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# **New Carried Interest Rules for Investment Funds: Analysis, Planning Opportunities and Pitfalls**

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Today's faculty features:

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# New Carried Interest Rules for Investment Funds: Analysis, Planning Opportunities and Pitfalls

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# Agenda

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- Overview
- Parsing the Statute
- Open Questions
- Planning Opportunities

## Overview: Setting the Stage

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- **“Carried Interest”** – a profits interest granted to fund managers in return for the performance of investment management services
- **The “issue”** – as a partnership interest, carried interest is taxed based on character of tax items realized by the fund, including long term capital gains
  - Numerous proposals over the past 10+ years to address perceived inequity of permitting LTCG treatment for the provision of services
- **The latest “solution”** – §1061\* targets a specific type of gains for re-classification as short-term capital gains

\*NB: Unless otherwise indicated, section references used herein are to the Internal Revenue Code of 1986, as amended.

## Overview: Section 1061

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- Applies to certain items with respect to “partnership interests held in connection with performance of substantial services” in investment management services
- For certain “carried interests” the holding period for long term capital gains (**LTCG**) treatment is 3 years (rather than one year); capital gains from an asset with a holding period of 1-3 years re-characterized as short term capital gains (**STCG**)
- No grandfathering for existing carried interest arrangements



## Overview: Impact on Funds

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- Not all funds are equally impacted:
  - **Hedge**: generally unaffected where typical hold period is 1 year or less
  - **Buyout**: potential issue for dividend recaps (distributions in excess of E+P and basis) and shorter term holds
  - **Growth Equity**: potential issue depending on expected hold periods
  - **Venture**: early stage investments generally have longer hold periods, but follow-on investments may be an issue
  - **Real Estate**: generally included, but 1231 gains excluded (for now)



## Parsing the Statute: The General Rule of Section 1061

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- General Rule [§1061(a)]
  - If one or more **applicable partnership interests** are held by a **taxpayer** at any time during a taxable year,
  - treat as STCG the excess (if any) of
    - the taxpayer’s net LTCG with respect to such interests for such taxable year *over*
    - the taxpayer’s net LTCG with respect to such interests for such taxable year computed by applying paragraphs (3) and (4) of **§1222** by substituting “3 years” for “1 year”
- Special Rule [§1061(b)]: to the extent provided by the Secretary, §1061(a) shall not apply to income or gain attributable to any asset not held for portfolio investment on behalf of third party investors

## Parsing the Statute: “Applicable Partnership Interest”

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Any interest in a partnership which

- directly or indirectly is transferred to (or is held by) the taxpayer in connection with the performance of substantial services by the taxpayer, or any **other related person**,
- in any **applicable trade or business** (see slide after next)
- Certain interests excepted (see next slide)



## Parsing the Statute: “Applicable Partnership Interest” (Cont’d)

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### Exceptions

- **“does not apply to”** 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 other entity
- **“does not include”** any interest held directly or indirectly by a corporation
- **“does not include”** any capital interest in a partnership which provides the taxpayer with the right to share in partnership capital commensurate with (i) the amount of capital contributed (determined at that time of receipt of such partnership interest), or (ii) the value of such interest subject to tax under §83 upon the receipt or vesting of such interest

## Parsing the Statute: “Applicable Trade or Business”

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- Any activity conducted on a regular, continuous, and substantial basis which, **regardless of whether the activity is conducted in one or more entities**, consists, in whole or in part, of
  - Raising or returning capital, and
  - Either (a) investing in (or disposing of) **specified assets** (or identifying specified assets for such investing or disposition), or (b) developing specified assets

## Parsing the Statute: “Specified Assets”

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- Securities as defined in §475(c)(2) (without regard to the last sentence thereof)
- Commodities as defined in §475(e)(2)
- Real estate held for rental or investment
- Cash or cash equivalents
- Options or derivatives with respect to any of the foregoing
- An interest in a partnership to the extent of the partnership’s proportionate interest in any of the foregoing

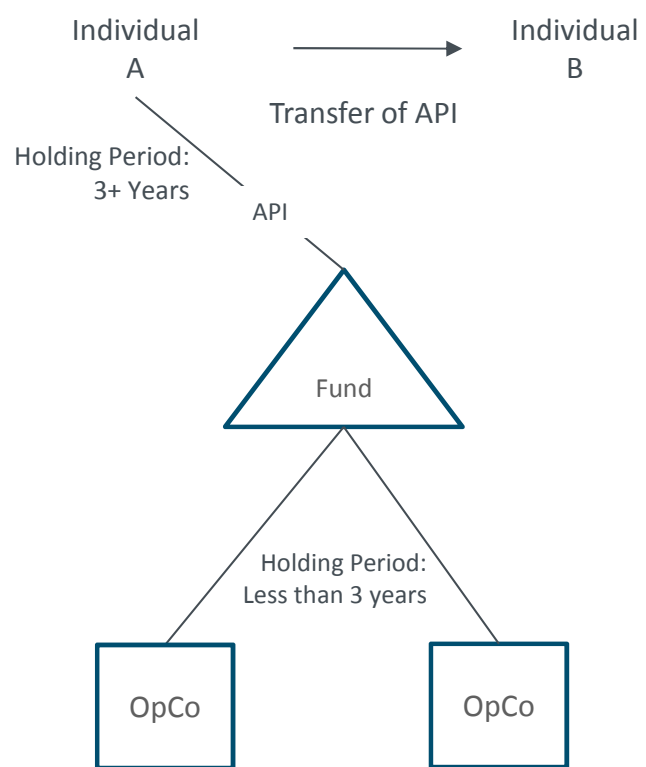
## Parsing the Statute: **Transfers to Related Persons**

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- **§ 1061(d)**

- If a taxpayer transfers an API (directly or indirectly) to a **related person**, the taxpayer shall include in gross income as STCG the excess (if any) of
  - so much of the taxpayer’s LTCG **with respect to such interest** for such taxable year attributable to such sale or exchange of **any asset held for not more than 3 years** as is allocable to such interest over
  - any amount treated as STCG under §1061(a) with respect to such transfer
- “Related person”
  - a member of the taxpayer’s family within the meaning of §318(a)(1) OR
  - someone who performed a service within the current calendar year or the preceding 3 calendar years in any applicable trade or business in which or for which the taxpayer performed a service

# Parsing the Statute: Transfers to Related Persons (cont'd)



## What is the intended effect of §1061(d)?

- Look-through rule?
- Anti-netting rule?
- Override of third party investor exception [§1061(b)]?
- Override of non-recognition treatment (if applicable)?
- Intended to expand scope of §1061 beyond §1222 LTCG (see slide after next)?





## Authority for future guidance

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- Reporting [§1061(e)]: The Secretary shall require such reporting (at the time and in the manner prescribed by the Secretary) as is necessary to carry out the purposes of this section.
- Regulations [§1061(f)]: The Secretary shall issue such regulations or other guidance as is necessary or appropriate to carry out the purpose of this section.

## Open Questions: §1222 LTCG v Other LTCG Provisions

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- §1061 applies to LTCG under §1222(3) and (4)
  - Long term capital gain (loss) means gain (loss) from the sale or exchange of a capital asset held for more than 1 year, if and to the extent such gain (loss) is taken into account in computing taxable income
- But, a separate 1 year holding period is set forth in §1231 for property used in the trade or business.
  - §1231 generally applies to property subject to allowance for depreciation in §167 and real property used in the trade or business, other than certain items, including (A) inventory, (B) property primarily for sale to customers, (C) a patent, invention, secret formula or process or a copyright.
- Intentional or inadvertent? Include other LTCG provisions?

## Open Questions: What securities are Specified Assets?

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Securities as defined in §475(c)(2):

- A. share of stock in a corporation;
- B. partnership or beneficial ownership interest in a widely held or publicly traded partnership or trust;**
- C. note, bond, debenture, or other evidence of indebtedness;
- D. interest rate, currency, or equity notional principal contract;
- E. evidence of an interest in, or a derivative financial instrument in, any security described in subparagraph (A) , (B) , (C) , or (D) , or any currency, including any option, forward contract, short position, and any similar financial instrument in such a security or currency; and
- F. position which (1) is not a security described in subparagraph (A) , (B) , (C) , (D) , or (E) , (2) is a hedge with respect to such a security, and (3) is clearly identified in the dealer's records as being described in this subparagraph before the close of the day on which it was acquired or entered into (or such other time as the Secretary may by regulations prescribe).

Subparagraph (E) shall not include any contract to which section 1256(a) applies. **[NOTE: Gain from §1256 contract not treated as LTCG pursuant to §1222]**



## Open Questions: Held on behalf of third party investors?

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- Recall: to the extent provided by the Secretary, the general re-characterization rule **shall not apply** to income or gain attributable **to any asset not held for portfolio investment on behalf of third party investors**
- Third party investor means a person who:
  - (A) holds an interest in the partnership which does not constitute property held in connection with an applicable trade or business; and
  - (B) is not (and has not been) actively engaged, and is (and was) not related to a person so engaged, in (directly or indirectly) providing substantial services referenced in §1061(c)(1) for such partnership or any applicable trade or business
- Third party investor exception overrides §1061(a), but what about re-characterization rules for related person transfers in §1061(d)?



## Open Questions: **Person employed by another entity?**

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- Recall: “applicable partnership interest” definition does not apply to 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.
- Who and what is this meant to cover?
- How does this interact with
  - third party investor exception [§1061(b)] and
  - related person transfer rules (if transferred to a non-employee related person) [§1061(d)]?

## Open Questions: **Share commensurate with contribution?**

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- Recall: “applicable partnership interest” does not include any capital interest which provides the taxpayer with a right to **share in partnership capital commensurate with the amount of capital contributed** (determined at the time of receipt of such partnership interest) or the value of such interest subject to tax under §83 upon receipt
- Implications for sponsor capital:
  - No fees or carry on GP capital?
  - “Fee waiver” strategy
  - Hedge fund reinvestment of carried interest

## Planning Opportunities

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- Adjust Investment Structure
  - No “applicable partnership interest”
  - No “applicable trade or business”
  - Holding period planning
- Adjust Economic Deal
  - Investment Level
  - Fund Level

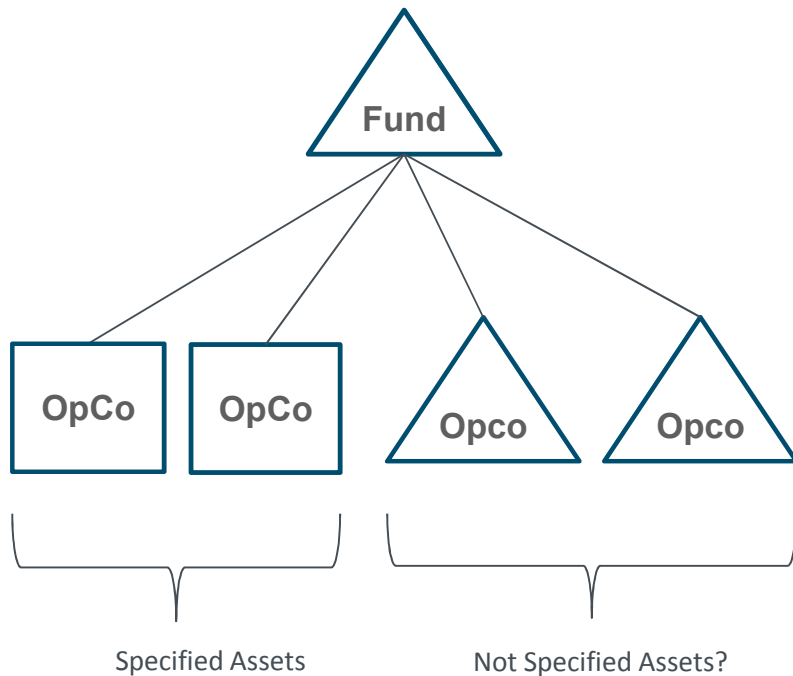
## Planning Opportunity: No “Applicable Partnership Interest”

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- Recall: partnership interest held directly or indirectly by a corporation is not an API with respect to such corporation
- Opportunity: structure carry vehicle as a corporation
- Considerations
  - Notice 2018-19 says S-corps are out
  - US v. non-US?
    - CFC/PFIC Considerations
  - Impact on income other than LTCG?



# Question of Law: No “Applicable Trade or Business”



## Legal Analysis

- Recall → ATB is any activity conducted on a regular, continuous and substantial basis which (regardless of whether the activity is conducted through one or more entities) consists, in whole or in part, of (A) raising or returning capital and (B) either investment/dispositions or developing of specified assets
- Unclear whether “specified assets” includes partnership interests that are not widely held or publicly traded
  - But specified asset includes an interest in a partnership to the extent of partnership’s proportionate interest in specified assets

## Considerations

- Legislative intent?
- How many specified assets required to meet the test?
- When is ATB tested: at investment, at sale, other?
- What is a widely held partnership?



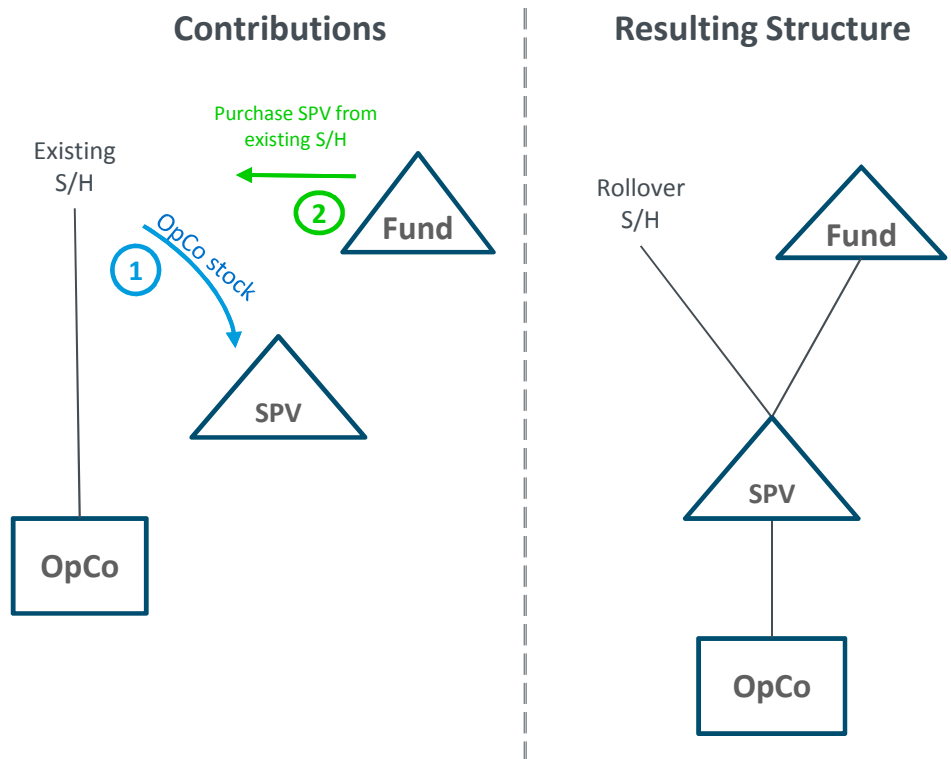
## Refresher: Certain Partnership Holding Period Rules

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- The holding period of a partnership interest received in exchange for a capital asset includes the holding period of the capital asset exchanged, if the partnership interest received has the “same basis in whole or in part” as the basis of the capital asset exchanged (§1223(1))
- The basis of a partnership interest acquired by a contribution of property to the partnership includes the basis of such property to the contributing partner (§722)
- The holding period of property (other than inventory) distributed to a partner from a partnership shall include the partnership’s holding period with respect to such property (§735)
- The holding period of a partnership interest does not impact the holding period of the partnership asset and vice versa (subject to look-through rules) (§702(b))
- A partner will have a divided holding period if it acquires different portions of a partnership interest at different times (e.g., follow-on investment) (Treas. Reg. §1.1223-3(a))



# Planning Opportunity: Holding Periods



## Planning Opportunity

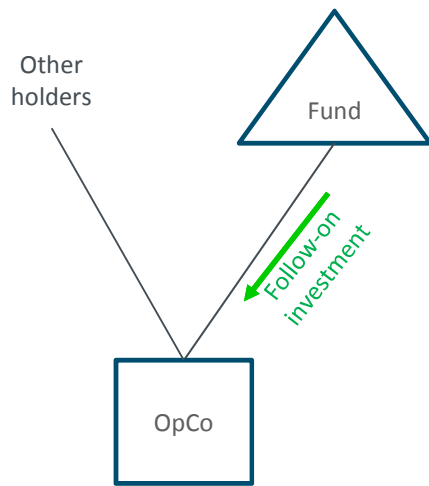
- (1) Contribution of target OpCo stock to SPV (partnership for US tax purposes) followed by
- (2) purchase of SPV interest by Fund

## Considerations

- Additional cost and complexity of SPV
- Economics and governance of SPV
- Non-tax considerations
- Partnership anti-abuse?
- Divided holding period for future investments in OpCo

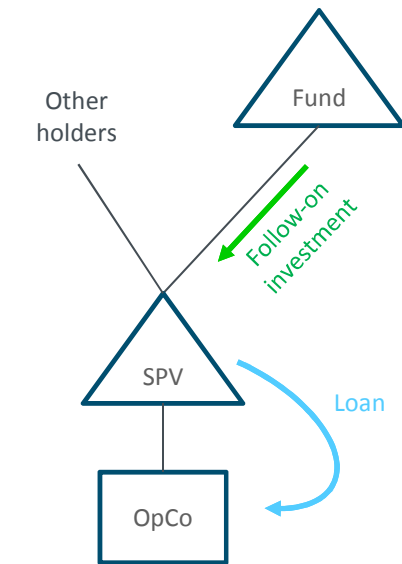
# Planning Opportunity: Holding Periods

## Direct Loan



Holding period for equity from follow on investment begins when investment is made

## SPV Loan



No new holding period for SPV's equity in OpCo

## Planning Opportunity

Fund follow-on rounds through debt rather than equity

## Considerations

- Additional cost/complexity of SPV
- Economics and governance of SPV
- Non tax considerations
- Partnership anti-abuse?
- FDAP withholding?

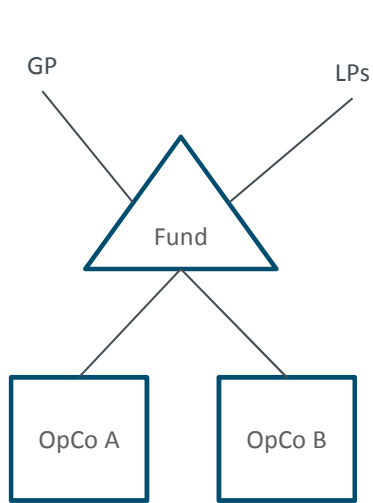


## Adjust Economic Deal: **Investment Level**

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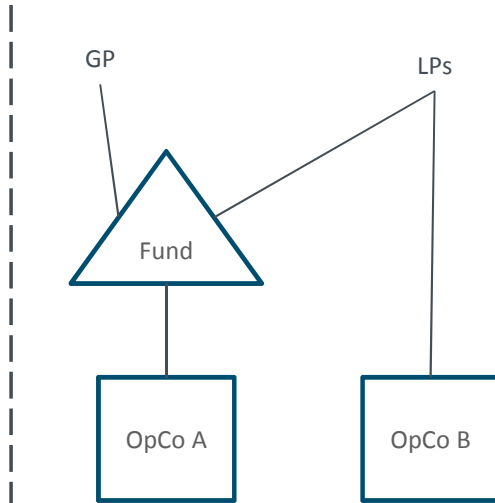
- **Planning Opportunity**: utilize dividends in order to minimize exit proceeds that will be subject to re-characterization rule
- **Considerations**
  - FDAP withholding for non-US persons
  - Dividends recast as gain from sale?

# Adjust Economic Deal: Fund Level – Stock Distributions



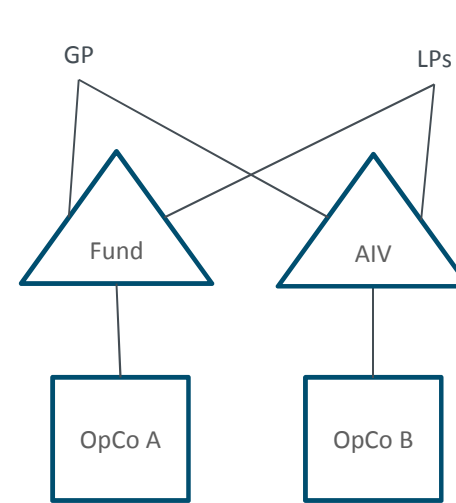
Scenario

- Assume sale of OpCo B, with <3 year holding period and carry allocated but no carry distributable.
- Disregard GP capital.



Option 1

- Distribute OpCo B stock to LPs, and LPs sell.
- GP carry from gain in capital account, resulting in distributions in excess of basis to GP.
- Practical limitations for LPs to effect a sale
- Potential limitations on ability to distribute illiquid securities.



Option 2

- Fund contributes OpCo B stock to AIV and distributes AIV interests to Partners; AIV sells OpCo B stock.
- Various tax risks.



## Adjust Economic Deal: Fund Level – Carry Allocations

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- **Planning Opportunity**: “hard wired” waiver - carry allocations do not include gain from assets with a holding period that is not more than 3 years (but total carry is measured by reference to all gains)
- **Considerations**
  - Business risks
  - Potential GP-LP conflict issues
  - Risks of changes in law

## Adjust Economic Deal: Fund Level – Waiver Mechanism

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- **Planning Opportunity**: discretionary gain allocation waiver mechanism
  - GP waives allocation of gain, to be made whole out of future gain
- **Considerations**
  - Make-whole only out of future net appreciation in value creates business risk?
  - Timing for waiver?
  - Make-whole allocations arising in same year?
  - Tax items to include in make-whole allocation?



# Thank You

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