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Not Getting Carried Away: Proposed Regulations on Carried Interest

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Prior to 2017, a taxpayer receiving a "carried interest" in a partnership could generally receive long-term capital gain treatment on a sale or redemption of such interest, provided that the taxpayer held the interest for at least one year. In 2017, as part of P.L. 115-97, commonly known as the Tax Cuts and Jobs Act, Congress enacted new Section 1061 of the Internal Revenue Code, which significantly changed these rules. The statute contained some significant uncertainties, which Treasury has now mostly addressed in newly issued proposed regulations.

Section 1061 generally provides that if a taxpayer holds an applicable partnership interest for less than three years, then any capital gain recognized by the taxpayer with respect to such interest will be taxed at ordinary income rates rather than at capital gain rates. For this purpose, an "applicable partnership interest" is generally defined as any partnership interest that was transferred to the taxpayer in connection with the performance of substantial services by the taxpayer in an applicable trade or business. An "applicable trade or business" is, in turn, defined to include most businesses that consist of raising or returning capital and either investing in or developing certain specified assets (including real estate, securities, and similar assets). These definitions would generally cover a typical carried interest that a real estate sponsor might receive.

Section 1061 does not apply to partnership interests held by corporations, or to partnership interests that provide a partner with the right to share in partnership capital commensurate with the amount of capital such partner contributed.

There were a number of questions raised by the statute. For example, the statute by its terms applies only to income that would be capital gain. As a highly technical matter, property that is used in a trade or business, including real estate, is not treated as a capital asset for income tax purposes, and thus gain from the sale or exchange of such property is technically not capital gain. Instead, property used in a trade or business is treated under Section 1231, which provides that any gain from the sale of such property is generally treated as long-term capital gain and any loss from the sale of such property is treated as an ordinary loss. From the words of the statute, it appeared that Section 1061 would not apply to Section 1231 gains, although it was not clear that the IRS would agree with that interpretation.

On July 31, 2020, Treasury released proposed regulations under Section 1061. The proposed regulations clarify many provisions of these rules. The proposed regulations provide that Section 1061 applies to both (1) a partner's share of capital gains recognized by a partnership on the sale of property held for less than three years and (2) a partner's capital gain recognized on the sale of all or part of his partnership interest.

As expected, the proposed regulations provide that Section 1061 cannot be avoided by holding an applicable partnership interest through an S corporation.

Most importantly, the proposed regulations specifically provide that Section 1061 does not apply to Section 1231 gains. Therefore, if a partnership sells real estate used in a trade or business, the partners' shares of the resulting gain will not be re-characterized as ordinary income under Section 1061, even if the property was held by the partnership for less than three years. In contrast, if a partner holding an applicable partnership interest in a partnership that holds real property sold his partnership interest after holding it for less than three years, the resulting gain would be subject to Section 1061.

Thus, in the case of partnerships that primarily hold real estate, the carried interest rules of Section 1061 can usually be avoided simply by having the partnership selling the underlying real property instead of the partners selling partnership interests. However, certain triple-net-leased properties might not be considered to be assets used in a trade or business, and thus gain from a sale of those assets could be capital gain subject to Section 1061 rather than Section 1231 gain.

The proposed regulations also clarify the relevant holding period for purposes of Section 1061. Subject to certain anti-abuse rules, if a partnership sells an asset and recognizes capital gain, it is the partnership's holding period in the asset that is relevant, not the carried interest partner's holding period in his partnership interest.

Therefore, if a partnership sells an asset that it has owned for more than three years, Section 1061 will generally not apply, even if a carried interest partner has held his partnership interest for less than three years. Likewise, if a carried interest partner sells his partnership interest, it is the partner's holding period in the partnership interest that is relevant, not the partnership's holding period in its underlying assets.

In addition, the proposed regulations provide that if a holder of an applicable partnership interest transfers such interest to certain related persons, the transferor must recognize short-term capital gain (taxed at ordinary rates) in an amount equal to the long-term capital gain the transferor would have been allocated with respect to property held for less than three years if all of the partnership's property were sold for fair market value. This rule is significant because it requires gain recognition even in situations that would not normally be taxable events, such as gifts and certain contributions.

In sum, for funds that invest in real estate, the proposed Section 1061 regulations are generally favorable for taxpayers, because the exclusion of Section 1231 gains means that the rules simply do not apply in many cases. However, the proposed Section 1061 regulations are complex, and contain traps for the unwary. Any transaction involving carried interests should be carefully reviewed, particularly those involving gifts or sales of partnership interests.

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