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Proposed IRS Regulations Interpreting 3-Year Holding Period Requirement for PE Fund Carried Interest to Qualify as Long-Term Capital Gain

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Gain from the sale of a capital asset ("CG") held by a private equity fund ("PE Fund") for more than one year ("LTCG") is normally taxed favorably to an individual who is a partner in the fund.[1] Prior to January 1, 2018, this favorable LTCG tax treatment applied in the same way to LTCG allocated to an individual member of a PE Fund's general partner ("GP") (i.e., the investment professionals who manage the fund, each an "Individual GP") as carried interest ("CI"). However, beginning January 1, 2018, Code §1061 (enacted as part of the 2017 tax reform legislation) imposed a new more-than-three-year holding period requirement (the "3-Year Hold Requirement") for such CI CG allocated to an Individual GP to be eligible for favorable LTCG treatment.

This 3-Year Hold Requirement also applies to a CG allocation to an Individual GP under a management fee waiver arrangement as well as (a) CG from such an individual's sale of an interest in CI and (b) CG from the sale of an interest in a PE Fund management company ("Mgmt Co").

On July 31, 2020, IRS issued proposed regulations (the "Proposed Rules") interpreting — expansively in certain respects — the 3-Year Hold Requirement under §1061. Key takeaways from the Proposed Rules include:

- The Proposed Rules confirm that the 3-Year Hold Requirement for CI CG is measured by PE Fund's holding period in the investment generating the CG (rather than the entity GP's holding period in its PE Fund interest or an Individual GP's holding period in his/her GP interest).

- The Proposed Rules implicitly confirm how to measure the 3-Year Hold Requirement when PE Fund makes a follow-on investment in an existing portfolio company (as explained in more detail below).
- The Proposed Rules do not expressly address so-called “carried interest waivers” (an arrangement under which the GP entity waives its right to CI attributable to less-than-3-year CG in exchange for a later catch-up of CG recognized from sale of another investment which satisfies the 3-Year Hold Requirement), other than to say that such arrangements “may not be respected and may be challenged” by IRS under “the substance over form or economic substance doctrines” or various statutory or regulatory provisions.
- The Proposed Rules confirm that the 3-Year Hold Requirement does not apply to (1) qualified dividend income (“QDI”), (2) CG from the sale of real property used in a trade or business or depreciable business property (“1231 assets”), or (3) certain REIT CG dividends. The latter two exclusions are especially useful to real estate and energy-focused fund managers.
- The Proposed Rules impose burdensome new reporting requirements and significant accounting complexities, and interpret a key exception to the 3-Year Hold Requirement (for CG allocations on invested capital) in a particularly restrictive manner.
- Subject to certain exceptions, the Proposed Rules would apply only to a taxable year beginning after the regulations are issued in final form, and hence are unlikely to apply to a calendar year taxpayer before the 2022 taxable year.

Background and Overview. §1061 applies to a partnership interest (such as CI) granted to a person (such as an Individual GP) who provides regular and continuous services in the nature of (i) raising or returning capital *and* (ii) investing in or developing investment assets (e.g., securities, derivatives, real estate, and/or certain partnership interests). Thus, §1061 applies to CI and certain Mgmt Co interests[2] held by most PE Fund and real estate fund managers.

Holding Periods. The Proposed Rules confirm that existing rules on capital asset holding periods generally apply for purposes of the 3-Year Hold Requirement.

- For CI gains allocated by PE Fund to its GP (as the result of PE Fund’s sale of an investment), the Proposed Rules clarify that the 3-Year Hold Requirement applies to PE Fund’s holding period in the investment which generated the CG, rather than GP’s holding period for its PE Fund partnership interest (or an Individual GP’s holding period in his/her GP interest). Thus, CI CG attributable to PE Fund’s sale of an investment held by PE Fund for three years or less is taxed at higher STCG rates for an Individual GP, even though the same CG is taxed at lower LTCG rates when

allocated to an individual PE Fund investor (i.e., an "LP") so long as PE Fund held the investment for more than one year.

- If PE Fund acquires different blocks of shares in a corporate portfolio company at different times (e.g., one block as part of the original acquisition and a subsequent block as the result of a follow-on equity investment in the portfolio company), the 3-Year Hold Requirement applies **separately** to each block of shares. Thus, if at the time of sale, PE Fund has held its first block of (corporate) portfolio company shares for more than three years but made a second equity investment in such company, e.g., only two years before the sale, CI attributable to the original block of shares is taxed to the Individual GPs at the lower LTCG rate while CI attributable to the follow-on shares is taxed to the Individual GPs at the higher STCG rates.[3]
- Similarly, if PE Fund holds its shares of the corporate portfolio company indirectly through a holding partnership or LLC taxed as a partnership ("Holdco"), and Holdco sells shares of the corporate portfolio company, the relevant holding period is Holdco's holding period in each block of corporate portfolio company shares sold. If instead PE Fund sells its Holdco units, the relevant holding period is PE Fund's holding period in its Holdco units.
- On the other hand, if one or more Individual GPs sell (all or a portion of) their interests in CI or their interests in Mgmt Co (e.g., to a financial institution that acquires ownership stakes in various PE Fund managers), the relevant holding period generally is the Individual GP's holding period in the CI or Mgmt Co interests sold, subject to a new exception in the Proposed Rules which measures an Individual GP's CI holding period based on PE Fund's holding period for its investments if 80% or more of PE Fund's asset value is attributable to PE Fund investments held for three years or less.

Key Exceptions and Exclusions. The Proposed Rules also interpret some of §1061's key exceptions and exclusions:

- *Portfolio Company Interest Held by a Portfolio Company Employee.* If PE Fund structures its ownership in a portfolio company through a holding partnership specific to that (single) portfolio company, the 3-Year Hold Requirement does not apply to an employee of that portfolio company who receives a profits interest in that holding partnership for services provided by such employee to the portfolio company.
- *CI and/or Mgmt Co Interest Held by a Corporation.* If a corporation holds CI or a profits interest in Mgmt Co (e.g., a corporation formed by an Individual GP to hold CI or a Mgmt Co interest), §1061's literal language states that the 3-Year Hold Requirement does not apply to that corporate holder. However, IRS previously issued guidance stating that the 3-Year Hold Requirement nevertheless ***does*** apply to an S

corporation that holds CI or a profits interest in Mgmt Co. The Proposed Rules reconfirm this IRS position on S corporations and also impose the 3-Year Hold Requirement on certain foreign corporations[4] used to hold CI or a Mgmt Co interest.

- *Capital Interest.* Under §1061, CG allocated to a PE Fund partnership interest issued in exchange for invested capital (i.e., a "capital interest" rather than a CI) is not subject to the 3-Year Hold Requirement.
    - However, the Proposed Rules interpret this capital interest exception narrowly.[5] If finalized in their current form, the Proposed Rules potentially would cause all CG allocated to an Individual GP (including CG attributable to a capital interest rather than a CI) to be subject to the 3-Year Hold Requirement unless PE Fund's partnership agreement contains distribution and allocation mechanics that are not currently found in most PE Fund partnership agreements (and which may not be acceptable to PE Fund investors). IRS has requested comments on alternative interpretations.

    - The Proposed Rules also provide that a capital interest funded by GP (or an Individual GP) through certain borrowings (e.g., from a PE Fund investor) will not be respected as a capital interest for this purpose.

- *Unrelated Purchaser of GP or Mgmt Co Interest.* If a passive investor (such as a financial institution formed to acquire ownership stakes in various PE Fund managers) that is unaffiliated with (and not providing services to) GP or any of GP's members or related entities acquires an interest in GP or Mgmt Co at a fair market value price, the Proposed Rules clarify that the 3-Year Hold Requirement generally does not apply to the GP or Mgmt Co interest acquired by such investor.

- *Excluded Income and Gains.* The Proposed Rules confirm that the 3-Year Hold Requirement does not affect CG from the sale of 1231 assets, gains from certain derivative contracts, certain REIT or RIC CG dividends (if the REIT or RIC satisfies certain reporting requirements) and QDI.
    - Due to this exception for 1231 assets, if PE Fund (or a real estate fund) is able to structure the sale of an investment as a sale of portfolio company assets or of real estate assets (as distinguished from a sale of corporate stock or a partnership interest), a significant portion of the CG from such a sale may be exempt from the 3-Year Hold Requirement.

In-Kind Distributions. The Proposed Rules take the position that an asset distributed in-kind to an Individual GP remains subject to the 3-Year Hold Requirement, so that gains recognized by an Individual GP upon sale of such an asset are eligible for LTCG treatment only if the Individual GP's holding period in the asset satisfies the 3-Year

Hold Requirement. For this purpose, the Proposed Rules confirm that existing holding period "tacking" rules apply, so that the Individual GP generally would include PE Fund's holding period in the distributed asset in determining whether the Individual GP has satisfied the 3-Year Hold Requirement.

Transfers of CI to Related Persons. §1061 includes a rule designed to prevent taxpayers from avoiding the 3-Year Hold Requirement by either:

> (i) transferring CI to a "related" person (such as a gift of CI to a trust or a family member who is not performing services for GP) or
> (ii) transferring CI to another Individual GP.

The Proposed Rules would tax (or increase the tax on) the transferring Individual GP **currently** (at **STCG** rates) at the time the Individual GP transfers CI to certain direct family members or to an employee of (or other service provider to) GP, where PE Fund has held some of its investments for three years or less and has unrealized gains in those assets. This draconian rule applies by looking through PE Fund to its investments and comparing the transferring Individual GP's share of PE Fund's unrealized gains on investments held for three years or less ("look-through STCG") to the STCG (if any) recognized by the Individual GP on such a transfer. For example, if the transfer is a gift that otherwise would be nontaxable (and results in no cash proceeds for the transferor), this rule would nonetheless tax the transferring Individual GP **currently** on his/her share of look-through STCG.

Reporting Requirements. The Proposed Rules would impose complex and burdensome reporting rules (on PE Fund or GP) to provide Individual GPs with the information needed to determine their tax liability under §1061. Information not properly reported could (i) require GP (and Individual GPs) to report extra STCG and (ii) subject PE Fund and/or GP to penalties under existing tax law.

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1. LTCG is currently taxed to an individual at 20% plus a "net investment income tax" of 3.8%, while CG on assets held one year or less ("short-term capital gain" or "STCG") is taxed at ordinary income rates of up to 37% plus 3.8%.↩

2. Under the Proposed Rules, it is unclear exactly how the 3-Year Hold Requirement applies to many Mgmt Co interests. The 3-Year Hold Requirement is potentially relevant when (a) an investment professional sells a Mgmt Co interest (e.g., to a financial institution that acquires ownership stakes in various PE fund managers) and/or (b) a Mgmt Co holds an interest in CI. Some Mgmt Co interests may be exempt from the 3-Year Hold Requirement under the "capital interest" exception described below, although the narrow interpretation of the "capital interest"

exception adopted by the Proposed Rules could effectively subject many such Mgmt Co interests to the 3-Year Hold Requirement.↩

3. The holding period and gain calculation rules for interests in a "flow-through" portfolio company (i.e., a company organized as a partnership or LLC taxed as a partnership) are more complex because the partnership holding period and tax basis rules do not recognize the concept of separate "blocks" of equity. Instead, an owner of such a flow-through company interest has (i) a single (or "unified") tax basis for all of its equity interests in the partnership portfolio company (even if different prices were paid for different and separately identifiable units) and (ii) a bifurcated holding period for each of the units held (where units were acquired at more than one time).↩

4. Specifically, a so-called "passive foreign investment company" ("PFIC") if the owner of the PFIC makes a "qualified electing fund" election (which causes some or all of the PFIC's income to "flow-through" to its owner).↩

5. Despite this narrow interpretation, PE Fund interests held by most PE Fund LPs still are not subject to the 3-Year Hold Requirement because such LPs do not provide services related to the PE Fund, nor are such LPs related to PE Fund professionals providing such services.↩

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