CARRIED INTEREST REGULATIONS

Update for investment fund managers

Aug. 13, 2020
**With you today**

<table>
<thead>
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<th>Title and Position</th>
<th>Details</th>
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<tbody>
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• Carried interest criticized by some who argued that “capital gains are for those with capital”

• Defenders say this merely extends to the investment management business a benefit enjoyed by all other businesses


• Fee-waiver regulations proposed to curb “abuses” on July 23, 2015

• 2017 Tax Cuts and Jobs Act – first major cut-back – imposed three year holding period

• After 2020 – will capital gains even be available for those with capital?
Major issues left open by statute

• What is a carried interest on an applicable partnership interest
• Some effective date questions
• How to ensure that capital interests are not affected
• Are S corporations, corporations?
• Is section 1231 property (real estate, purchased good will, etc.) exempt?
• A series of mechanical issues (whose holding period matters?)
• Gifts of interests
• Waivers of carry on particular assets
Generally, not effective until calendar year 2022 at the earliest!

Some exceptions
What interests in what partnerships are covered?

- What is a carried interest?
- What is an applicable partnership interest?
- Whose holding period matters (units or assets)?
- What about capital interests?
Applicable trade or business. The term applicable trade or business means any activity conducted on a regular, continuous, and substantial basis which, regardless of whether the activity is conducted in one or more entities, consists, in whole or in part, of —

a) raising or returning capital, and

b) either:

   i) investing in (or disposing of) specified assets (or identifying specified assets for such investing or disposition), or

   ii) developing specified assets.
“The relevant holding period is the direct owner’s holding period in the asset sold. Accordingly, for purposes of determining an API Holder’s Taxpayer’s API One Year Distributive Share Amount and API Three Year Distributive Share Amount for the taxable year under paragraph (a)(3) of this section, the partnership’s holding period in the asset being sold or disposed of (whether a directly held asset or a partnership interest) is the relevant holding period for purposes of section 1061.”
Defining the borders

- S corporations
- Section 1231 property (property used in a trade or business, such as real estate or in some cases purchased goodwill)
- Dividends and certain futures
“The following items of long-term capital gain and loss are excluded from the calculation of the API One Year Distributive Share Amount in paragraph (a)(3)(i) of this section and the API Three Year Distributive Share Amount in paragraph (a)(3)(ii) of this section:

(i) Long-term capital gain and long-term capital loss determined under section 1231;

(ii) Long-term capital gain and long-term capital loss determined under section 1256;

(iii) Qualified dividends included in net capital gain for purposes of section 1(h)(11)(B)”
“For purposes of this section, a corporation does not include an entity for which an election was made to treat the entity as a Passthrough Entity. Thus, the following entities are not treated as corporations for purposes of section 1061—

(i) An **S corporation** for which an election under section 1362(a) is in effect; and

(ii) A passive foreign investment company (PFIC) with respect to which the shareholder has a **qualified electing fund (QEF)** election under section 1295 in effect.”
“Alternatively, taxpayers may waive their rights to API Gains and substitute gains that are not taken into account for purposes of determining the Recharacterization Amount. [...] These arrangements are often referred to as carry waivers or carried interest waivers. Taxpayers should be aware that these and similar arrangements may not be respected and may be challenged under section 707(a)(2)(A), sections 1.701-2 and 1.704-1(b)(2)(iii), and/or the substance over form or economic substance doctrines.”
Major developments in regulations

Gifts and other transfers
“Rather, the Treasury Department and the IRS interpret section 1061(d)(1) to require that gain equal to the amount described in that section be recognized and included in income as short-term capital gain on the transfer of an API to a Section 1061(d) Related Person even if the transfer is not a transaction in which gain is otherwise recognized under the Code. The term transfer under the proposed regulations includes, but is not limited to, contributions, distributions, sales and exchanges, and gifts.”
QUESTIONS AND ANSWERS
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