exception.

In light of this ambiguity, sponsors should carefully consider whether partnership agreements should be amended to clearly identify the allocations intended to qualify for the capital interest exception. Since this type of amendment to the partnership agreement is in the nature of a clarification and should not alter the actual allocations or distributions to the partners, it should not be adverse to investors.

Partnership interest held by an employee of an entity not conducting an ATB

Consistent with Section 1061 and the Proposed Regulations, the Final Regulations adopt the exception for interests transferred to a person who is only providing services for an entity that is not engaged in an applicable trade or business (ATB). This rule may permit profits interests granted to employees of portfolio companies that conduct typical operating businesses to avoid the application of the three-year holding period requirement.

Family office exception — 1061(b)

Both the Proposed Regulations and the Final Regulations reserve on the application of Section 1061(b), which authorizes Treasury to establish an exception to the application of Section 1061 for gain attributable to any assets not held for portfolio investment on behalf of third-party investors.

What types of income are subject to the three-year holding period requirement?

The Final Regulations generally recharacterize long-term capital gain allocated to an API holder from the sale of an asset with a holding period of three years or less as short-term capital gain.

The following types of gains and income are excluded from long-term capital gains subject to recharacterization under Section 1061:

- Gains and losses under Section 1231, which applies to gain on the sale of property used in an active trade or business, including real estate, oil and gas assets, and certain assets owned by operating partnerships
- Gains and losses from mark-to-market gains from certain futures and options contracts
- Qualified dividend income eligible for long-term capital gains rates
- Capital gains and losses characterized as short-term or long-term without regard to the underlying holding period of the asset
- Dividends attributable to the sale of capital assets from real estate investment trusts (REITs) and regulated investment companies (RICs), if the REIT or RIC discloses the amount of net capital gain from the disposition of assets with a holding period of more than three years

> **Observation:** The exclusion of these items could cause sponsors to favor sales of assets that generate Section 1231 gains (as opposed to sales of partnership interests or interests in blocker corporations) and to favor leveraged recapitalizations that generate qualified dividend income over alternative transactions that generate short-term capital gain for the sponsor.

Which holding period is relevant when applying the three-year holding period requirement?

Consistent with the Proposed Regulations, the Final Regulations generally provide that the relevant holding period is the holding period of the person disposing of the asset. As a result, so long as the entity disposing of the applicable asset has a holding period of greater than three years at the time of sale, Section 1061 would not apply even if carried interest recipients were issued APIs from an upper-tier partnership within the past three years. Under a special "look-through" rule in the Final Regulations, a sale of an API that has been held for more than three years may still be subject to recharacterization under Section 1061 based on the holding period of the underlying partnership assets. This look-through rule applies if either (1) the taxpayer's holding period in the API would be three years or less if it did not include any period before the date on which any unrelated non-service partners were required to commit substantial amounts of money or property to the partnership, or (2) a series of transactions has taken place with a principal purpose of avoiding the recharacterization rules of Section 1061. The look-through rule is intended to prevent sponsors from setting up a dormant carry vehicle in advance of raising capital in order to claim a longer holding period in the interests issued by the vehicle.

> **Observation:** This rule underscores the need for funds to consider the holding period of the asset being disposed of, as a different holding period can apply to different blocks of stock of a corporation or to the assets of a partnership versus the interests in a partnership. This consideration can also be important when making a follow-on investment in an existing portfolio company. For example, if partial dispositions are anticipated, identified blocks of stock with longer holding periods may be sold first in a partial exit. On the other hand, a partial sale of a partnership interest will generally include pro rata share of each tranche of partnership interest (including older and new holding periods). Setting up a separate acquisition vehicle to make follow-on investments in a partnership may facilitate the sale of tranches with longer holding periods upon a partial exit.

How do the rules apply to secondary transactions and third-party investments involving GP/sponsor entities?

The sale of an interest in a general partner entity will generally be subject to the three-year holding period requirement based on the holding period of the seller's interest in the general partner entity (subject to the application of the "look-through" rule discussed above). To the extent a portion of the gain would be attributable to the sale of a capital interest eligible for the capital interest exception, a portion of the gain from the sale of the general partner interest may be treated as capital interest and not subject to recharacterization under the three-year holding period requirement. The sale of an interest in a manager entity may also be subject to the three-year holding period requirement based on the holding period in the manager entity. While the manager may hold assets that are eligible for the capital interest exception, there is no apparent exclusion applicable to the enterprise value (i.e., self-created good will) of the manager entity, although in the preamble to the Final Regulations, Treasury noted that it continues to study how enterprise value should be treated under these rules. As a result, any gain attributable to the enterprise value of the manager may be subject to the three-year holding period requirement.

A purchaser of an interest in a taxable secondary transaction will generally not be subject to the three-year holding period requirement with respect to the acquired interest if the purchaser is an unrelated non-service provider. However, this exception does not apply to partnership interests acquired by an unrelated non-service provider in a primary transaction and also does not prevent the three-year holding period requirement from applying to a lower-tier API when an interest in an upper-tier API is acquired. Thus, an interest in a fund general partner acquired in a secondary or primary acquisition is likely to continue to be subject to the three-year holding period requirement with respect to the general partner's carried interest in the underlying fund, even if the purchaser of the interest is an unrelated non-service provider.

Transfers to related persons

Under the Final Regulations, if a taxpayer transfers an API in a taxable transaction to a member of the taxpayer's family or a pass-through entity in which the transferring taxpayer or a person who performed services in the same applicable trade or business as the transferor is a partner, then the taxpayer will recognize short-term capital gain on the transfer to the extent the taxpayer would have been allocated short-term capital gain (under the three-year holding period requirement) in a hypothetical liquidation of the partnership. This rule is a helpful departure from the approach taken in the Proposed Regulations, which had interpreted the ambiguous language in the statute to impose tax even in the case of certain non-recognition transactions, including gifts.

Carried interest waivers

Neither the Final Regulations nor the Proposed Regulations explicitly address arrangements found in many fund agreements whereby a general partner may elect to waive or defer allocations and distributions of carried interest for capital gains that are subject to recharacterization under Section 1061 as a result of not meeting the three-year holding period requirement. In the preamble to the Proposed Regulations, Treasury noted that carried interest waivers and other similar arrangements may not be respected under existing US federal income tax law, either because such waiver arrangements create allocations that lack substantial economic effect or because they are subject to challenge under general economic substance doctrines. While the preamble to the Final Regulations does not discuss carried interest waivers, fund sponsors should continue to take note of the discussion in the preamble to the Proposed Regulations.

Effective date of the Final Regulations

The Final Regulations are generally effective for taxable years beginning on or after January 19, 2021 (the date the regulations were published in the Federal Register). As a result, pre-existing calendar-year taxpayers are not required to apply the Final Regulations until 2022, although they may elect to apply the Final Regulations in their entirety this year. New partnerships not in existence prior to January 19, 2021, are required to apply the Final Regulations beginning in 2021.

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Endnotes

[1] All references to "Section" refer to sections of the Internal Revenue Code of 1986, as amended (the Code), or the Treasury regulations promulgated thereunder.

[2] For this purpose, the activities taken into account are Raising or Returning Capital Actions and Investing or Developing Actions. Raising or Returning Capital Actions is defined as any actions involving raising or returning capital but does not include Investing or Developing Actions. Investing or Developing Actions is defined as any actions involving either (i) investing in (or disposing of) specified assets (or identifying specified assets for investing or disposition); or (ii) developing specified assets.