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Proposed Carried Interest Regulations: Impact on Fund Managers and Tax Planning

TUESDAY, NOVEMBER 17, 2020, 1:00-2:50 pm Eastern

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Proposed Carried Interest Regulations: Impact on Fund Managers and Tax Planning

Presenters

Philip Gross, James McCann, Deborah Taeid

Kleinberg, Kaplan, Wolff & Cohen, P.C.

Contact Information

Kleinberg, Kaplan Wolff & Cohen, P.C.

500 Fifth Avenue
New York, NY 10110
www.kkwc.com
LinkedIn   Twitter

Philip Gross
pgross@kkwc.com
(212) 880-9828

James McCann
jmccann@kkwc.com
(212) 880-9834

Deborah Taeid
dtaeid@kkwc.com
(212) 880-9819

Agenda

- Background
- IRC 1061 and Proposed Regulations
- Exceptions to 1061
- Tax Reporting Obligations
- Effective Date
- State and Local Tax Issues
- Questions

Background

Carried Interest: History and Meaning

What is the Carried Interest?

- Also is sometimes referred to as the incentive allocation, the performance allocation, the profits interest, the carry, or the promote
- Carried Interest is essentially an allocation to the general partner (generally) of a portion of the partnership's profits
- Historically, the benefit of the carry to the general partner is that the tax character of the partnership's income flows through to the general partner so that he or she can realize certain tax benefits – e.g., long-term capital gains
- Common for all types of investment funds – hedge funds, private equity funds, real estate funds, venture capital funds

Carried Interest: History and Meaning

What does the term "carried interest" mean?

- Hedge fund context
  - A percentage of net appreciation over a period of time, typically 1 year; there is a high water mark; there may be a hurdle
- Private equity fund context
  - A percentage of cash flow after the limited partners have received back their capital contributions plus a preferred return
- Issued to general partner at time the fund is set up
- History
  - Long settled that an incentive allocation passed through income and losses with the tax characteristics of the applicable partnership
- Notoriety of hedge funds and large incentive allocations brought attention to the issue in the early 2000s

Carried Interest: History and Meaning

- There were a number of legislative proposals to change the taxation of carried interest prior to the 2017 Tax Cuts and Jobs Act (the "TCJA")
- The proposals were generally similar to each other but had a number of nuances
- Nothing was enacted until December 2017 in the TCJA
- TCJA enacted Section 1061 of the Code
- There are recent proposals to broaden the taxation of carried interests
- Effect of a Biden administration
- Weighing an incentive allocation versus an incentive fee

Section 1061 and the Proposed Regulations

Section 1061 of the Code

- Enacted in December 2017; effective for taxable years beginning on or after January 1, 2018
- Section 1061 generally recharacterizes certain long term capital gains with respect to an applicable partnership interest "API" with less than a three year hold period as short term capital gains.
- APIs are generally 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.

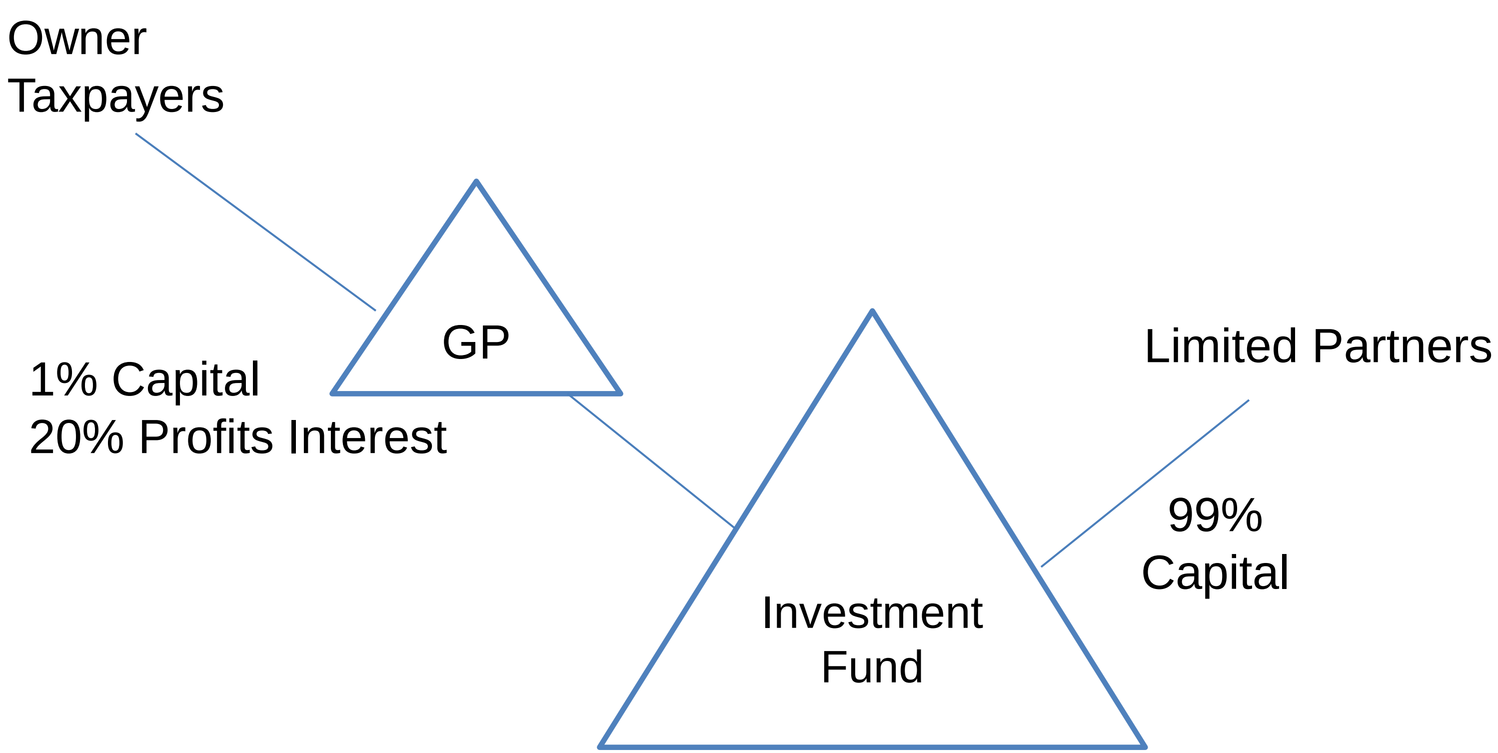
Applicable Trade or Business

Any activity conducted on a regular, continuous, and substantial basis which consists, in whole or in part, of raising or returning capital, and either (i) investing in (or disposing of) specified assets (or identifying specified assets for such investing or disposition), or (ii) developing specified assets.

Specified Asset

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

Owner Taxpayer



Proposed Regulations

- The IRS recently issued proposed regulations (the “Regulations”) on the carried interest rules set forth in Section 1061 of the Code. Section 1061 was enacted on December 22, 2017, as part of the TCJA and applies to taxable years beginning on or after January 1, 2018. The Regulations are approximately 150 pages, which is actually short in comparison to other recent regulations. They are extremely complicated and introduce a number of new definitions and concepts.
- Many tax groups including the tax section of the New York State Bar Association have published commentary indicating that there are still a number of uncertainties on how the rules should be applied in common fund structures.
- Most managers will continue to take incentive allocations as opposed to incentive fees. The proposed regulations probably do not change that determination that much.
- Released on July 31, 2020; published in Federal Register on August 14, 2020

Recharacterization of 1 to 3 Year Capital Gains as Short-Term Capital Gains

- Consistent with the statute, the Regulations provide that gain which would have been long-term capital gain because the applicable property was held for more than 1 year is recharacterized as short-term capital gain if the holding period was not more than 3 years.
- The amounts are netted at the owner taxpayer level (i.e., the ultimate person subject to tax).
- Generally, combine all LTCGs and LTCLs and then subtract portion attributable to assets held more than 3 years. If overall net capital gains is zero or less, no recharacterization.
- No grandfathering of assets held prior to January 1, 2018.

Three year holding period

- The Proposed Regulations generally provide that for the purposes of Section 1061, the holding period of the direct owner of the asset controls in determining the recharacterization amount.
- If a partnership sells an asset that it has owned for more than three years, Section 1061 will generally not apply, even if a carried interest partner has held his or her partnership interest for less than three years.

Exceptions

Exceptions

There are exceptions for:

- Certain types of income
- Carried interest held by corporations
- Carried interest issued for services to a “single employer”
- Purchased carry
- Capital interests

Note that there are different technical bases for these exceptions. For example, first one applies to income earned with respect to an API; next three prevent the partnership interest from being classified as an API; and the last one (capital interests exception) is - statutorily - an exception from API definition, but the Regulations recraft as an exception for income earned through an API.

What about?

- Family offices (i.e., IRC 1061(b))
- Seeders

Exceptions from Recharacterization: Amounts treated as LTCG not based on holding period

The following types of income are not subject to recharacterization even if earned with respect to an API:

- Section 1231 gains
- Section 1256 contracts
- Qualified dividend income
- Other capital gains and losses that are deemed long- or short-term without regard to holding period, such as under the mixed straddle rules

Exceptions from API: Corporations

Statute: API does not include any interest in a partnership directly or indirectly held by a corporation. IRC 1061(c)(4)(A)

Regulations mirror this provision, except for exclusions of partnership interests held by:

- PFICs subject to a qualified electing fund election ("QEFs"), or
- S corporations.

2018 administrative guidance excluded S corporations; exclusion of QEFs is new with the regulations.

Arguable as to whether Treasury has statutory authority to exclude QEFs or S corporations.

Exceptions from API: Single Employer Exception

An API does not include any interest transferred to a person in connection with the performance of substantial services by that person as an employee of another entity that is conducting a trade or business (other than an ATB) and the person provides services <u>only</u> to such other entity.

E.g.: PE fund owns a portfolio company; carry issued to employee of portfolio company. Limited to carry in the portfolio company, or can it extend to fund or other assets within the fund? Suppose portfolio company is in the oil and gas industry, and employee also advises fund owner regarding other oil and gas assets?

Exceptions from API: Third Party Purchaser Exception

Regulations provide that partnership interest will not be treated as an API if taxpayer is a bona fide purchaser who:

- Has not, does not, and does not contemplate providing services,
- is unrelated to any service provider, and
- acquired the interest "by taxable purchase for fair market value" (e.g., not available if interest acquired through a capital contribution to the general partner).

Consider various permutations of seeder deals and other "revenue share" transactions :

- Acquisition coincides with launch vs. existing fund.
- At fund level vs. interest in GP.

Exception has been described as non-statutory. Regulations explain: "section 1061 … applies to service providers and persons related to service providers and is not meant to apply to bona fide purchasers of a partnership interest who do not provide services". Query whether this exception is actually embedded within the statute, which defines an API as "any interest in a partnership which … 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".

Exceptions from API: IRC 1061(b)

IRC 1061(b): “To the extent provided by the Secretary, subsection (a) shall not apply to income or gain attributable to any asset not held for portfolio investment on behalf of third party investors.”

- Regulations reserve on this.
- Many thought intended to exclude family offices. Treasury appears to believe that family offices are effectively excluded by the capital interest exception (specifically for “passthrough interest direct investment allocations”), though this exception may be problematic. Treasury requested comments on this point.
- It has been suggested that guidance under this provision might also address “enterprise value”.

Exceptions from Recharacterization: Capital Interest Exception

Statute <u>suggests</u> a relatively simple exception, covering “any capital interest in the partnership 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 interest)” or commensurate with the value of such interest subject to tax under Section 83 upon its receipt or vesting.

In practice, not so simple. Divergence of opinions and practice for very common fact patterns, in particular for “leaving carry in the fund”.

Under statute, capital interests excluded from definition of API.

Exceptions from Recharacterization: Capital Interest Exception

Under the Regulations, the capital interest exception is clearly very complex.

Rather than excluding capital interests from being characterized as APIs, Regulations exclude "capital interest gains and losses" from recharacterization under Section 1061.

"Capital interest gains and losses" are certain items of income that meet certain requirements.

Exceptions from Recharacterization: Capital Interest Exception

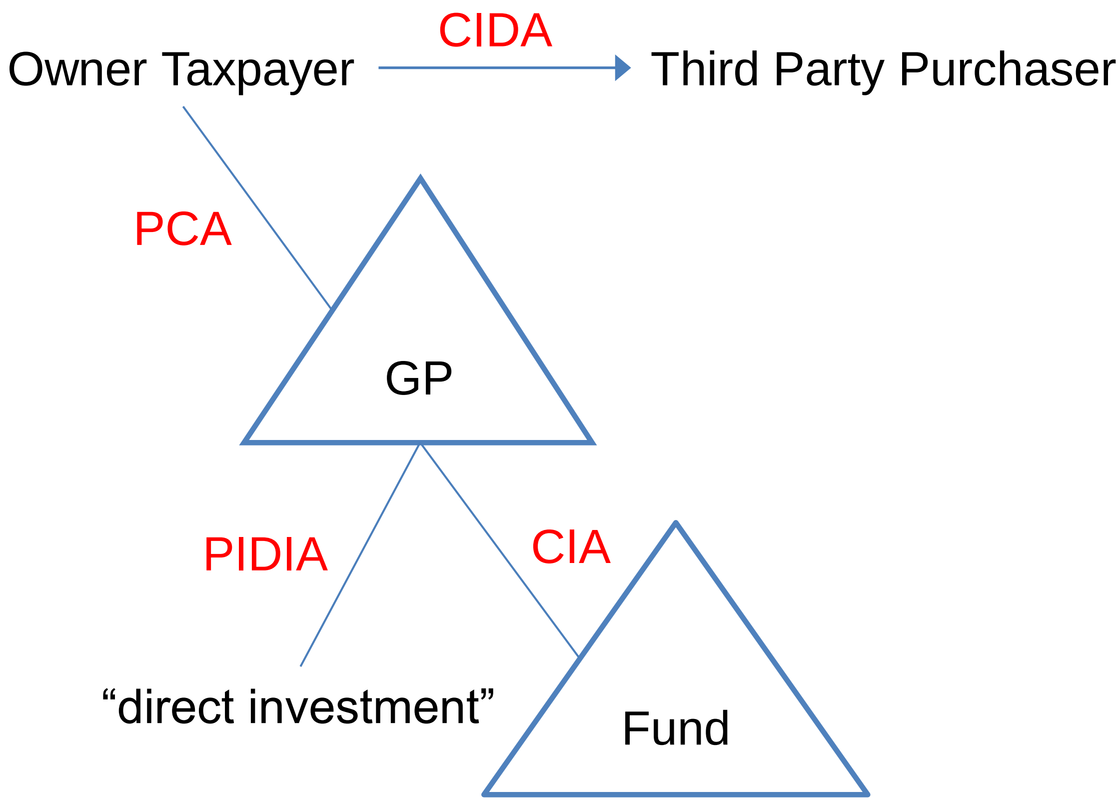
- Is the exception generally even necessary? i.e., if a manager or associated entity purchases a fund LP interest at the same price and on substantially the same terms as third-party investors, should the LP interest even fall within the scope of an API, i.e., "any interest in a partnership which … is transferred to (or is held by) the taxpayer in connection with the performance of substantial services by the taxpayer, or any other related person".
- Clearly Treasury believes that it is within the scope of an API; consider third party purchaser exception.
- Is this interpretation supported by the statute?
- Alternative interpretation: it is not within the scope of an API. Capital interest exception still necessary/appropriate, to carve-out the GP interest from definition of an API, to the extent it represents a capital investment and not carry.

Exceptions from Recharacterization: Capital Interest Exception Capital Interest Gains and Losses

"Capital interest gains and losses" comprised of the following, provided that the applicable requirements are satisfied:

- Capital interest allocations (CIA). Allocations derived through an API to the first API holder in a chain of ownership. E.g., allocations from the fund to its general partner.
- Passthrough capital allocations (PCA). Essentially "indirect" capital interest allocations. E.g., allocations to the direct/indirect owners of the fund's general partner.
- Passthrough interest direct investment allocations (PIDIA). Allocations based on non-API investments. E.g., a non-API investment by the fund's general partner. Does this exception apply to tiered structures?
- Capital interest disposition amounts (CIDA). Gains and losses derived from the sale of passthrough entities that are entitled to the foregoing, e.g., the sale of a direct or indirect interest in the fund's general partner.

Exceptions from Recharacterization: Capital Interest Exception Capital Interest Gains and Losses



Exceptions from Recharacterization: Capital Interest Exception Requirements

Basic requirements for capital interest allocations and passthrough capital allocations:

- "based on the relative capital accounts of the partners"
- "terms, priority, type and level of risk, rate of return, and rights to cash or property distributions during the partnership's operations and on liquidation are the same"

Regulations 1.1061-3(c)(3)(i)

Exceptions from Recharacterization: Capital Interest Exception Requirements – Capital Account

Capital interest allocations and passthrough capital allocations must be "based on the relative capital accounts of the partners", i.e., 704(b) capital accounts.

- Contrast statutory reference to "the amount of capital contributed".
- Appears to resolve the treatment of carry left in the fund, i.e., there should not be any requirement to withdraw and recontribute.
- Because carried interest exception is based on 704(b) capital accounts, earnings on unrealized amounts may qualify for the exception, and thus regulations introduce another concept ("unrealized API gains and losses") to ensure that such unrealized amounts continue to be tainted by IRC 1061. May arise through the normal operation of a hedge fund carried interest (which is economically applied on a mark-to-market basis), through book-ups (which are mandatory for purposes of applying the capital interests exception, and which must be applied through tiers of pass-through entities), through 704(c) transactions, etc. There are many technical questions about how these rules coordinate with the existing 704(b) and (c) rules, and how they are applied in practice.
  - E.g. $100 economic carry, but only $80 realized gains. If left in the fund, earnings on entire $100 may qualify for capital interest exception, but $20 unrealized does not.

Exceptions from Recharacterization: Capital Interest Exception Requirements – Capital Account

Other potential issues:

- Exception only contemplates “pro rata” allocations based on 704(b) (i.e., “tax”) capital accounts. Does not take into account that different partners may have different sharing ratios for different assets.
- Capital accounts do not include “the contribution of amounts directly or indirectly attributable to any loan or other advance made or guaranteed, directly or indirectly, by any other partner or the partnership”, or related persons. E.g., employee co-investments funded by loans from the management company. Does borrowing even a fraction of such a contribution disqualify the entire contribution? Is borrowing for an entirely unrelated purpose problematic? (i.e., because money is fungible.)

Exceptions from Recharacterization: Capital Interest Exception Requirements – "Same" Treatment as Third Party Investors

For capital interest allocations, the "terms, priority, type and level of risk, rate of return, and rights to cash or property distributions during the partnership's operations and on liquidation are the same". For purposes of comparison, requires "significant" third-party investors at the level of the API issuer (i.e., the fund).

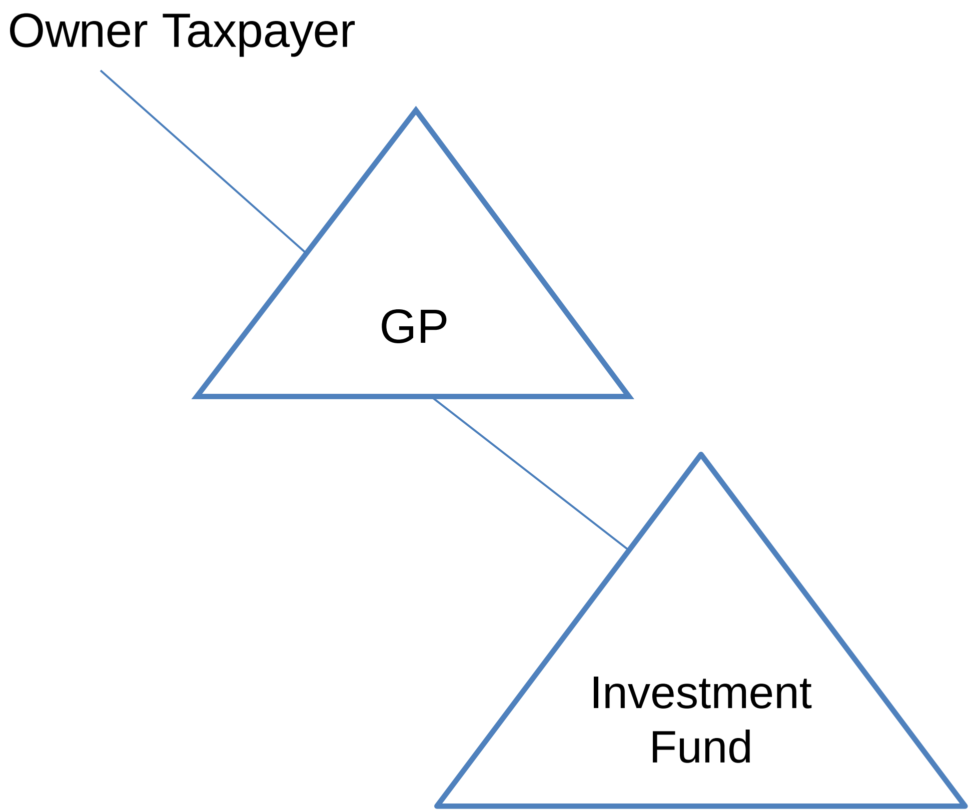
Permitted differences:

- Allocations to the API holder may be subordinated to third parties.
- Allocations to the API holder does not have to be reduced by the "cost of services" (management fee? carry?)

Potential issues:

- Different liquidity rights
- Tracking allocations
- GP right to tax distributions

Sales of API



Look Through Rule: Directly Held API

The look-through rule may recharacterize some or all of the gain on the sale of an API as short-term capital gain

The look through rule applies if:

- an API Holder disposes of a directly held API in a taxable transaction to which section 1061(d) does not apply;
- recognizes capital gain;
- the API Holder's holding period in the API is more than three years; and
- the assets of the partnership meet the Substantially All Test; 80% or more test

Calculating Substantially All Test

Total FMV of the partnership's assets that would produce capital gain or loss that is not described in Prop Reg. 1.1061-4(b)(6) (e.g., Section 1231 and Section 1256 gain) if disposed of by the partnership as of the date of disposition of the API and that have a holding period of three years or less

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Total FMV of all of the partnership's assets as of the date of disposition of the API

- *Cash, cash equivalents, unrealized receivables under Code Sec. 751(c) and inventory items under Code Sec. 751(d) are not taken into account for purposes of determining the numerator or the denominator

Look Through Rule: Indirectly held API

- Look through rule also applies to the disposition of an API that is held indirectly through one or more pass-through entities if
  - The pass-through entity through which the API is held has a holding period related to the API of three years or less; or
  - The pass-through entity through which the API is held has a holding period of more than three year and the assets of the partnership holding the API meet the Substantially All Test

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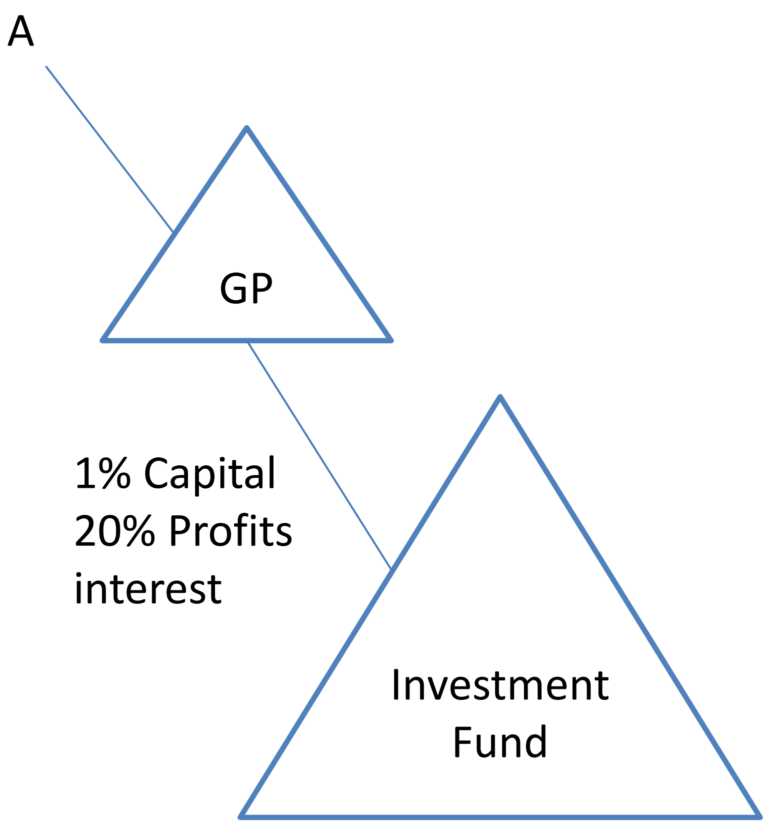
Look Through: Example



- A is a partner in GP. GP is a partnership and holds an API in Investment Fund, which GP has held for 2 years. A's interest in GP includes both an indirect interest in GP's API in Investment Fund and a capital account in GP that entitles A to Capital Interest Gains and Losses from GP. A has held its interest in GP for 4 years. During the year, A sold its interest in GP for a gain (not to a related party).

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Waivers and Deferrals

- API holders may consider a carried interest waiver in an effort to avoid the provisions of Sec. 1061(a)
- This would involve foregoing the right to receive a distribution now in exchange for the right to receive a potential future distribution

Waivers and Deferrals

- By waiving a current allocation related to the API, the API holder is hoping there will be future taxable income available that will be more tax advantageous for them (i.e. a holding period longer than 3 years).
- Proposed Regulations do not include any new rules on carried interest waivers, however, the concept was addressed in the Preamble to the Proposed Regulations

Waivers and Deferrals

- "Taxpayers should be aware that these and similar arrangements may not be respected and may be challenged under section 707(a)(2)(A), §§ 1.701-2 and 1.704-1(b)(2)(iii), and/or the substance over form or economic substance doctrines."
- Although the Preamble is not authoritative, taxpayers are now aware that the IRS may challenge carried interest waivers

Anti Avoidance

- Section 1061(d) generally provides that if a taxpayer transfers an API to a related person that taxpayer shall include in gross income the excess of the taxpayer's "long-term capital gain with respect to such interest for such taxable year attributable to the sale or exchange of any asset held for not more than three years as is allocable to such interest, over any amount treated as short-term capital gain under 1061(a) with respect to the transfer of such interest"
- The statute is not clear as to what transfers it applies to.
- Effectively the proposed regulations under 1.1061-5 override other nonrecognition provisions.
- Does not apply to transfers that are nontaxable under Section 721 of the Code.

Regardless of whether a transfer is otherwise taxable…

- Prop. reg. 1.1061-5 generally requires the taxpayer transferring the API to recognize and include in gross income, short-term capital gain in an amount equal to the excess of (i) the net built-in long-term capital gain in assets held for three years or less attributable to the transferred interest, over (ii) the amount of long-term capital gain recognized on the transfer that is treated as short-term capital gain under section 1061(a).

Examples where 1061(d) may apply

- Transfers to family members for estate planning purposes.
- When a service partner leaves a partnership before an interest is vested, the forfeited interest is transferred back to the employer in a non-taxable event. Under the current rules it is possible that an API holder could be subject to 1061(d) on gain attributable to the unvested portion that he or she forfeits.
- Unclear if it applies to transfers at death and step up under 1014

In Kind Distributions

- If property is distributed to the GP (as holder of an API) and the GP later sells the property, the gain from the sale of the distributed property will be short-term capital gain under Section 1061 if the holding period is three years or less (allowing tacking of the partnership's holding period).
- A GP that received a distribution of appreciated property with less than a 3 year holding period may continue to hold the property until the 3 year holding period requirement is met and then sell the property for long-term capital gain.
- It appears that the contribution of appreciated stock that is distributed by an API to the GP and then to a partner in the GP who then donates the stock to charity needs to meet the more than 3 year holding period in order for the donor to obtain a charitable contribution equal to fair market value.

Tax Reporting Challenges Involving Carried Interests

Tax Reporting Challenges Involving Carried Interest

- The regulations require upper-tier partnerships and Owner Taxpayers to request from lower-tier partnerships information related to one-year and three-year distributive share amounts, capital gains and losses allocated to the API Holder that are excluded from 1061 and other amounts
- In addition to other penalties (e.g., failure to furnish correct payee statement), if the information is not provided to the requestor and the IRS, then exclusions from section 1061 may not apply.

THIS CONSEQUENCE FOR NON-COMPLIANCE WILL CONVERT CERTAIN ITEMS OF INCOME TO SHORT-TERM CAPITAL GAINS IF PROPER INFORMATION REPORTING ISN'T PROVIDED.

Information that Must be Reported to an API Holder

– The API one-year distributive share amount and the API three-year distributive share amount;
– Capital gains and losses allocated to the API holder that are excluded from Sec. 1061 (e.g., Section 1231 gain, Section 475 gains);
– Capital Interest Gains and Losses allocated to the API holder;
– API holder transition amounts; and
– Any information the API holder may need to properly account for a disposition of an API during the tax year

Information that must be reported to an API Holder: Tiered Partnerships

- In tiered partnerships, it is possible that information from a lower tier partnership may be required in order to comply with these requirements.
- In that case, the pass-through entity must request the necessary information from the lower tier partnership by the later of:
  - The 30th day after the close of the tax year to which the request relates; or
  - 14 days after the date of a request for information from an upper tier partnership.

Information that must be reported to an API Holder: REITs and RICs

REITs and RICs designating a dividend (or a portion of a dividend) as a capital gain dividend must provide Sec. 1061 disclosures for the recipient of the capital gain dividend to be eligible for favorable treatment when calculating the amount to be recharacterized.

Information that must be reported to an API Holder: PFICs

Passive foreign investment companies with respect to which a shareholder has made a QEF election may provide additional information in order to allow the shareholder to determine the proper treatment of those gains under Sec. 1061. If no disclosure is provided, the gains must be considered one-year gain amounts by the API Holder.

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Effective Date

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Effective Date

- The regulations are only proposed and generally will not be effective until taxable years beginning on or after final regulations are published in the Federal Register.
  - HOPEFULLY this is not before 12/31/2020!
- S corporation rule effective for taxable years beginning after December 31, 2017
- QEF rule effective for taxable years beginning after August 14, 2020
- Can rely on the proposed regulations prior to finalization if applied consistently and in their entirety
  - Any early adopters?

Differences between federal and state tax treatment of carried interests

State and local tax treatment of carried interests

- Many funds and fund managers are moving to states with little or no income tax already (e.g., Florida).
- States incorporate provisions of the Code into their own tax codes in varying degrees.
- New Jersey, New York, and Connecticut conform to the federal treatment of partnership interest held in connection with the performance of services.
- Some states have proposed legislation or enacted actual legislation to impose an additional tax on carried interest. Most are tied to surrounding or nearby states adopting a similar rule. Practically, could not do this at the state and local level.

State and local tax treatment of carried interests

- Some states may have a different tax rate with respect to capital gain income
- Some states might try to source carried income to the place of business where it is generated as opposed to the residency. This is generally not the case and is an important rule in state and local tax planning.

What should managers do and when? Any impact on investors in funds?

- Most managers should generally continue to do what they have been doing. That is, the decision whether or not to receive an inactive allocation or an incentive fee should not be affected by the Regulations. It is probably best to continue to change realized carried income to a limited partner account (which is also helpful for asset protection purposes). It may also be helpful to change unrealized carry to an LP account as well, although separate accounting would be best so recharacterization can be tracked.
- No impact on investors generally, other than potentially seed or anchor investors as mentioned above.
- Section 1061 would only impact investors to the extent it causes the carried interest to be restructured or changed.

What should managers do and when? Any impact on investors in funds?

- Alternatives to carried interests? Fee income? Stock appreciation rights? Waivers?
- Which party controls the Senate may have an impact on any future tax legislation that may affect the taxation of carried interest.
- When final regulations are issued and what they provide will impact when and what tax planning may need to be done.

Thank You