Tax Treatment of Carried Interest: Planning Opportunities for Tax, Private Equity and Real Estate Professionals
IRC Section 1061, Capital Contributions, Transfers to Unrelated Parties, Special Allocations, Section 1231 Property

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August 29, 2019

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What Makes The Carried Interest Special

• In the Service World environment, the “Carried Interest” essentially allows for the converting of “services income” a/k/a “ordinary income” into “long-term capital gain”
  • The tax rate differential between ordinary income and capital gain makes this conversion the Holy Grail of tax planning

• Nature of Carried Interest
  • Participation in future appreciation with
    • No money down
    • No risk
    • No immediate recognition of income (no up-front tax payment)

• Common Structure
  • For Funds, 20% of the future appreciation
  • For individuals, a smaller percentage of appreciation

• Also known as “the Promote”, “the Profits Interest”, “the Carry”

• Applies in the Real Estate Fund sector, the Hedge Fund sector, the Private Equity Fund sector and many private ownership arrangements
What Makes Carried Interest Special (cont.)

• Comparison to Other Vehicles
  • Qualified Stock Options
    • Limited amount of potential value based on Options permitted in Plan
  • Non-Qualified Stock Options
    • Non publicly traded options - Necessity to recognize ordinary income at time of exercise
    • Publicly traded options
      • Not common in private equity and real estate world
      • Must pay for the options, thus cash need and risk of loss, or immediate tax recognition as ordinary income for receipt without payment
  • Grants of Equity Interests
    • Requires immediate recognition of income and payment of tax at ordinary income rates
How to Issue a Carried Interest

• What is a Carried Interest
  • Ownership interest in a Partnership or Limited Liability Company
  • Interest has no initial capital value assigned to it
    • Thus, if there is a liquidation of the entity immediately after issuance of the carried interest, the Carried Interest owner would receive NO distribution

• Determination of Value of Entity
  • Appraisal of Entity
  • Allocation of Entity Value to Capital Accounts of Existing Owners/Members
    • Important that Capital Account interests of other owners/members be equal to 100% of entity value at time of issuance of the Carried Interest

• Carried Interest Owner
  • Receives interest with initial Capital Account at Zero
How to Issue a Carried Interest (cont.)

- For Funds, generally a part of the initial fund raising process.
- For individuals,
  - IRC Sec 83(b) issues
    - Making a protective election at time of issuance
      - 83(b) is intended to apply only to interests subject to vesting
        - Most commentators recommend filing protective election *EVEN IF THERE IS NO VESTING REQUIREMENT*
    - 30 day requirement for making election upon receipt of interest *MAJOR TIMING ISSUE*
    - No pre-printed form for 83(b) election
    - Must value the interest
      - No need for appraisal for privately held companies
      - Board will often adopt value for 409A purposes
How to Issue a Carried Interest (cont.)

- For individuals,
  - IRC Rev. Proc. 93-27 issues
    - Addressed receipt by service provider of a profits interest in a partnership
    - If the issued partnership interest would receive NO distribution if assets sold at FMV on date of issuance and partnership liquidated, then the interest qualified as a “profits interest” and there would be NO taxable income on receipt of the partnership interest.
  - Not a “profits interest” if
    - Substantially certain and predictable stream of income
  - Within 2 years, the interest was sold
    - The interest was in a “publicly traded partnership”
  - 2005 Proposed Regulations never finalized

- If individual service provider invests into the fund, split the interest into 2 “pieces”
  - Issue one interest for capital investment
  - Issue second interest as profits interest for services
How Owning the Carried Interest Operates

- Annual Allocations
  - Preferences
  - Balance
- Allocations on Sales of Entity Assets
  - Special allocations and “catch-up”
- Distributions
  - Generally not taxable unless exceeds allocations
  - “Stuffing” allocations to departing partner
- Sale of Carried Interest
  - Fund Issues Form 8308 if has unrealized receivables - unlikely
- Case issues
- Vesting vs. Non-Vesting
Effects of IRC Sec 1061

- IRC Sec 1061 does not change the basic theory underlying the income tax benefits of the Carried Interest
  - Legislative proposals to reduce or eliminate the tax benefits of the Carried Interest have failed on several occasions in the last 10 years (including in 2017)
- 3 year holding period (rather than 1 year) to obtain long-term capital gain treatment
  - Holding period applies to sale of Carried Interest
  - Holding period also applies to distributions from Entity
    - This concept is new, although some felt it did apply
  - Holding period also applies to allocations of Entity income (i.e. sale of Entity assets)
- Re-characterization as short term capital gain, NOT ORDINARY INCOME, even though the concept was to prohibit service income from being treated as capital gain.
  - Not subject to self-employment tax
  - Able to offset capital losses
  - Liability is subject to IRS Sec. 1411 (Net Inv. Income Tax)
Tax Treatment of Carried Interest: Planning Opportunities for Tax, Private Equity and Real Estate Professionals

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Taxation of Carried Interest

Prior to TCJA, taxation of amounts received from a carried interest followed the general provisions of the Internal Revenue Code.

Example – Fund raises capital of $100 million and sells its investments for $150 million two years later, realizing a long term capital gain of $50 million. Assuming manager received a 20% carried interest, the manager would be allocated $10 million of the long term capital gain. If, alternatively, manager received a management fee equal to 20% of gross profits, tax on the management fee would be at ordinary rates.
Changes to Carried Interest under TCJA

Prior proposals, which were never finalized, provided that an arrangement would be treated as a disguised payment for services if:

- The service provider performs services to or for the benefit of the partnership;
- There is a related direct or indirect allocation and distribution to the service provider; and
- The performance of services and the allocation and distribution, when viewed together, are properly characterized as a transaction between the partnership and an outsider.

Would have resulted in taxable as **ORDINARY INCOME**
Changes under TCJA

Tax Cuts and Jobs Act adds Sec. 1061(a), which changes the tax treatment of gains from a profits interest by providing that:

- If one or more “applicable partnership interests” are held by the taxpayer at any time during the year, the excess of:
  - The taxpayer’s net long-term capital gain with respect to those interests, over
  - The taxpayer’s net long-term capital gain with respect to those interests computed by substituting “3 years” for “1 year”

- Will be treated as **SHORT TERM CAPITAL GAIN**
Changes under TCJA

Consider earlier example – Fund liquidates an investment after two years and realizes long term capital gain of $50 million. Manager receives a 20% carried interest and is therefore allocated $10 million of this gain. Under Sec. 1061, the excess of the allocated long term capital gain ($10 million) over the amount that would be long term gain if tested based on a 3 year holding period ($0), is reclassified as short term capital gain by the manager when reporting this gain.
Changes under TCJA

Consider earlier example (cont’d) – As a result, under Sec. 1061, entire gain allocated to manager will be reported as short term capital gain by the manager.

NOTE – Manager’s tax filing will be inconsistent with the Schedule K-1 received from the fund
Changes under TCJA

Example, multiple investments – Manager M holds a 20% profits interest in partnership P that was received in connection for services. P realizes long-term capital gain of $300 million, but only $200 million of that amount is attributable to underlying investments that have been held for more than three years.
Changes under TCJA

Example, multiple investments (cont’d) – M will be allocated $60 million of long-term capital gain on Schedule K-1. Of this amount, only $40 million would be considered long term gain if tested using a 3-year holding period. As a result, $20 million will be taxed as short term capital gain and the remaining $40 million receive the benefit of the long term capital gains rate.
Carried Interest Definitions

An “applicable partnership interest” is an interest in a partnership which is transferred to the taxpayer in connection with the performance of substantial services by the taxpayer in any applicable trade or business.
Carried Interest Definitions

 Exceptions to “applicable partnership interest”

- Any interest in a partnership held by a corporation, or
- Any capital interest in a partnership which provides the taxpayer with a right to share in partnership capital commensurate with either:
  - The amount of capital contributed (determined at the time the interest is received), or
  - The value of the interest subject to tax under Sec. 83 upon receipt or vesting of the interest.
Carried Interest Definitions

Applicable trade or business is an activity conducted on a regular, continuous and substantial basis which consists of raising or returning capital, and:

- Investing in specified assets (securities, commodities, real estate held for rental or investment, cash or equivalents, options or derivatives), or
- Developing specified assets
Effects of IRC Sec 1061 (cont.)

• Effect on a Carried Interest received from various entities
  • Private Equity Funds
    • Depends
      • For Carried Interest itself, probably very little since most P.E. arrangements are for longer than 3 years
      • Assumes that the Carried Interest owner will not be selling his/her Carried Interest prior to the 3 year period
      • Could have a significant effect on a Carried Interest owner joining the P.E. in the “middle of a holding period”
        • P.E. could have held a capital asset for 3+ years before it sold the asset but the sale occurred prior to the 3+ year holding period for the Carried Interest owner of his/her Carried Interest
  • Hedge Funds
    • Depends on the Fund
      • Some Funds have short-term trading (less than one-year), so that gains were short-term gain to the Fund
      • Funds in the mostly Long trading cycle see the effect for the initial years of Carried Interest Owner/Member’s holding period (similar to sale by P.E. Fund of its capital assets)
  • Real Estate Funds
    • Special exclusion for IRC Sec 1231 property (more on this later)
      • May provide important work-around for real estate professionals
  • Privately Owned Operating Companies
    • Should have little or no effect (does not meet the definition of an “applicable partnership interest” (see next slide)
Effects of IRC Sec 1061 (cont.)

- Requirements of IRC 1061
  - 3 year holding period requirement only applies to “Applicable Partnership Interest” (API)
    - Important to understand the difference between API and non-API
- API
  - Partnership Interest received for services
    - But NOT interest received for services where there is income under IRC Sec 83 (this is a capital interest)
  - Not a capital interest (interest received for contribution of funds), to the extent of prorata share of appreciation based on contribution
    - Contribution INCLUDES Taxable Income recognized under IRC Sec 83
  - API does not apply to corporations (as entity or as owner)
    - In March 2018, IRS indicated that it would provide guidance that S Corporation could NOT be used as a “workaround”. IRS Notice 2018-18. No guidance yet.
  - Services are to be “substantial” – good luck avoiding that one.
Effects of IRC Sec 1061 (cont.)

• API only applies to “applicable trade or business”
  • Raising or returning capital AND
  • Identifying, Investing in, disposing of or developing “specified assets”
    • “Specified assets” include securities, commodities, real estate held for rental or investment, options or derivative contracts regarding the foregoing
    • “Developing” means that the service provider’s efforts with enhance value
Effects of IRC Sec 1061 (cont.)

- Example
  - Private Equity Fund portfolio company issues 20% carried interest to its P.E. firm. An API
  - Private Equity Firm issues a profits interest to its management team… An API
  - The Private Equity Fund portfolio company issues a profits interest to ITS management team. **NOT an API**, because there is not an “applicable trade or business” (no fund raising)
    - See IRC 1061(c)(1), 2nd sentence
Effects of IRC Sec 1061 (cont.)

• What happens on a sale
  • Sale of the API
    • Prior to IRC Sec 1061, only a 1 year holding period was required for Long Term Capital gain treatment on the sale of an API
    • Under IRC Sec 1061, if less than 3 years, then characterized as Short Term Capital Gain
      • Any gain related to “hot assets” (IRC Sec 751) are treated as ordinary income (depreciation recapture, amortization recapture, inventory, depreciable real estate held for less than one year. This is not a 1061 issue.
  • Sale of capital asset by Entity
    • Holder of Carried Interest will have Short Term Capital Gain UNLESS the Holder has owned the Carried Interest for THREE years
      • This is regardless of the holding period of the capital asset by the entity
    • Prior to IRC Sec 1061, it was possible that appreciation of Fund capital assets occurring after the issuance of the Carried Interest could be allocated to the owner of the Carried Interest and treated as Long Term Capital Gain on a sale if that was the entity’s treatment, EVEN IF THE CARRIED INTEREST OWNER HAD HELD THE CARRIED INTEREST FOR LESS THAN ONE YEAR
Sale of a Carried Interest

- If there is a sale or exchange of the applicable partnership, the three year holding period will apply.

- If the interest is sold to a related person, any gain would be considered ordinary without regard to the holding period.
Sale of a Carried Interest

Example, sale of carried interest – Manager M holds a 20% profits interest in partnership P that was received in connection for services. P makes investments in various applicable trades or businesses. After two years, M sells his profits interest in P to unrelated person A. Based on underlying valuations, A’s purchase price for the interest is $10 million. Since the interest in question is an applicable partnership interest and the interest was not held by M for three years, 100% of the gain on sale of the profits interest to A will be taxed as short term capital gain.
Effects of IRC Sec 1061 (cont.)

• Effect on APIs held prior to January 1, 2018
  • The API rules apply

• Effect on Qualified Dividends  Apparently is not within the IRC Sec 1061 rules

• Effect on IRC Sec 1231 items
  • The IRC 1061 reference to change the 1 year holding period to a 3 year holding period is based on IRC Sec 1222.
    • IRC Sec 1222 does not apply to IRC Sec 1231
    • It appears that sales of 1231 Assets would only require a 1 year holding period to obtain the Long Term Capital Gain treatment
      • Thus, IRC Sec 1061 may not apply for sales of 1231 assets
      • See February 2018 decision regarding IRC 1234A (Leslie LLC v. Comm, 11th Cir)

• 3 year rule (per IRC Sec 1061) v.v. 2 year rule (per Rev Proc 93-27)
  • Was the interest subject to vesting and NO IRC Sec 83(b) election made

• Profits Interest v.v. APIs
  • Note while not all profits interests are APIs, all APIs will have the economic features of a profits interest. The difference between an API and a Profits Interest is that Rev Proc 93-27 did not contemplate splitting an interest into separate capital interest and profits interest components.
Effects of IRC Sec 1061 (cont.)

• Open items
  • IRC Sec 1061 does not apply to “any asset not held for portfolio investment on behalf of third party investors”. IRC Sec 1061(b)
    • Third party investors
      • Do not hold an interest in an “applicable trade or business" and
      • Are not providing services for partnership or “applicable trade or business”
      Q - How would the 1061 rules EVER apply to a third party investor ?
  • This may be helpful to family office investment managers
Effects of IRC Sec 1061 (cont.)

- Planning
  - Specially allocate all gains prior to 3 year holding period to other owners, with catch-up provision for post 3 year holding period.
  - Does converting profits interest to capital interest (*non-API*) have potential?
    - Possible loan by Fund to cover investment
      - Note non-recourse loan viewed as an “option”, not property for IRC Sec 83 purposes
  - Transfers to family members
    - Transfer rules apply to direct relationships. Attribution rules for partnerships, trusts, etc. were omitted. Possible planning to avoid the 3 year rule.
  - Carried interest held for more than 3 years, but asset in fund will be sold with less than 3 year holding period
    - Focus on whether timing will create short term capital gain and whether there may be alternative ownership arrangements
Effects of IRC Sec 1061 (cont.)

• Planning (cont.)
  • Fund may distribute assets to owners/members
    • IRC Sec 1061 does not apply to sale of assets directly (no extension of holding period, unlike distributions of inventory property in non hot asset arrangement to partners (where 5 year holding period by partner required to avoid ordinary income treatment))
    • Be careful with inside/outside basis rules of IRC Sec 732
    • Be careful with the distribution of marketable securities under IRC Sec 731 (except “investment partnerships”)

• Using S Corporations
  • IRS has indicated that it will issue guidance in this area and that the “regulations will provide that the term ‘corporation’… does not include an S corporation”. Does the IRS have the authority do to this? Is it worth the risk in light of clear language by the IRS?