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Treasury Issues Final Regulations on Carried Interest

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Before 2017, if a taxpayer received a "carried interest" in a partnership and held that interest for at least one year, the taxpayer would generally receive long-term capital gain treatment on a sale or redemption of such interest. In 2017, Congress enacted P.L. 115-97, which added new Section 1061 to the Internal Revenue Code. Section 1061 generally imposes a three-year holding period requirement in order for any capital gains with respect to carried interests to be treated as long-term capital gains.

On July 31, 2020, Treasury released proposed regulations under Section 1061, and on January 7, 2021, Treasury finalized these regulations. The final regulations largely adopt the proposed regulations, but with some important modifications that are largely favorable to taxpayers.

Section 1061 applies to a taxpayer that holds an "applicable partnership interest," which is defined as a partnership interest that was transferred to the taxpayer in connection with the performance of substantial services in an applicable trade or business. An "applicable trade or business" is defined to include businesses that consist of (1) raising or returning capital and (2) either investing in or developing certain specified assets such as real estate or securities. Thus, Section 1061 would apply to a typical carried interest received by a real estate sponsor.

In general, under the final regulations, (1) if a partnership sells property that it has held for less than three years, then any capital gain allocated to the holder of an applicable partnership interest will be treated as short-term capital gain (and thus will be taxed at ordinary income rates) and (2) if a partner sells an applicable partnership interest that he has held for less than three years, then any capital gain resulting from the sale will likewise be treated as short-term capital gain. Thus, as a general matter, if a partnership sells property, it is the partnership's holding period in the property that is relevant, and if a partner sells an applicable partnership interest, it is the partner's holding period in his partnership interest that is taken into account.

The proposed regulations contained a special look-through rule where, in certain circumstances, a partner could have recognized short-term capital gain on the sale of an applicable partnership interest even if he had held the interest for more than three years. In response to concerns that this look-through rule was unnecessarily complex, the final regulations significantly simplified it.

The new look-through rule adopted in the final regulations provides that, even if a partner has held an applicable partnership interest for more than three years, Section 1061 will still apply on a sale of the applicable partnership interest if either (1) the partner's holding period would be less than three years if it had started at the time that an unrelated non-service partner was legally obligated to contribute substantial money to the partnership, or (2) a transaction has taken place with the principal purpose of avoiding Section 1061. This rule appears to be intended to prevent taxpayers from creating inactive entities for the purpose of avoiding the three-year holding period.

Both the final and proposed regulations provide that gain from the sale of property (including real estate) used in a trade or business (so-called "Section 1231 gain") is not subject to Section 1061, because it is technically not capital gain (even though it is generally taxed at capital gain rates). Therefore, if a partnership sells real estate used in a trade or business that it has held for less than three years but more than one year, partners holding applicable partnership interests would generally recognize long-term capital gain, even if they have held their partnership interests for less than three years. This exception is very important since it places many common real estate partnership transactions outside the application of these rules. However, any gain from the sale of a partnership interest will not be Section 1231 gain and thus is subject to Section 1061.

The most important change made by the final regulations relates to Section 1061(d). That subsection provides that if a taxpayer transfers an applicable partnership interest to certain related persons, the taxpayer recognizes short-term capital gain equal to the long-term capital gain that would have been allocated to the partner with respect to assets held for less than three years if the partnership sold all of its assets at the time of the transfer for their fair market value. Under the proposed regulations, this gain would have been recognized upon any transfer to a related person, even in the case of a gift or other transfer that would not usually be taxable, subject to only limited exceptions.

The final regulations change this rule, and provide that Section 1061(d) only recharacterizes long-term capital gain that the taxpayer otherwise would have recognized; it does not cause a non-taxable transfer (such as a gift) to be taxable. In addition, if Section 1061(d) does apply, in determining the amount of the recharacterized gain, gain attributable to property used in a trade or business is not taken into account. Therefore, the final regulations significantly narrow the scope of Section 1061(d) in a way that is very favorable to taxpayers.

The final regulations contain several reporting requirements. For example, a partnership in which a partner holds an applicable partnership interest must report to the partner such information as is necessary for him to calculate his gain under Section 1061. If the partnership fails to provide this information, then the partner may be required to treat *all* capital gain allocated by the partnership as short-term capital gain, even if some of the gain would have qualified for long-term capital gain treatment despite Section 1061.

To conclude, the final Section 1061 regulations are generally favorable for taxpayers, particularly for those in the real estate industry. However, the rules remain complex, and any transaction involving carried interests should be carefully reviewed. In particular, the distinction between capital gains and Section 1231 gains, which under prior law was often not relevant, is now of vital importance. As the rules governing the taxation of partnerships grow increasingly complex, it becomes more important to pay attention to details such as these.

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