STROOCK
SPECIAL BULLETIN

Get Out The Backpacks: Carried Interests Must Be Carried For Longer

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On December 22, 2017, a sweeping tax reform bill (the "Tax Reform Act" or the "Act") was signed into law.[1] Stroock has already released a Special Bulletin covering the implications of the Act generally.[2] This **Stroock Special Bulletin** focuses on how the Act changes the treatment of a so-called "carried interest" and how these changes may affect the ability of a recipient of a carried interest to recognize long-term capital gain on the disposition of such interest, or a disposition of the assets held by the entity with respect to which the carried interest is issued. Carried interest programs have been the subject of media and legislative attention over the years and, despite multiple congressional efforts to eliminate the carried interest benefit, the Tax Reform Act represents the first meaningful change in the tax law applicable to such arrangements.[3] As described in further detail below, the Tax Reform Act changes are unlikely to minimize the traditional use and/or practice of many common carried interest arrangements. Nevertheless, clients and friends of the firm would be wise to consider their existing practices and forward planning carefully in light of these changes, particularly with respect to exit and disposition strategies.

Background: Carried Interest

A carried interest generally is an interest received by a general partner, sponsor, manager, employee or other service provider in the future profits of an entity treated as a partnership for U.S. federal income tax purposes. Carried interest arrangements have traditionally raised some technical issues under the Internal Revenue Code — namely whether they should be treated under the tax rules governing the transfer of property in connection with compensation, or whether they should be treated under the regime governing

1 P.L. 115-97.

2 "The Largest Tax Reform in 30 Years," *Stroock Special Bulletin*, available at https://www.stroock.com/siteFiles/Publications/TheLargestTaxReformIn30Years2017.pdf.

3 Most notably by Congressman Levin (D-Michigan), through the Extenders Act of 2010, but also others in the past have proposed changes to the U.S. Federal income tax considerations associated with carried interests. *See also* the American Jobs and Closing Loopholes Act of 2010 (H.R. 4213), which would have been effective in 2011 had it been enacted. The Senate passed a similar bill in 2010, the American Jobs and Tax Cuts Act of 2010 (S. 3793). Before 2010, the House passed several bills that would have enacted a new Section 710 to the Code that would have treated as ordinary income amounts attributable to a service partner's carried interest.

partnerships. While a detailed discussion of this debate is beyond the scope of this *Stroock Special Bulletin*, many practitioners have worked with both regimes when dealing with carried interests programs because not all arrangements necessarily "fit" within one or the other neatly or completely.

A starting point for present purposes is relief granted by the Internal Revenue Service (the "Service") addressing the grant of a bare ***profits*** interest held for at least two years. Subject to certain conditions, the Service ruled in 1993, as expanded in 2001, that the service provider may receive a profits interest without recognizing U.S. federal income tax at the time of the grant — or later vesting.[4] (Many carried interests are subject to either time based or performance based vesting conditions). These Revenue Procedures have been utilized by many practitioners to structure carried interest arrangements to avoid the receipt of a compensatory profits interest resulting in U.S. federal income taxation at the time of the grant — or vesting.[5] Following the guidelines outlined by these authorities, many practitioners have concluded that carried interest arrangements could be structured so that the service provider would be treated as a partner of the partnership with respect to its carried interest, as of the date of the grant thereof, and would be allocated and recognize income, gain, losses or deductions with the same character as reported by the partnership.

Of course, not all fact patterns fit squarely within this guidance, and many practitioners continued to treat the grant of such unvested awards as a possible transfer of compensatory property, as to which Section 83 of the Internal Revenue Code of 1986, as amended (the "Code") could be applicable. In such circumstances, many practitioners have advised making prophylactic Section 83(b) elections which permit a taxpayer to include the value of unvested property (in this case, arguably, the "property" being the unvested profits interest) received at the time it is granted. In this way, the recognition event for U.S. federal income tax purpose would occur at a time when the value of the "property" is less than the value over its projected lifespan.[6] However, more recent proposed authority may have muddied some of the analysis.[7]

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4 Rev. Proc. 93-27, 1993-27 C.B. 343. Rev. Proc. 2001-43, 2001-34 I.R.B. 191. A profits interest confers the right to share in the enterprise's future profits. By contrast, a capital interest provides the holder with the right to receive a share of the proceeds of the partnership after giving effect to a liquidation. See also *Diamond v. Commissioner* [Dec. 30,838], 56 T.C. 530 (1971), affd. [74-1 USTC ¶ 9306] 492 F.2d 286 (7th Cir. 1974); *Campbell v. Commissioner*, 59 T.C.M. (CCH) 236 (1990), rev'd, 943 F.2d 815(8th Cir. 1991); *Diamond v. Commissioner* [Dec. 30,838], 56 T.C. 530 (1971), affd. [74-1 USTC ¶ 9306] 492 F.2d 286 (7th Cir. 1974). *See also* Treasury regulation section 1.83(a).

5 Rev. Proc. 2001-45 2001-2 C.B. 191.

6 For example, the Revenue Procedures do not apply to interests that are anything but a profits interest, do not apply to interests in partnerships that have assets with predictable streams of income (i.e., a portfolio of tax exempt bonds), or interests which are transferred within two years of the grant. Many practitioners have debated whether a profits interest is or is not "property" for purposes of Section 83 or otherwise. Treasury regulation section 1.83(a) "(the term property includes real and personal property ***other than either money or an unfunded and unsecured promise to pay money or property in the future)***" [Emphasis supplied].
There are other technical issues associated with the tension between the Code's partnership and compensation for property rules. The regulations generally require partnerships to maintain a Section 704(b) book value capital account for each partner to reflect the partner's economic interest in the partnership. By contrast, Section 83 uses a discounted fair market value methodology. For purposes of a prophylactic Section 83(b) election, should the employee report as income the Section 83(b) value or the Section 704 value of the interest? We believe the latter would be more consistent with the general view of the IRS on carried interests.

7 *See*, Notice 2005-43, 2005-1 C.B. 1221 (May 24, 2005).

Carried interests structured as profits interest have often been regarded as particularly valuable where the pool of assets involved generated capital gain, rather than ordinary income. If the service provider was treated as a partner by virtue of his or her profits interest when the partnership sold a capital asset that it held for more than a year, the gain allocated to the service provider from that sale would flow through as long-term capital gain.[8] Similarly, any gain from the disposition of a carried interest and attributable to capital assets owned by the partnership would be treated as long-term capital gain if the carried interest were held for more than a year. The disposition of assets or carried interests that have been held for one year or less would otherwise give rise to short-term capital gain or loss. Carried interests may often be redeemed by the issuing partnership or purchased by the other partners for cash, or sometimes be converted into straight percentage interests in the partnership going forward.

Tax Reform Act: Section 1061(a)

We expect that the Tax Reform Act modifications to carried interests will not significantly change the current practice of issuing carried interests as an alternative to making compensatory payments to service providers. Importantly, while implicitly giving a "nod" to the compensatory regime over the partnership regime, it would not appear that the Tax Reform Act impacts the U.S. federal income tax consequences associated with the non-recognition of income upon the grant of a profits interest to a service provider in exchange for services. That said, it is important to point out that to assure this treatment and the desired long-term capital gains treatment associated with the later sale or disposition of the interest, the Tax Reform Act generally now requires that the service provider hold the interest for over three years, rather than the two years called for under the existing Revenue Procedures. It also requires that assets held by the issuing partnership be retained for over three years rather than the one year under current law. Accordingly, whether the Tax Reform Act will impact particular carried interest arrangements will depend in large measure on the nature of the investments and the position or exit strategies of the issuing partnership.

Specifically, Section 13309 of the Tax Reform Act modifies the treatment of carried interests, including those granted prior to 2018, by introducing a new Code Section 1061.[9] Section 1061(a) provides that gain "with respect to" (*i.e.*, gain allocated to the holder of) an "applicable partnership interest" is treated as short-term capital gain if the gain relates to an interest or asset that has been held for three years or less (rather than the typical one-year-or-less holding period for determining whether capital gain is short-term or long-term). Accordingly, if the holder of an applicable partnership interest disposes of that interest within three years, the gain on that disposition will generally be treated as short-term capital gain.

An "applicable partnership interest" is, generally, an interest in a partnership received in connection with the performance of substantial services in an "applicable trade or business" other than certain services performed for entities other than the issuer of the interest. An "applicable trade or business" consists of a business that is regularly, continuously and substantially conducted in connection with raising or returning capital and which either invests in or develops "specified assets." "Specified assets," for this purpose, generally include stocks and securities, commodities, real estate held for rental or investment, cash or cash equivalents, and certain options, derivatives or partnership interests relating to any of the aforementioned assets. Accordingly, in light of these definitions, the new carried interest legislation is designed to apply primarily to carried interests in hedge, real estate and certain private equity funds and joint

[8] Of course, as a commercial matter, they have also been regarded as arrangements designed to align investor and service provider interests.

[9] Unless otherwise stated, "Sections" herein refer to the Internal Revenue Code of 1986, as amended.

ventures. Exceptions are carved out for interests held by a corporation, and for any capital interest in a partnership where the right to share in profits is commensurate with the holder's capital contributions.

Application of Carried Interest Provisions in Section 1061(a)

As noted above, Section 1061(a) is not really a gain recognition provision, and thus, may not result in significant changes to the desired non-recognition of income by a service provider recipient of a profits interest at the time of its grant. Rather, it simply provides that if gain is recognized, it will be recharacterized as short-term capital gain if the requisite three-year holding period is not satisfied. A potential issue is how the sale of an applicable partnership interest is treated where the interest is held for more than three years but some of the assets are held for less than three years. There is a special rule dealing with transfers of carried interests to related parties that provides a look-through approach to treat any gain recognized with respect to assets of the partnership not meeting the three-year requirement as short-term capital gain. However, absent any language in the statute to the contrary, we believe that there is no look-through concept in the case of a disposition to an unrelated party.

There are a number of questions prompted by these new provisions. One question is how Section 1061(a) is meant to apply to carried interests with contingent profit-sharing ratios that are subsequently converted into fixed-percentage interests in a partnership. Consider, for example, a carried interest award granted as a profits interest that, as time passes, is later converted into a straight partnership interest. Does the conversion itself potentially taint the later disposition of the interest by restarting the three-year holding period as of the date of conversion?

In addition, it is uncertain whether carried interest arrangements with portfolios of assets of real property are exempt from recharacterization under Section 1061(a). Section 1061(a) serves to convert what otherwise would be "long term capital gain" as defined in Section 1222, into short-term capital gain. However, under Section 1231, gain from certain real estate and other property used in a trade or business is treated as long-term capital gain without regard to Section 1221. Since real estate is expressly included in the definition of "specified assets", it would be expected that the sale of real estate held under a carried interest arrangement would be covered by the rules of Section 1061(a). However, the ambiguity created by the dichotomy in defining long-term capital gain will have to be resolved through future guidance from the Service.

Examples of Application of Section 1061(a)

The following scenarios illustrate the mechanics of how, subject to confirmation through clarifying guidance, practitioners generally understand Section 1061(a) to operate.

(A) A partner ("P") holds an applicable partnership interest for two years, then sells the partnership interest. Previously, P would have recognized long-term capital gain, but under Section 1061(a), this gain is recharacterized as short-term capital gain.

(B) P has held an applicable partnership interest for four years, but the partnership has only held Asset X for two years and the partnership now sells Asset X. As partnerships are pass-through entities, P would recognize capital gain in the amount of its proportionate share of the partnership gain. Section 1061(a) would apply to P's gain with respect to its partnership interest, and accordingly recharacterize P's share of the partnership's gain as short-term capital gain.

(C) As in (A), P has held an applicable partnership interest for two years and the partnership has held Asset X for four years. The partnership now sells Asset X and recognizes gain. P's share of such gain would presumably not be recharacterized, and would be treated as long-term capital gain.

(D) As in (B), P has held an applicable partnership interest for four years, but the partnership has only held Asset X for two years. P now sells its partnership interest to an unrelated party (but the partnership continues to own Asset X). Section 1061(a) does **not** seem to apply to this transaction, as the gain recognized by P with respect to the partnership interest is the gain on the sale of such interest and the asset being sold is the partnership interest itself, which has been held for more than 3 years. Thus it is expected that P would recognize long-term capital gain.

(E) As in (D), P has held an applicable partnership interest for four years, but the partnership has only held Asset X for two years. P sells its partnership interest to T, who is related to P and was not previously a partner in the partnership. Assume that P recognizes long-term capital gain on the sale and that the partnership has a Section 754 election in place.[10] Accordingly, T may be entitled to a "step-up" in the tax basis of Asset X such that a subsequent sale by the partnership of Asset X within that year would not result in any taxable gain for T. Thus, in the absence of Section 1061(d), P would recognize only long-term capital gain on P's sale of the partnership interest to T, whereas P would have had to recognize short-term capital gain had Asset X been sold while P was still a partner in the partnership. In this situation, it appears that Section 1061(d) would recharacterize a portion (attributable to Asset X) of P's gain on the sale of its partnership interest to T as short-term capital gain.

Take-Away

The Tax Reform Act will likely not have a significant impact on the continued proliferation of carried interest arrangements. However, although the benefits have not been eliminated entirely (as many times threatened in Congress), recipients of carried interests will have to be more cognizant of the holding periods for their interests and for the timing of disposition of partnership assets. To the extent that three years is viewed as too long a period to hold, or bear economic risk with respect to, assets or investments, it is expected that novel and sophisticated strategies will develop to permit sponsors and service providers the ability to lock in their profits. The reach of the new legislation is broad, affecting all kinds of funds and joint ventures.

Stroock's tax team is dedicated to staying ahead of the game on all strategies and developments in this area, and is available for further consultation on these matters.

Please note that the above is not intended to be tax advice and that no attorney-client relationship is created between Stroock and any reader. However, the Stroock tax team's contact information can be found below if you have further questions about the above changes, how they will affect real estate transactions going forward, and how they may affect you or your business.

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[10] Section 754 permits, among other things, the purchaser of an interest in a partnership generally to step-up the tax basis of the underlying assets of the partnership.

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