



# Carried Interest



# New Carried Interest Rules

- The Tax Cuts and Jobs Act (“TCJA”) extended the holding period for an “**applicable partnership interest**” to more than three years to receive long-term capital gain treatment under the new Section 1061.
- 1061(a) – If one or more applicable partnership interests are held by a taxpayer at any time during the taxable year, the **excess** (if any) of
  - The taxpayer’s net long-term capital gains with respect to such interests for such taxable year, over
  - The taxpayer’s net long-term capital gains with respect to such interests computed by applying paras (3) and (4) of Section 1222 by substituting “3 years” for “1 year.”

**Shall be treated as short-term capital gain**, notwithstanding section 83 or any election in effect under Section 83(b).



# Definition of “Applicable Partnership Interest”

- A taxpayer is only subject to the three year holding period if he or she owns an **“applicable partnership interest.”**
- “Applicable partnership interest” is defined as:
  - Any partnership interest transferred to a taxpayer directly or indirectly, in exchange for substantial services performed by the taxpayer (or any related person) in any **“applicable trade or business”**.
- “Applicable trade or business” is defined as:
  - any activity conducted on a **regular, continuous and substantial** basis which consists wholly or only partially of raising or returning capital and is either:
    1. Investing in or disposing of **“specified assets”** or identifying specified assets for such investing or disposition; or
    2. Developing specified assets.



# Specified Assets Include:

1. Securities
2. Commodities
3. **Real estate held for rental or investment**
4. Cash or cash equivalents
5. Options or derivative contracts
6. An interest in a partnership to the extent of the partnership's proportionate interest in any of the foregoing.



# New Carried Interest Rules

- The three year holding period will apply even if:
  - the taxpayer included an amount in income upon the acquisition of the partnership interest or
  - an 83(b) election was made
- Applies for tax years beginning after December 31, 2017.



# Exceptions to the Three Year Holding Period

- Interest in a partnership held by a corporation (S Corps?)
- Any capital interest giving the taxpayer either:
  - (1) a right to share in the partnership capital to the extent of the amount of capital contributed (as of the time the interest was received); or
  - (2) a right to share in the partnership capital commensurate with the value of the partnership interest that is taxed under Section 83 upon receipt or vesting of the partnership interest.
- An interest held by a person who is employed by another entity that is conducting a trade or business (**other than** an applicable trade or business) and only provides services to such entity
  - EX: A profits interest issued to an employee in a partnership portfolio company held by an investment fund
- To the extent provided by the Secretary, any income or gain attributable to any asset not held for portfolio investment on behalf of third-party investors



# Transfers to a Related Person

- If a taxpayer transfers an API to a related person, Section 1061(d)(1) requires the taxpayer to include in gross income as STCG the excess of an “amount” described in Section 1061(d)(1)(A) over any amount treated as STCG under 1061(a) with respect to the interest.
- “Amount” is “so much of the taxpayer’s LTCG with respect to such interest for such taxable year attributable to the sale or exchange of any asset held for more than 3 years as is allocable to such interest”
- “Related Person” means:
  - Family members; or
  - Someone who has performed a service within the current year or preceding three calendar years in any applicable trade or business in which the taxpayer has also performed a service.
- ABA recommends suspending the application of 1061(d) until further guidance can be published



# Example

- 1-year test vs 3-year test:
  - Individual A issued an API in partnership PS on January 1, 2018. In 2019, A is allocated from PS: \$100 of LTCG from the sale of asset X, in which PS had a 1.5-year holding period, \$50 of LTCG from the sale of asset Y, in which PS had a 3.5 year holding period, and (\$100) of LTCL from the sale of asset Z, in which PS had a 1.5 year holding period.
  - 1-year test: A's LTCG =  $\$100 + \$50 - \$100 = \$50$
  - 3-year test: A's LTCG =  $\$50$
  - No excess; no recharacterization





# Example

- 1-year test vs 3-year test:
  - Individual A issued an API in partnership PS on January 1, 2018. In 2019, A is allocated from PS: \$100 of LTCG from the sale of asset X, in which PS had a 1.5-year holding period, \$50 of LTCG from the sale of asset Y, in which PS had a 3.5 year holding period, and (\$100) of LTCL from the sale of asset Z, in which PS had a 3.5 year holding period.
  - 1-year test: A's LTCG =  $\$100 + \$50 - \$100 = \$50$
  - 3-year test: A's LTCG =  $\$50 - \$100 = 0$  (instead, A has a (\$50 LTCL)
  - \$50 excess; \$50 will be recharacterized as STCG



# Currently Unsettled Issues

- Except with respect to related party transfers (which have their own rules), defining the holding period.
- 3 Options:
  - “68-79 Approach” (Recommended by ABA): holding period of the capital asset sold (either the API or a capital asset owned by a partnership in which a taxpayer holds an API).
  - Holding period is the partner’s holding period in its API, regardless of whether the partnership sells assets or the partner sells the API
  - Holding period is the partnership’s holding period in the assets, regardless of whether the partnership sells a capital asset or the partner sells the API



# Currently Unsettled Issues

- Whether the taxpayer nets all its APIs for the tax year, or each API is calculated separately.
- Plain reading of the statute: if a taxpayer holds several APIs,
  - they would first calculate net LTCG with respect to all APIs for a taxable year, and then
  - Subtract from that amount net LTCG with respect to the same APIs calculated with a 3 year (rather than a 1 year) holding period
  - Any excess is treated as STCG
- Although the legislative history mentions calculation of “any” applicable interest, the statute seems to clearly indicate netting.
- ABA recommends publishing confirmatory guidance



# Currently Unsettled Issues

- Whether a Section 1231 asset held for use in a trade or business is governed by the new carried interest rules.
  - The text of the new Section 1061 refers only to Section 1222 capital assets, whereas real property used in a trade or business is governed by Section 1231, not Section 1222.