

Section 1061 Final Regulations on the Taxation of Carried Interest

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On January 7, 2021, the Internal Revenue Service (the “IRS”) and the U.S. Department of the Treasury (the “Treasury”) issued [final regulations\[1\]](#) (the “Final Regulations”) providing guidance on Section 1061 of the Internal Revenue Code (the “Code”).^[2] The Final Regulations modify the [proposed regulations\[3\]](#) (the “Proposed Regulations”) that were released in July of 2020. We previously discussed the Proposed Regulations with a series of “Key Takeaways” in our client alert published [here](#). This post highlights certain changes made to the Proposed Regulations, and certain important provisions of the Proposed Regulations that remain unchanged in the Final Regulations.

In general, Section 1061 requires a three-year holding period for an investment fund manager’s share of capital gains earned through a fund to be eligible for the lower tax rates applicable to long-term capital gain.^[4] This is a departure from the one-year holding period that is typically required for long-term capital gain treatment. The Proposed Regulations provided some guidance on the application of Section 1061; however, many of the provisions in the Proposed Regulations were unclear or unworkable and were criticized by commentators.

The Final Regulations are generally helpful to taxpayers, except with respect to allocations of unrealized gain, as discussed below. However, some questions remain unresolved and fund managers should continue to exercise care in interpreting and applying the Final Regulations. As discussed further below, the majority of the provisions will not be effective until at least January 1, 2022, allowing fund managers some time to prepare and plan. However, taxpayers are allowed to apply the Final Regulations prior to that date if they are applied consistently.^[5]

Changes Introduced by the Final Regulations

Expansion of the Capital Interest Exception

Section 1061 applies to an applicable partnership interest (an “API”) held by or transferred to a taxpayer in connection with the performance by that taxpayer (or a related person) of substantial services in an applicable trade or business.^[6] Section 1061 provides an exception for gain with respect to “capital interests” (generally understood to mean gain earned with respect to invested capital). The Proposed Regulations narrowly defined the scope of this exception, but the Final Regulations provide more flexibility.

Under the Proposed Regulations, the capital interest exception applied only to allocations in respect of a fund manager’s capital if those allocations were made in the “same manner” as allocations made to other unrelated non-service partners with a “significant” aggregate capital account balance in a fund (defined as at least 5% or more of the aggregate capital account balances of the partnership).^[7] An allocation would be considered to be made in the “same manner” if the allocation were based on the relative capital account balances of the partners and the terms, priority, type, level of risk, rate of return and rights to cash or property distributions during the partnership’s operations and liquidation were the same.^[8]

This approach was unworkable for managers of many closed-end private investment funds because it was unclear the extent to which differences in allocations and distributions between fund managers and other partners may violate the “same manner” requirement. Second, many partnership agreements use so-called “targeted allocation” provisions rather than allocating items in accordance with the partners’ respective capital account balances, a requirement under the Proposed Regulations. Lastly, the Proposed Regulations seemed to provide no flexibility for situations where allocations and distributions are made on a “deal-by-deal” basis or other than with respect to a partner’s entire interest in a partnership.

The Final Regulations replace the “same manner” requirement with a “similar manner” requirement, where allocation and distribution rights with respect to fund managers’ capital interests must now be “reasonably consistent” with such rights applicable to limited partners with a “significant” aggregate capital account balance in a fund (still defined as at least 5% or more of the aggregate capital account balances of the partnership).^[9] The similar manner test may be applied on an investment-by-investment basis or on the basis of allocations made to a particular class of interests.^[10] Under the Final Regulations, as under the Proposed Regulations, capital interest allocations must be clearly identified both under the partnership agreement and on the partnership’s contemporaneous books and records as separate and apart from allocations made to a fund manager with respect to its API.^[11]

Finally, the Final Regulations explicitly confirm that a fund manager’s capital interest will not be ineligible for the capital interest exception solely because that fund manager is not charged management fees or carried interest, or because a fund manager has a right to receive tax distributions but unrelated non-service partners do not have such a right, so long as such distributions are treated as advances against future distributions.^[12] The Final Regulations leave open whether certain other differences in economic terms, such as a disproportionate allocation of certain expenses (such as placement agent fees), or lock-ups and redemption rights in hedge funds, would disqualify a capital interest from benefitting from the exception.

Treatment of Capital Interests Acquired with Loan Proceeds

Under the Proposed Regulations, any loan or other advance made or guaranteed, directly or indirectly, by any partner, the partnership or any person related to another partner or the partnership, that is used to fund the acquisition of a fund manager’s capital interest would disqualify the interest from the capital interest exception.^[13] These disqualified arrangements could include a loan from a management company to the general partner or individual members of the general partner to fund capital commitment amounts, a loan provided by the fund to the general partner or even a bank loan to an individual fund manager that is guaranteed by the management company or other partners. The rule applied to recourse and nonrecourse loans alike and applied without respect to a partner’s risk of loss in respect of a loan.

The Final Regulations retain the general rule that the capital interest exception does not apply to capital funded with the proceeds of a loan made or guaranteed, directly or indirectly, by the partnership, a partner or any person related to the foregoing.^[14] However, the Final Regulations helpfully contain an exception to this general rule that allows capital interests of an individual service provider acquired with loan proceeds made, directly or indirectly, by any partner or any related person (other than the partnership) to still qualify for the capital interest exception so long as the individual service provider is personally liable for the repayment of such loan or advance.^[15] The Final Regulations further provide that an individual service provider is considered personally liable for the repayment of a loan or advance made by a partner (or any related person, other than the partnership) if (i) the loan or advance is fully recourse to the individual service provider, (ii) the individual service provider has no right to reimbursement from any other person, and (iii) the loan or advance is not guaranteed by any other person.^[16]

The retention of the prohibition of guarantees may continue to limit typical arrangements entered into by fund managers. For example, if an individual service provider employed by a fund manager borrows from a bank in order to fund the acquisition of its capital interest in the fund, and the fund's management company guarantees the loan, the loaned proceeds fail to qualify for the capital interest exception under the Final Regulations even if the loan is fully recourse. However, it is possible that such an arrangement may be restructured in a manner that would allow the fund manager's capital interest to satisfy the capital interest exception (for example, if the individual service provider funded its capital contributions with proceeds of a loan from a management company, which the management company acquired through a direct borrowing from a bank).

Given the complexity of the interaction of loans and guarantees in the context of the capital interest exception, fund managers should review carefully the specifics of any loan program that they use to fund capital commitments to their funds to ensure that such arrangements do not run afoul of the capital interest exception.

Treatment of Unrealized Gain

Some commentators had questioned whether, under the Proposed Regulations, unrealized gains that were allocated to a fund manager's capital account as a result of a "book-up" or other revaluation event could be treated as capital of the fund manager for purposes of the capital interest exception (in other words whether a fund manager could get "credit" for economic gains in its capital account for purposes of the capital interest exception). Hedge funds typically allocate unrealized gains to their managers. If allocations of unrealized gains allowed the manager to qualify for the capital interest exception, future allocations in respect of the unrealized capital interest would not be subject to Section 1061.

The Final Regulations clarify that gains must be realized before a fund manager receives credit for purposes of the capital interest exception, and, therefore, a fund manager cannot get "credit" for unrealized gains. The Final Regulations provide that any such realized gains will be treated as reinvested for these purposes whether such realized gains are distributed and recontributed to the fund by the fund manager or retained by the fund manager in the fund.

Transfers of APIs to Related Persons

Section 1061(d) generally provides that, if a taxpayer transfers, directly or indirectly, any API that has been held for three years or less, to a person related to the taxpayer (defined to include a taxpayer's spouse, children, grandchildren, and parents, as well as colleagues), the transfer is taxable.^[17] The Proposed Regulations broadly defined "transfer" in this context to include nonrecognition transactions such as gifts or contributions to partnerships. As a result, under the Proposed Regulations, the gift of a profits interest would accelerate the transferor's gain.^[18]

The Final Regulations helpfully clarify that Section 1061(d) does not accelerate gain on a transfer and applies only to transfers where gain is recognized.^[19] Consequently, Section 1061(d) does not trigger the recognition of gain in otherwise tax-free transfers, such as contributions to partnerships or gift transfers that are often utilized in estate planning for fund managers. Nevertheless, any future realized gains in respect of such transferred APIs would remain subject to potential Section 1061 recharacterization.

Lookthrough Rule for Certain API Dispositions

The Proposed Regulations treated the gain on the sale of an API as short-term capital gain in certain circumstances, even if the API had been held for more than three years. [\[20\]](#) The relevant holding period for a sale of an API (or pass-through entity holding directly or indirectly an API) is generally tested by reference to the holding period in that entity. [\[21\]](#) However, under the Proposed Regulations, if gain with respect to “substantially all” (80% or more) of the entity’s assets would be recharacterized as short-term under Section 1061 if disposed of (due to a holding period of three years or less), then gain on the sale of such API would be recharacterized as short-term even if the seller of the API had satisfied the three-year holding period generally required by Section 1061. [\[22\]](#)

Under the Final Regulations, the Lookthrough Rule has been significantly pared back, and replaced with an anti-abuse rule that is applicable only where, at the time of disposition of an API held for more than three years, (1) the API would have a holding period of three years or less if the holding period of such API were determined by excluding any period before which third-party investors have capital commitments to the partnership, or (2) a transaction or series of transactions has taken place with a principal purpose of avoiding potential gain recharacterization under section 1061(a). [\[23\]](#)

Carry Waivers

In the Preamble to the Proposed Regulations, the IRS and the Treasury indicated they were aware of arrangements employed by fund managers to waive allocations of gain from a fund that would be treated as short-term capital gain pursuant to Section 1061, in order to be allocated future gain that could satisfy Section 1061’s three-year holding period. The Preamble to the Proposed Regulations included a warning that such arrangements may be subject to challenge on various grounds and should comply with generally applicable tax laws, including those that also apply to so-called “management fee waivers” (which we previously have discussed in a [prior alert](#)). The Final Regulations (including the Preamble), however, are completely silent on carry waiver arrangements. Nevertheless, careful planning should continue to be used when implementing such arrangements.

Guidance Consistent with the Proposed Regulations

APIs held by Corporations

Section 1061 provides an exception from the three-year holding period requirement for APIs held by “corporations”.^[24] Consistent with previous IRS announcements,^[25] and the Proposed Regulations, the Final Regulations confirm there is no exception for APIs held by S-corporations^[26] or “passive foreign investment companies” (or “PFICs”) with respect to which the applicable owner has made a “qualified electing fund” election.^[27]

Certain Income Not Subject to Recharacterization

The Final Regulations retain the rule in the Proposed Regulations that Section 1061 does not apply to (1) “qualified dividend income,”^[28] (2) Section 1231 gains (generally, gain from the sale of real property and depreciable personal property used in a trade or business and held for over one year),^[29] (3) gains characterized as long-term without regard to the holding period rules defined in Section 1222^[30] (which include gains characterized under the mixed straddle rules), or (4) “mark-to-market gains” under Section 1256^[31] (generally, gain from certain futures and options contracts).

Distributions of API Property

Stock of a portfolio company that a fund distributes to a fund manager continues to be subject to Section 1061. The Final Regulations confirm that a fund manager needs to continue to hold such shares following a distribution until the three-year holding period under Section 1061 has been met in order to obtain long-term capital gains treatment upon an ultimate sale of such stock.^[32]

Effective Dates

The Final Regulations generally apply to tax years beginning on or after the date the Final Regulations are published in the Federal Register, and will therefore apply to taxpayers with a calendar tax year beginning January 1, 2022.^[33] Taxpayers are allowed to apply the Final Regulations prior to that date, if they are applied consistently.^[34] Consistent with the Proposed Regulations, the rules for partnership interests held by S-corporations are effective for tax years beginning after December 31, 2017 (the effective date of Section 1061),^[35] and the rules for partnership interests held by PFICs that have made a QEF election are effective for tax years beginning after August 14, 2020.^[36]

Potential for Further Changes

The Preamble to the Final Regulations foreshadows that additional Section 1061 guidance could be released. The IRS flagged several topics as remaining under study, and solicited additional comments in those areas. In particular, the impact of Section 1061 on the taxation of enterprise value for sales of partnership interests and management contracts remains under IRS study.[\[37\]](#)

Please consult with the members of your Proskauer tax team to further discuss the details of the Final Regulations and how they may apply to your particular circumstances.

[\[1\]](#) T.D. 9945.

[\[2\]](#) All references to “Section” are references to the U.S. Internal Revenue Code of 1986, as amended.

[\[3\]](#) Reg. 107213-18.

[\[4\]](#) Section 1061(a).

[\[5\]](#) Final Treas. Reg. 1.1061-1(b), 1.1061-2(c), 1.1061-3(f)(1), 1.1061-4(d), 1.1061-5(g), 1.1061-6(e).

[\[6\]](#) Section 1061(c).

[\[7\]](#) Prop. Treas. Reg 1.1061-3(c)(3)(ii), 1.1061-3(c)(4)(ii).

[\[8\]](#) Prop. Treas. Reg. 1.1061-3(c)(3)(i).

[\[9\]](#) Final Treas. Reg 1.1061-3(c)(3)(ii).

[\[10\]](#) Final Treas. Reg 1.1061-3(c)(3)(ii).

[\[11\]](#) Final Treas. Reg. 1.1061-3(c)(3)(ii)(B).

[\[12\]](#) Final Treas. Reg. 1.1061-3(c)(3)(ii)(A).

[\[13\]](#) Prop. Treas. Reg. 1.1061-3(c)(3)(ii)(C).

[\[14\]](#) Final Treas. Reg. 1.1061-3(c)(3)(v)(A).

[\[15\]](#) Final Treas. Reg. 1.1061-3(c)(3)(v)(A).

[\[16\]](#) Final Treas. Reg. 1.1061-3(c)(3)(v)(B).

[\[17\]](#) Prop. Treas. Reg. 1.1061-5(e).

[\[18\]](#) Prop. Treas. Reg. 1.1061-5(b).

[\[19\]](#) Final Treas. Reg. 1.1061-5(a).

[\[20\]](#) Prop. Treas. Reg. 1.1061-4(b)(9).

[\[21\]](#) Treas. Reg. 1.1061-4(a)(3)(ii).

[\[22\]](#) Prop. Treas. Reg. 1.1061-4(b)(9)(i)(C).

[\[23\]](#) Final Treas. Reg. 1.1061-4(A).

[\[24\]](#) Section 1061(c)(4)(A)

[\[25\]](#) Notice 2018-18.

[\[26\]](#) Final Treas. Reg. 1.1061-3(b)(2)(i); Prop. Treas. Reg. 1.1061-3(b)(2)(i).

[\[27\]](#) Final Treas. Reg. 1.1061-3(b)(2)(ii).

[\[28\]](#) Prop. Treas. Reg. 1.1061-4(b)(6)(iii).

[\[29\]](#) Prop. Treas. Reg. 1.1061-4(b)(6)(i).

[\[30\]](#) Prop. Treas. Reg. 1.1061-4(b)(6)(iv).

[\[31\]](#) Prop. Treas. Reg. 1.1061-4(b)(6)(ii).

[\[32\]](#) Final Treas. Reg. 1.1061-4(a)(4)(i)(C); Prop. Treas. Reg. 1.1061-4(a)(4)(i)(C).

[\[33\]](#) Final Treas. Reg. 1.1061-1(b), 1.1061-2(c), 1.1061-3(f)(1), 1.1061-4(d), 1.1061-5(g), 1.1061-6(e).

[\[34\]](#) Final Treas. Reg. 1.1061-1(b), 1.1061-2(c), 1.1061-3(f)(1), 1.1061-4(d), 1.1061-5(g), 1.1061-6(e).

[\[35\]](#) Final Treas. Reg. 1.1061-3(f)(2).

[\[36\]](#) Final Treas. Reg. 1.1061-3(f)(3).

[\[37\]](#) Final Treas. Reg. Part IV. A.

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