KIRKLAND & ELLIS

KirklandPEN

IRS Issues Final Regulations for PE Fund Carried Interest Qualification as Long-Term Capital Gain

19 January 2021

On January 7, 2021, Internal Revenue Service ("IRS") and Treasury Department issued final regulations (T.D. 9945) on the tax treatment of private equity fund ("PE Fund") carried interest ("CI") under Internal Revenue Code §1061,[1] including a few taxpayer-favorable updates and clarifications to the July 31, 2020, proposed regulations. As discussed in our prior *KirklandPEN*[2], gain from a PE Fund's sale of a capital asset ("CG") held for more than one year is long-term capital gain ("LTCG") that is generally taxed at a reduced rate to an individual partner in the PE Fund.[3]

Prior to January 1, 2018, this favorable LTCG tax treatment applied not only to LTCG allocated to an LP, but also to LTCG CI allocated to an individual member of the PE Fund's general partner ("GP") or management partnership, i.e., the investment professionals who manage the fund ("Investment Professionals"). However, beginning on January 1, 2018, §1061 imposed a new, more-than-three-year holding period requirement (the "3-Year Hold Requirement") for such CI CG allocated to an Investment Professional to be eligible for favorable LTCG treatment.

The final regulations retain the general structure and many of the complex concepts from the proposed regulations, but contain three important updates:[4]

I. Capital Interest Exception

The 3-Year Hold Requirement does not apply to CG attributable to a partnership interest issued in exchange for invested capital (the “capital interest exception”). Under the final regulations:

- An Investment Professional’s interest in a PE Fund generally qualifies for the capital interest exception only if the Investment Professional’s economic entitlement is “reasonably consistent” with allocations and distributions to *unrelated* LPs who made “significant” capital contributions (i.e., *unrelated* LPs holding in the aggregate at least 5% of the aggregate amount of capital contributed to the PE Fund when the allocations are made), taking into account factors including the amount and timing of the capital contributed, the rate of return on the capital contributed, the terms, priority, type, and level of risk associated with the capital contributed, and the rights to cash or property distributions during the partnership’s operations and on liquidation.
- The capital interest exception is available for an Investment Professional even if not charged management fees and/or CI, and even if granted the right to receive tax distributions (i.e., the fact that *unrelated* LPs are not charged fees and/or granted a right to such tax distributions does not render the capital interest exception unavailable).
- Potentially useful for a hedge fund manager, an incentive allocation (CI) of realized income allocated to an Investment Professional can qualify for the capital interest exception, even if not distributed to and recontributed by the Investment Professional.
- The final regulations retained the general rule that the capital interest exception is not available where an Investment Professional directly or indirectly funds an investment in the GP with loan proceeds from the GP, another partner in the GP, or any person related to such persons. However, the final regulations override this general rule (i.e., permit the use of a loan to fund a capital interest) if certain requirements are satisfied. Specifically, the capital interest exception is available under the final regulations even where an Investment Professional directly or indirectly funds an investment in the GP with loan proceeds from another partner in the GP or a person related to another partner (but not from the GP and possibly not

from the PE Fund) so long as the Investment Professional is personally liable for the loan, i.e., the loan must be full recourse and not guaranteed by any other person (including by the PE Fund or its GP or management company).[5] PE Fund managers should review existing loan arrangements with counsel to determine whether revisions are warranted.

- The capital interest exception is satisfied only if allocations and distributions with respect to the Investment Professional's capital interest are "clearly identified" (in both the PE Fund's partnership agreement and its books and records) as "separate and apart" from the Investment Professional's CI allocations. It remains unclear whether PE Funds will need to amend their fund agreements in order satisfy this requirement.

II. Look-Through Rule for Partnership Interest Sales

When an Investment Professional recognizes CG from the sale of all or a portion of such person's partnership interest in the GP (rather than from the PE Fund's sale of an asset), the Final Regulations generally treat the proceeds as LTCG if the Individual GP satisfied the 3-Year Hold Requirement with respect to the GP partnership interest itself (i.e., without "looking through" to the holding period of the PE Fund's underlying assets), except that a portion of such gain may be recharacterized as STCG based on the holding period of the PE Fund's underlying assets if either:

- the Investment Professional would have had a holding period of three years or less in its GP partnership interest if any period before the underlying PE Fund had substantial third-party investor commitments (i.e., at least 5% of the underlying PE Fund's total capital contributions at time of sale) were ignored or
- there were transactions prior to the Investment Professional's sale of such partnership interest with "a principal purpose" of avoiding application of the 3-Year Hold Requirement.

III. Related-Person Transfers

Section 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 of the PE Fund's Investment Professionals.

Under the final regulations only a *taxable* related-person transfer (e.g., a taxable sale or exchange) of a CI is subject to potential §1061 STCG treatment. The proposed regulations had appeared to trigger STCG in a broad range of common and otherwise non-taxable transactions (including a partnership estate planning transfer or an internal partnership restructuring). The final regulations provide that in a *taxable* sale or exchange of a CI by an Investment Professional to a "related person" (i.e., a family member or certain individuals or entities affiliated with the PE Fund or the GP entity), a portion of the gain may be recharacterized as STCG even if the 3-Year Hold Requirement is otherwise met (and even if the "look-through rule" above does not apply).

Effective Date

The final regulations generally apply to a tax year beginning on or after the date formally published in the Federal Register (which has not yet been determined). Accordingly, the final regulations will generally not apply to a calendar year taxpayer until 2022. However, a PE Fund or an Investment Professional may choose to apply the final regulations in their entirety to a tax year beginning after December 31, 2017, so long as consistently and entirely applied to such year and all later years.

---

1. As used herein, all "§" references are to sections of the Internal Revenue Code of 1986, as amended.↩

2. This *KirklandPEN* does not repeat IRS rules discussed in our earlier *KirklandPEN* but not changed by the final regulations.↩

3. LTCG is generally taxed to an individual at a 20% rate, plus the 3.8% “net investment income tax,” 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 the 3.8% net investment income tax.↩

4. Notwithstanding these updates, a number of §1061 aspects remain unresolved. For example, the final regulations do not provide any exception from §1061 for gain attributable to the “enterprise value” of PE Fund management companies, although IRS continues to consider this issue. In addition, while the final regulations do not address so-called “carried interest waivers” (an arrangement under which the GP entity waives its right to CI attributable to less-than-three-year CG and is entitled to a later CI catch-up conditioned on future CG recognition from the sale of another investment which does satisfy the 3-Year Hold Requirement), the preamble to the proposed regulations states that such arrangements “may be challenged” by IRS under various existing statutory or regulatory provisions.↩

5. IRS noted in the preamble to the final regulations that it is continuing to study the treatment of guarantees generally in light of questions about who is treated as the borrower for tax purposes.↩

Authors

Stephen Butler

Partner / Houston

Michael J. Conroy

Associate / Chicago

Mike Greenberg

Partner / Los Angeles – Century City

David M. Grenker

Partner / New York

Jack S. Levin, P.C.

Partner / Chicago

Marguerite R. Lombardo

Partner / Boston

Daniel P. Meehan, P.C.

Partner / Chicago

Donald E. Rocap, P.C.

Partner / Chicago

Joel Peters-Fransen

Partner / San Francisco

Dean S. Shulman, P.C.

Partner / New York

Carol Wang

Partner / San Francisco

Related Services

Practices

- Transactional
- Private Equity
- Tax