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# Carried Interest: The New Frontier for Investment Professionals

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*May 2022*

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Mr. Viski-Hanka advises individuals, corporations, family offices, investment funds, small businesses, and tax-exempt organizations. Additionally, Mr. Viski-Hanka advises non-U.S. clients on the tax ramifications of inbound investment in the United States.

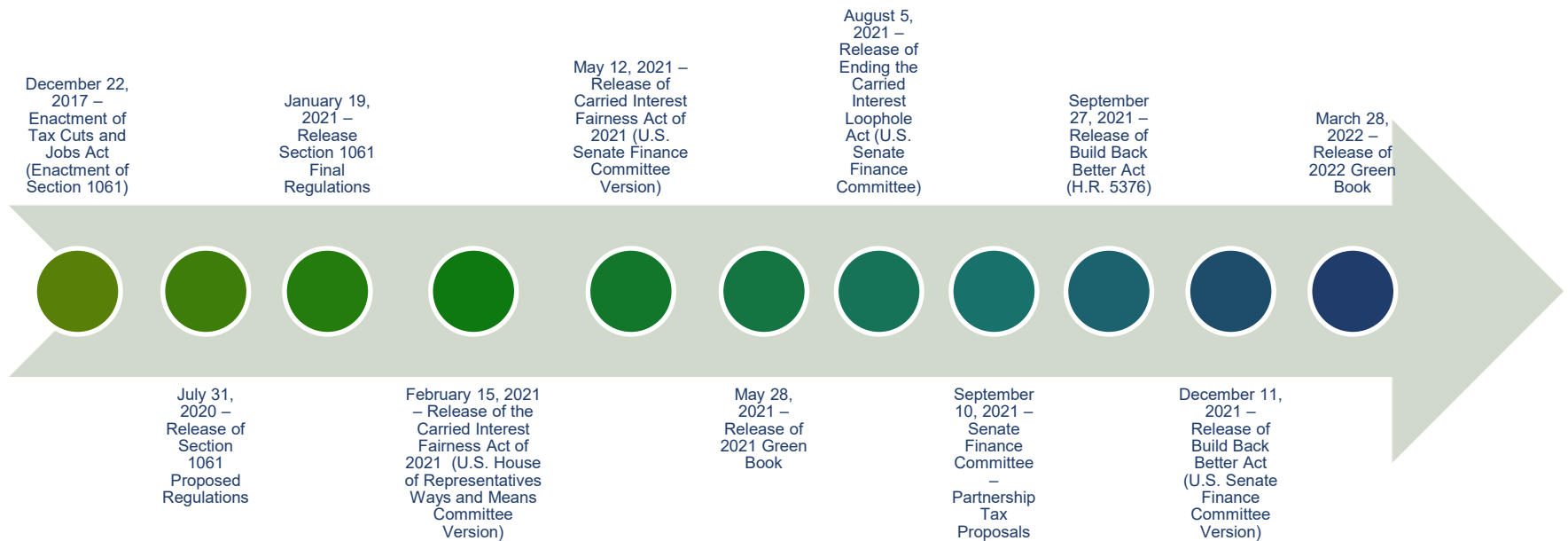
Mr. Viski-Hanka earned his LL.M. in taxation from the New York University School of Law where he was a Graduate Editor of the *Tax Law Review*. Additionally, Mr. Viski-Hanka is a 2015 *summa cum laude* graduate of the University of Miami School of Law where he was elected to be a member of the Order of the Coif. He speaks Hungarian and Spanish.

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# Timeline of Carried Interest Legislation (Proposed and Finalized)



## Timeline of Carried Interest Legislation (Proposed and Finalized)

- **December 22, 2017** - *Enactment of section 1061.*
- **July 21, 2020** – *Release of section 1061’s proposed regulations.*
- **January 19, 2021** – *Release of section 1061’s final regulations.*
- **February 15, 2021 & May 12, 2021** – *Release of Carried Interest Fairness Act of 2021 (H.R. 1068 & S. 1598).*
  - Introduced “investment services partnership interest” (“IPSI”) concept.
  - Contained provisions to treat the net capital gain with respect to certain carried interest as ordinary income only for taxpayers with taxable income exceeding \$400,000.
  - IPSI income subject to self-employment taxes.

## Timeline of Carried Interest Legislation (Proposed/Finalized)

- **May 28, 2021** – Release of 2021 General Explanations of the Administration’s Fiscal Year 2022 Revenue Proposals (“2021 Green Book”).
  - Based off of Carried Interest Fairness Act.
  - Flushed out IPSI Concept– a profits interest in an investment partnership that is held by a person who provides services to the partnership. This definition is broader than section 1061, which applies to interests in a partnership in the business of raising or returning capital and investing or developing certain investment type assets. For these purposes, a partnership is an investment partnership if substantially all of its assets are investment-type assets, but only if over half of the partnership’s contributed capital is from partners in whose hands the interests constitute property not held in connection with a trade or business.
  - A partner’s share of income attributable to an IPSI in an investment partnership would be generally taxable as ordinary income, and gain on the sale of an IPSI would be taxable as ordinary income if the partner’s taxable income (from all sources) exceeds \$400,000 (the 2021 Green Book proposed raising the ordinary income rate to 39.6% (43.4% including the net investment income tax)).
  - The 2021 Green Book would have required partners to pay self-employment tax on IPSI income.
  - The 2021 Green Book would have repealed section 1061 for taxpayers whose taxable income (from all sources) exceeds \$400,000.
- **August 5, 2021** – *Release of Ending of Carried Interest Loophole Act (U.S. Senate Finance Committee)*.
  - Introduced by Ron Wyden (D-Oregon) and Sheldon Whitehouse (D-Rhode Island).
  - Replaces section 1061 and proposes applying ordinary income treatment to carried interest holders regardless of holding period and regardless of the service provider’s level of taxable income.
  - Requires partners who hold carried interests in exchange for providing services to investment partnerships to recognize a specified amount of deemed compensation income each year regardless of whether the investment partnership recognizes income or gain and regardless of whether and when the service partner receive distributions in respect of their carried interests.
  - Deemed compensation income would be subject to income tax at ordinary income rates and self-employment taxes.

## Timeline of Carried Interest Legislation (Proposed/Finalized)

- **September 10, 2021** – *Release of Senate Finance Committee – Partnership Tax Proposals.*
  - Introduced by Ron Wyden.
  - Silent on section 1061.
- **September 27, 2021** - *Release of Build Back Better Act (H.R. 5376).*
  - Amendment to section 1061; increase of holding period to 5 years (3 years for taxpayer's with less than \$400,000 of adjustment gross income).
  - Silent on issue with respect to self-employment tax imposed on carried interest.
- **December 11, 2021** – *Release of Build Back Better Act (U.S. Senate Finance Committee Modifications)*
  - Silent on carried interest entirely.
- **March 28, 2022** – *Release of 2022 General Explanations of the Administration's Fiscal Year 2023 Revenue Proposals ("2022 Green Book").*
  - Similar to 2021 Green Book proposals with respect to carried interest and section 1061.
  - Generally tax as ordinary income a partner's share of income on an IPSI (and disposition of such IPSI) in an investment partnership, regardless of the character of income at the partnership level, if the partner's taxable income (from all sources) exceeds \$400,000 (the 2022 Green Book proposes raising the ordinary income rate to 39.6% (43.4% including the net investment income tax)).
  - Partners in such partners would have pay self-employment taxes on IPSI income if the partner's taxable income (from all sources) exceeds \$400,000.
  - **Section 1061 would be repealed for taxpayers with taxable income (from all sources) in excess of \$400,000.**
  - Effective for taxable years beginning after December 31, 2022.



## Section 1061: Statutory Provisions

- The Tax Cuts and Jobs Act of 2017 (the “TCJA”) enacted section 1061 of the IRC as a new taxing regime applied to carried interest.
- Section 1061 applies to the holders of carried interest by extending the long-term capital gains holding period from one year to greater than three years.
- More technically, section 1061 applies to any API which is transferred to a taxpayer in connection with the performance of substantial services by the taxpayer (or any other related person) to an ATB.
- Exceptions include:
  - 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:
    - 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 section 83 upon the receipt or vesting of such interest.

## What is an API?

- Section 1061 applies to **all** partnership interests transferred or held in connection with the performance of substantial services to an ATB, not simply profits interests.
- The final regulations include any financial instrument or contract, the value of which is determined in whole or in part by reference to the partnership.
- **Once an interest qualifies as an API, the interest remains an API unless and until an exception applies.**
  - For example, an API would remain an API even if such service provided partner stops performing services for the partnership.

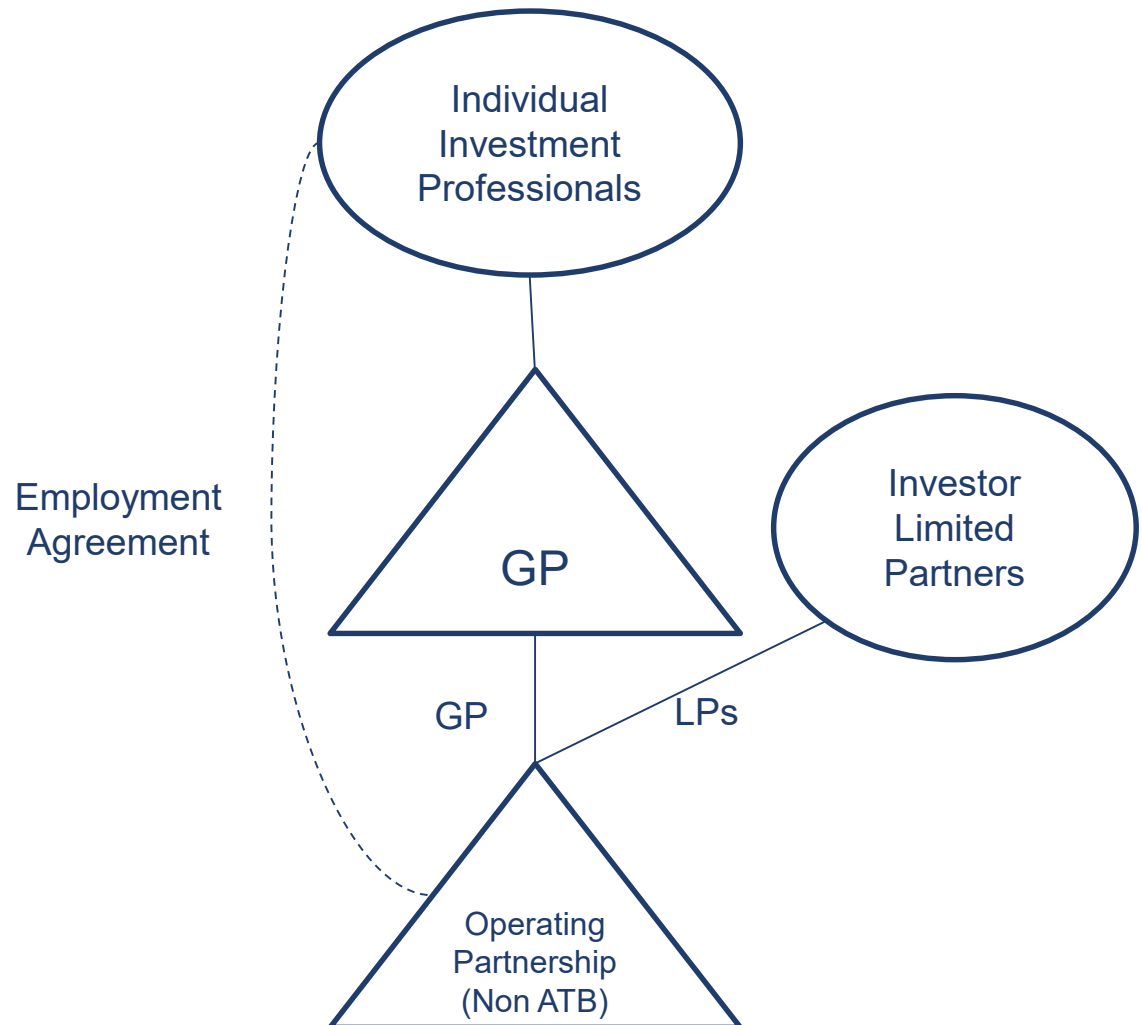
## Exceptions to the Definition of API

- The statutory language of section 1061 provides four exceptions to the definition of an API.
  - Non-ATB employee exception
  - Corporate exception
  - Capital interest gains and losses exception
  - Section 1061(b) exception – Known as the Self-Investment Exception
    - Section 1061(b) provides regulatory authority to establish an exception to section 1061(a) for gain attributable to any assets not held for portfolio investment on behalf of third-party investors. The final regulations provide that the Treasury and the Service are studying the application of 1061(b) moving forward.
    - The exception is intended to apply to family offices and similar arrangements in which the capital of related parties is managed.
- The final regulations provide an additional exception: The bona fide unrelated purchaser exception.

## Exceptions to the Definition of API

### Exception 1: Non-ATB Employee Exception

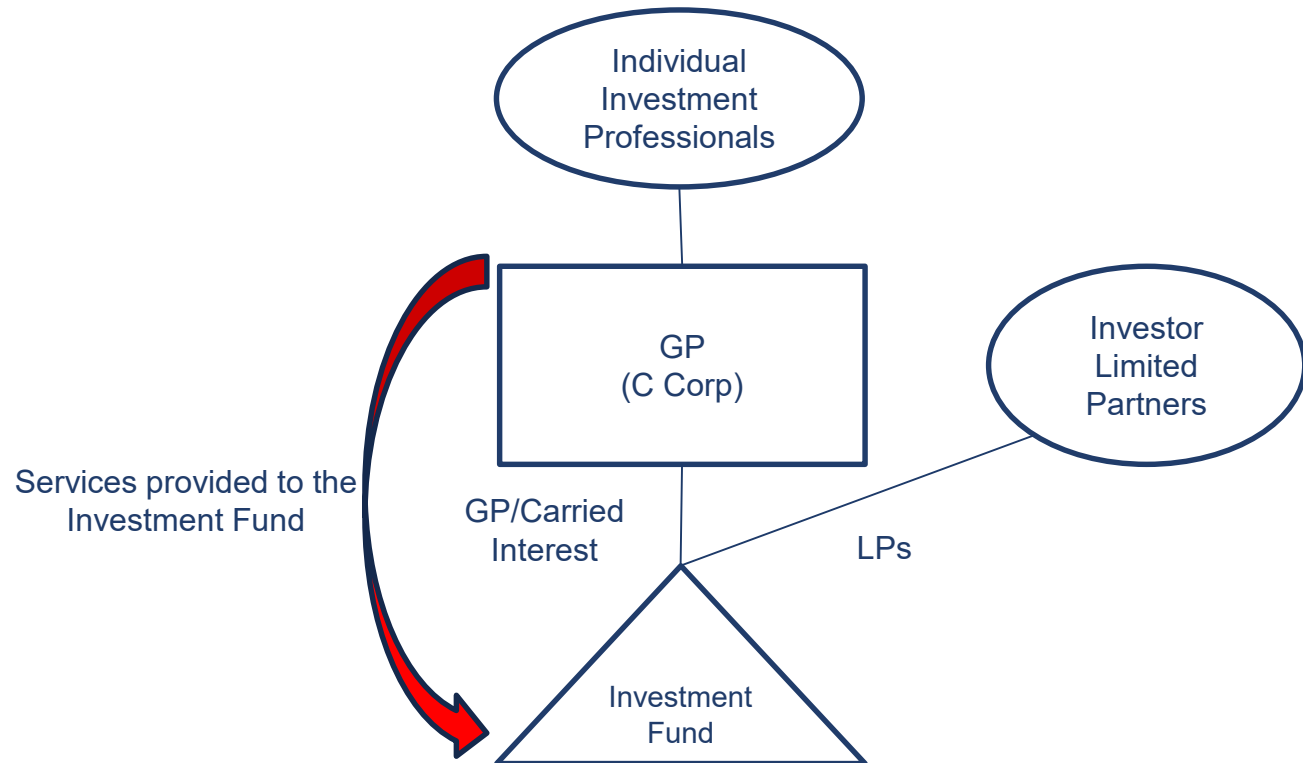
- An API does not include a partnership interest transferred to a person that is only conducting services for, and employed by, one entity that is not engaged in an ATB.
- For example, if the Individual Investment Professionals are employees of, and provide services to, **an operating partnership that is not engaged in investing activities and does not operate an ATB**, then their carried interest will not be treated as an API.



## Exceptions to the Definition of API

### Exception 2: Corporate Exception

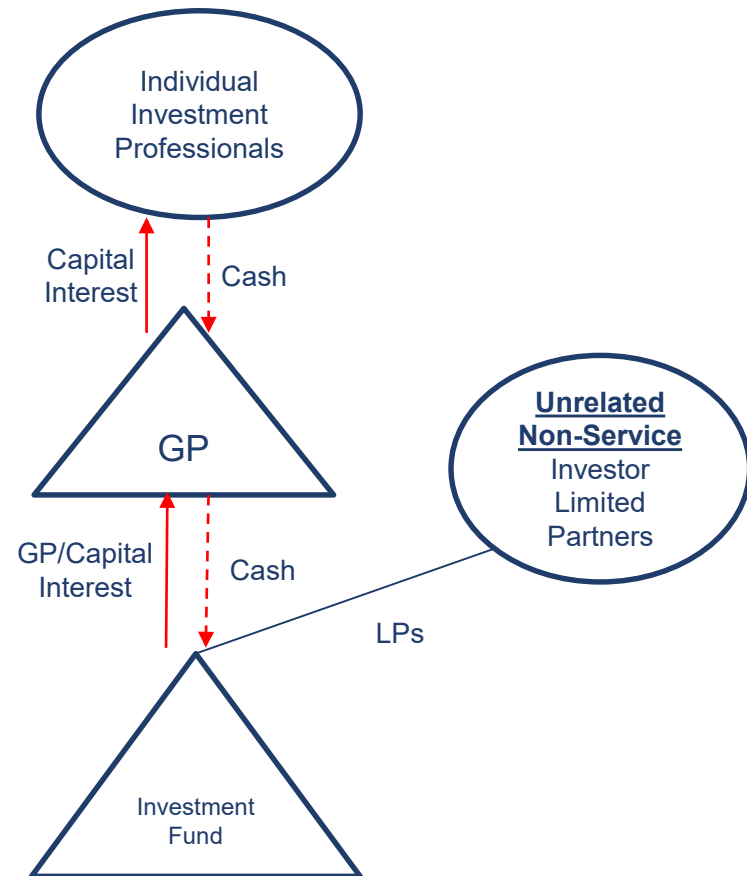
- **An API cannot be held by a C corporation.**
- Partnership interests held by S corporations and PFICs that have made a QEF election are treated as APIs if the interest otherwise meets the API definition.



## Exceptions to the Definition of API

### Exception 3: Capital Interest Exception

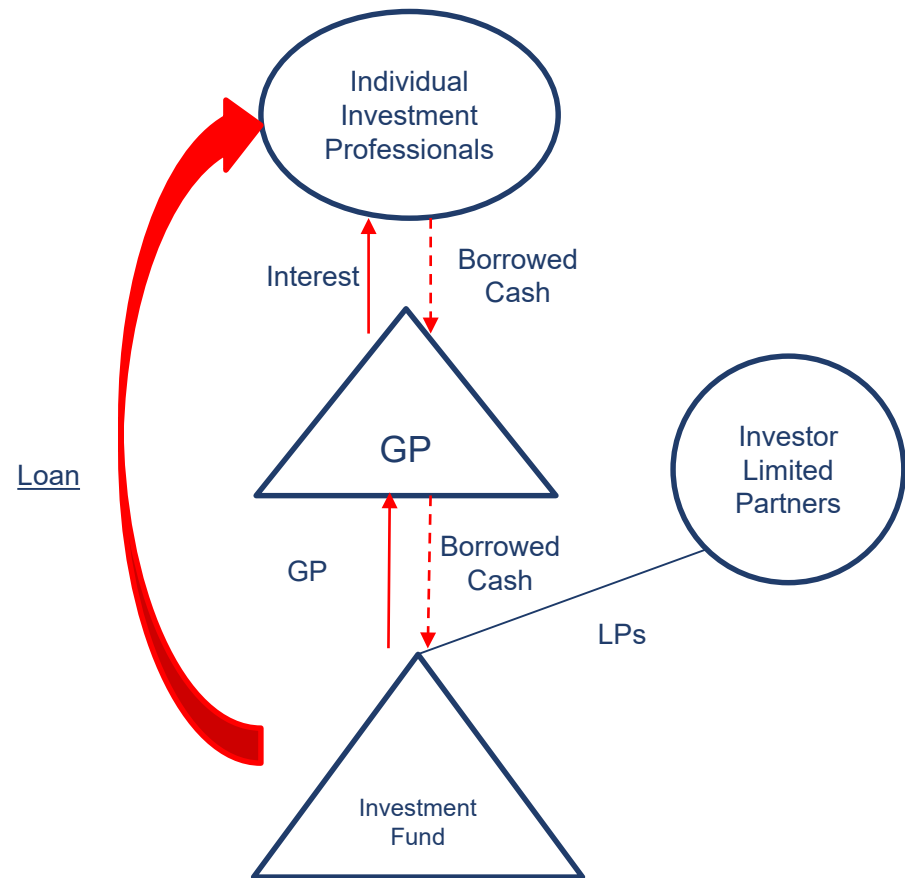
- **An API does not include certain capital interests.**
- The proposed regulations provided a rigid and complex “same manner” requirement based on relative capital account balances.
- The final regulations provide a simplified rule that looks to whether allocations are determined and calculated in a **similar manner** as the allocations with respect to capital interests held by similarly-situated “Unrelated Non-Service Partners” who have made significant aggregate capital contributions to the partnership.
- The “similar manner” requirement generally looks to whether rights are reasonably consistent based on factors such as: terms of priority, risk, rate of return, and rights to distributions during operation and upon liquidation. This requirement will not fail solely because: the rights are subordinated to allocations made to Unrelated Non-Service Partners, not reduced by the cost of services provided (incl. mgt. fee and API allocations), and tax distributions (if advanced against future distributions).
- Reinvestment of API gain may qualify for capital interest allocations.
- The books and records should clearly segregate a capital account interest from an API. For example, these requirements would essentially require the general partner in an investment fund to clearly bifurcate its capital interest from its API to avoid the entire general partner interest (including the capital portion of such interest being subject to section 1061 treatment).
- Unrelated Non-Service Partners are partners who do not (and did not) provide services in the relevant ATB and who are not (and were not) related to an API Holder in the partnership or any person who provides services in the relevant ATB.



## Exceptions to the Definition of API

### Exception 3: Capital Interest Exception: Loan From Fund

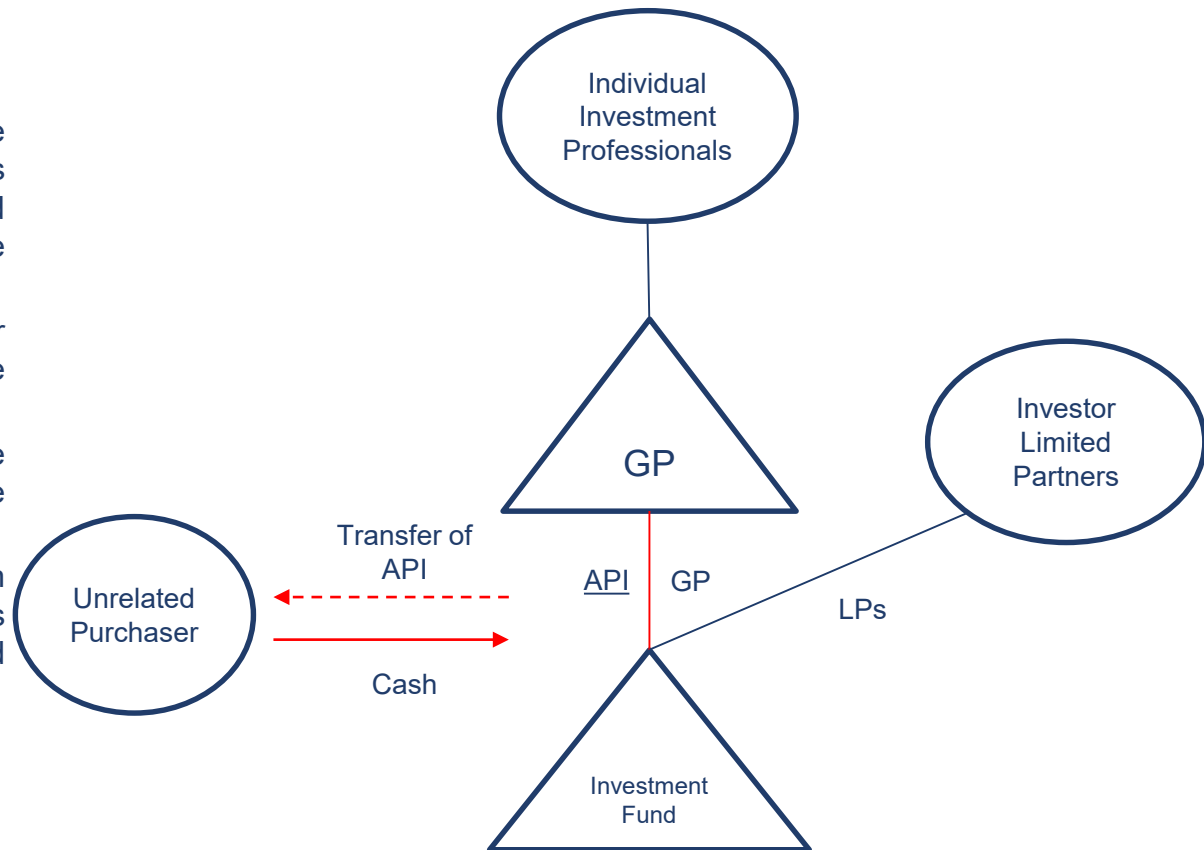
- Contributions funded with certain loan proceeds generally do **not** qualify for capital interest allocations if the loan or other advance is made or guaranteed, directly or indirectly, by the partnership, a partner or any related person.
- **The foregoing rule generally applies, unless the borrower is personally liable for the loan and:**
  - Loan is fully recourse
  - No right to reimbursement from any other person
  - Not guaranteed by any other person



## Exceptions to the Definition of API

### Exception 4: Bona Fide Unrelated Purchaser Exception

- An interest that would be treated as an API but is purchased by an unrelated buyer for its fair market value **is not an API to the buyer if:**
  - The buyer has never provided services to the relevant ATB;
  - Does not contemplate providing services in the future; and
  - Is not related to a person who provides services currently or has provided services in the past.





## Who Holds the API?

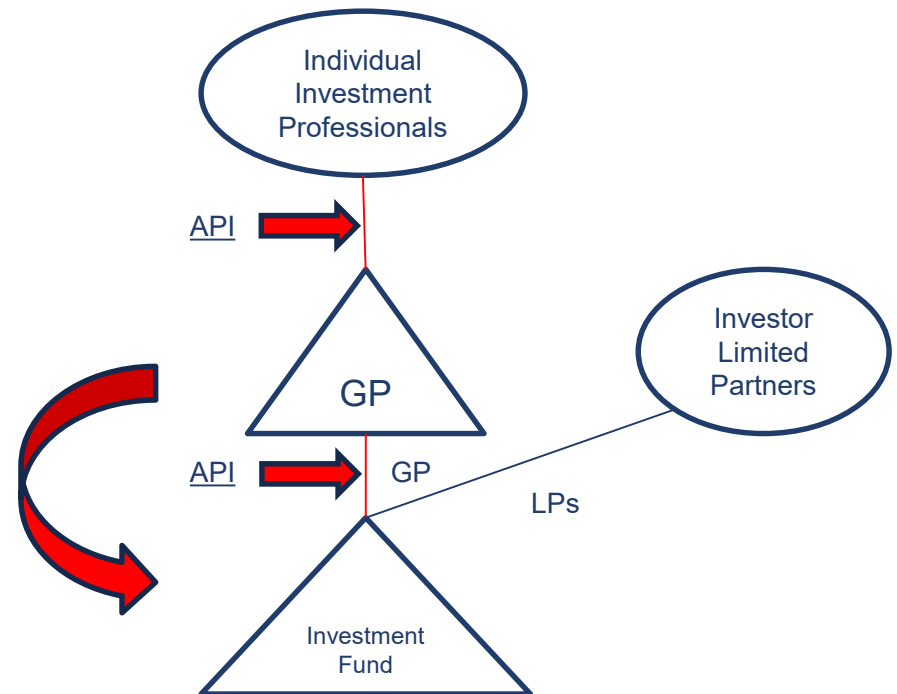
- The regulations provide a maze of defined terms to help readers ascertain who in fact holds an API. For example, the final regulations often refer to “Owner Taxpayers,” “API Holders” and “Passthrough Entities” as the direct or indirect holders of an API.
- An interest issued by a hedge fund, private equity fund or real estate investment partnership to a partner for performing services – whether the partner is an individual or an intermediate general partner/managing member LLC or other entity – will presumably be treated as an API.

## Who Holds the API?—Examples

### Example 1: API

- The Investment Fund is engaged in an ATB.
- In exchange for substantial services to the Investment Fund, the GP obtains a carried interest.
- GP holds an API and the Investment Professionals hold an API.
- **Takeaway: An API is generally the carried interest that is directly issued by a partnership, and any indirect interest in the API as well.**

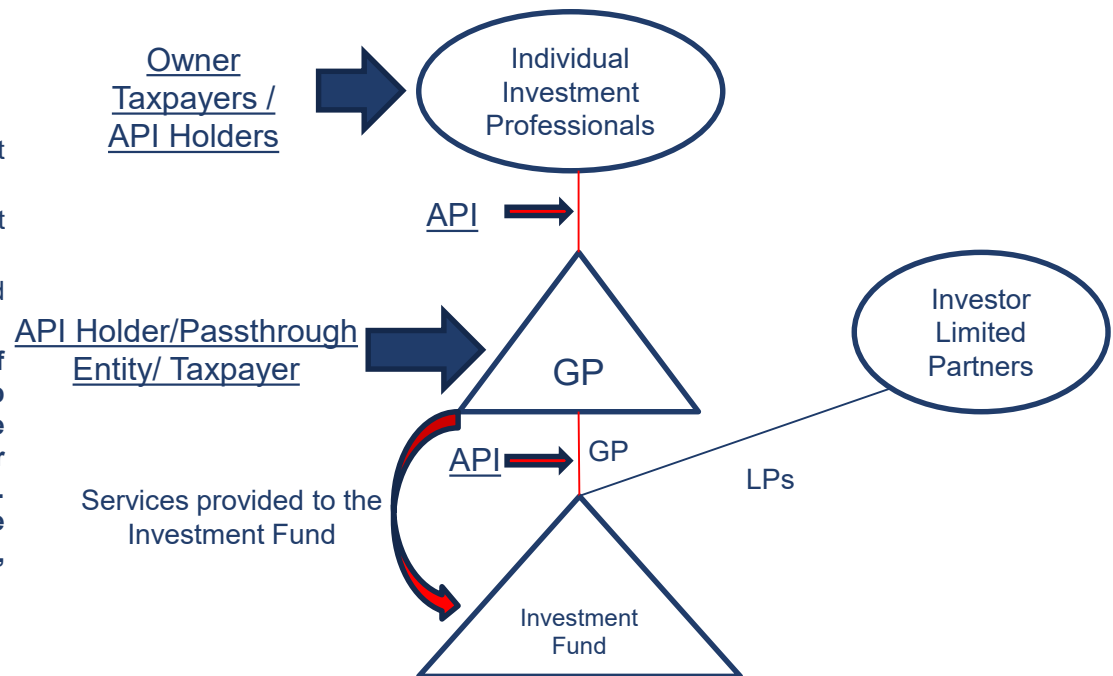
Services provided to the Investment Fund



## Who Holds the API?—Examples

### Example 2: Owner Taxpayers / API Holder / Passthrough Entity / Passthrough Taxpayer.

- Same facts as Example 1.
- Owner Taxpayers are the Individual Investment Professionals that own the GP.
- API Holders include the Individual Investment Professionals and the GP.
- The GP is both a Passthrough Entity and Passthrough Taxpayer.
- **Takeaway:** There may be one or more tiers of Passthrough Entities between the partnership that originally issued the API and the Passthrough Entity in which the Owner Taxpayer holds its indirect interest in the API. Each Passthrough Entity in the tiered structure is treated as holding an API, and each is thus, an API Holder.



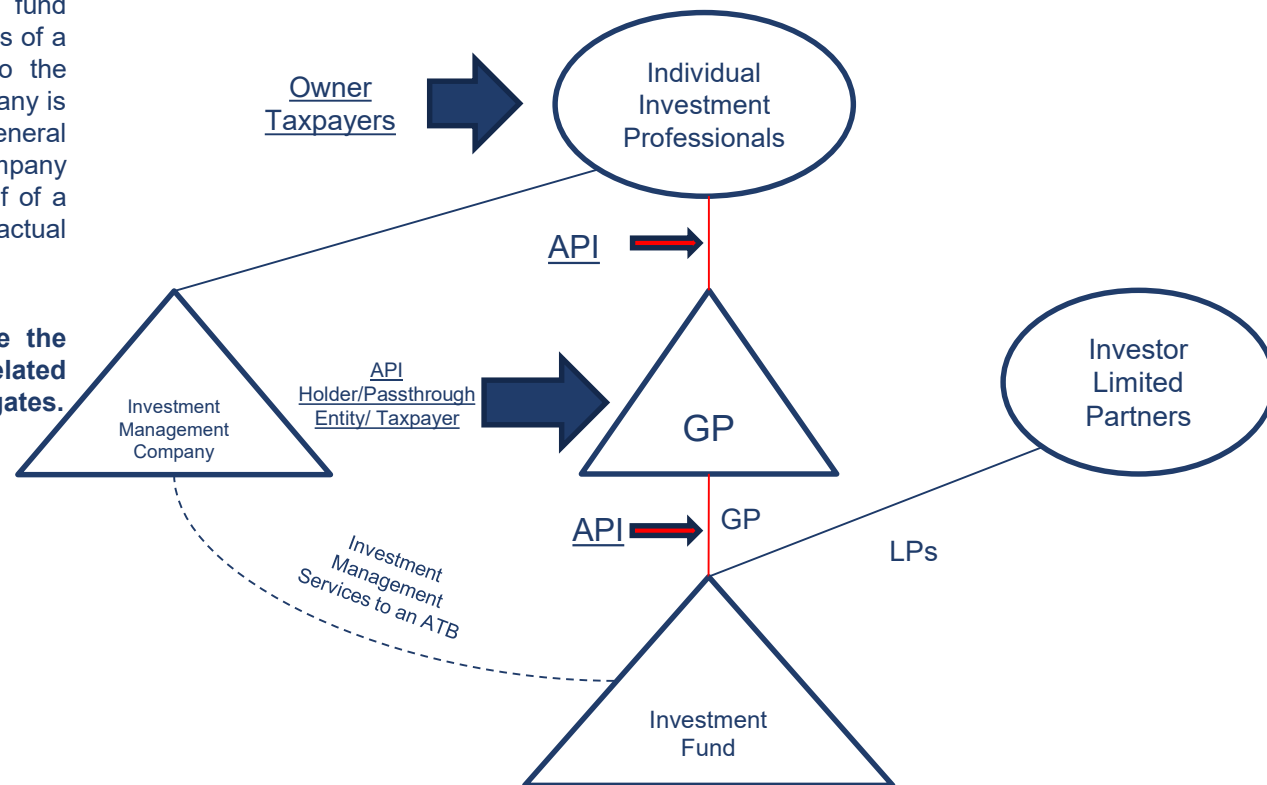
## Substantial Services to an ATB

- The rules establish an ATB activity test. Each year's Specified Actions performed must be sufficient to constitute the regular, continuous conduct of a trade or business. **The regulations create a presumption that services are substantial when a profits interest is exchanged for them.**
- The “ATB activity test” is met if the Specified Actions are conducted at a level of activity required for an activity to constitute a trade or business under section 162.
- For purposes of the ATB activity test, all of the Specified Actions conducted by related persons are combined. Multiple related persons' actions are combined and then attributed to each related person. Therefore, a single ATB can include the actions taken by multiple related persons.

# Substantial Services to an ATB: Related Persons

## Example: Related Persons

- For example, assuming an investment fund satisfies the ATB activity test, the activities of a management company are attributed to the general partner if the management company is considered a related person to the general partner or if the management company provides management services on behalf of a general partner pursuant to a contractual arrangement.
- Takeaway: The regulations aggregate the activities of the taxpayer and related persons, including any agents or delegates.**



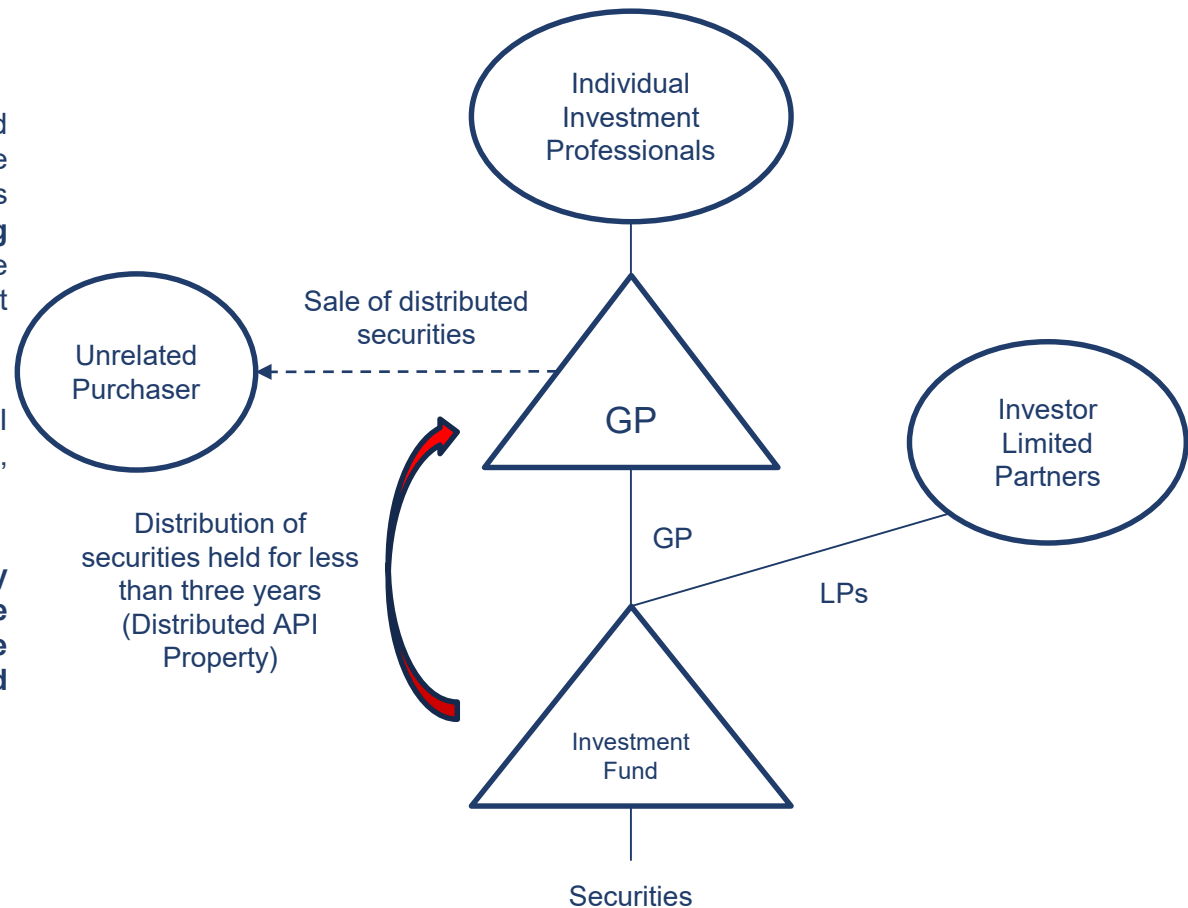
## Calculating API Gains and Losses

- Technically, section 1061(a) recharacterizes as short-term capital gain, the *difference* between a taxpayer's net long-term capital gain with respect to one or more APIs and the taxpayer's net long-term capital gain by using a three-year holding period rather than one-year holding period. This amount is defined as the API Holder's "Recharacterization Amount." (See *Glossary of Terms* for discussion regarding the Recharacterization Amount.)
- Items not taken into account:
  - Section 1231 gains (property that is real or depreciable and held for more than one year)
  - Section 1256 gains (mark-to-market gains from non-equity options, foreign currency contracts, regulated futures contracts, dealer equity options and dealer securities futures contracts)
  - Amounts treated as qualified dividends under section 1(h)(11)
  - Any capital gain that is characterized as long-term or short-term without regard to the holding period rules in section 1222, such as capital gains characterized under the identified mixed straddle rules described in section 1092(b) and treas. reg. secs. 1.1092-(b)-3T, 1.1092(b)-4T, and 1.1092(b)-6
- Addition of Installment Sale Gain
  - The regulations provide that the Owner Taxpayer's API gains will include gains from installment sales, regardless of whether the installment sale occurred before the effective date of section 1061. For example, if an API was sold on November 30, 2017 and, at the time of the sale, it had a holding period of two years, gain recognized on or after January 1, 2018 is subject to section 1061 even though the disposition occurred before effective date of section 1061.
- Addition of Distributed API Property (*see example on the next Slide*).

# Calculating API Gains and Losses: Distributed API Property—Examples

## Example: Distributed API Property

- If the Distributed API Property is disposed of by the distributee-partner when the holding period is three years or less (**inclusive of the partnership's holding period**), gain or loss with respect to the disposition is API gain or loss and subject to section 1061(a).
- At the time that the Distributed API Property is held for more than three years, it is no longer Distributed API Property.
- **Takeaway: Distributed API property must have a holding period of more than three years (inclusive of the partnership's holding period) to avoid the section 1061 taint.**



## Calculating API Gains and Losses: 1231 Gains and Losses

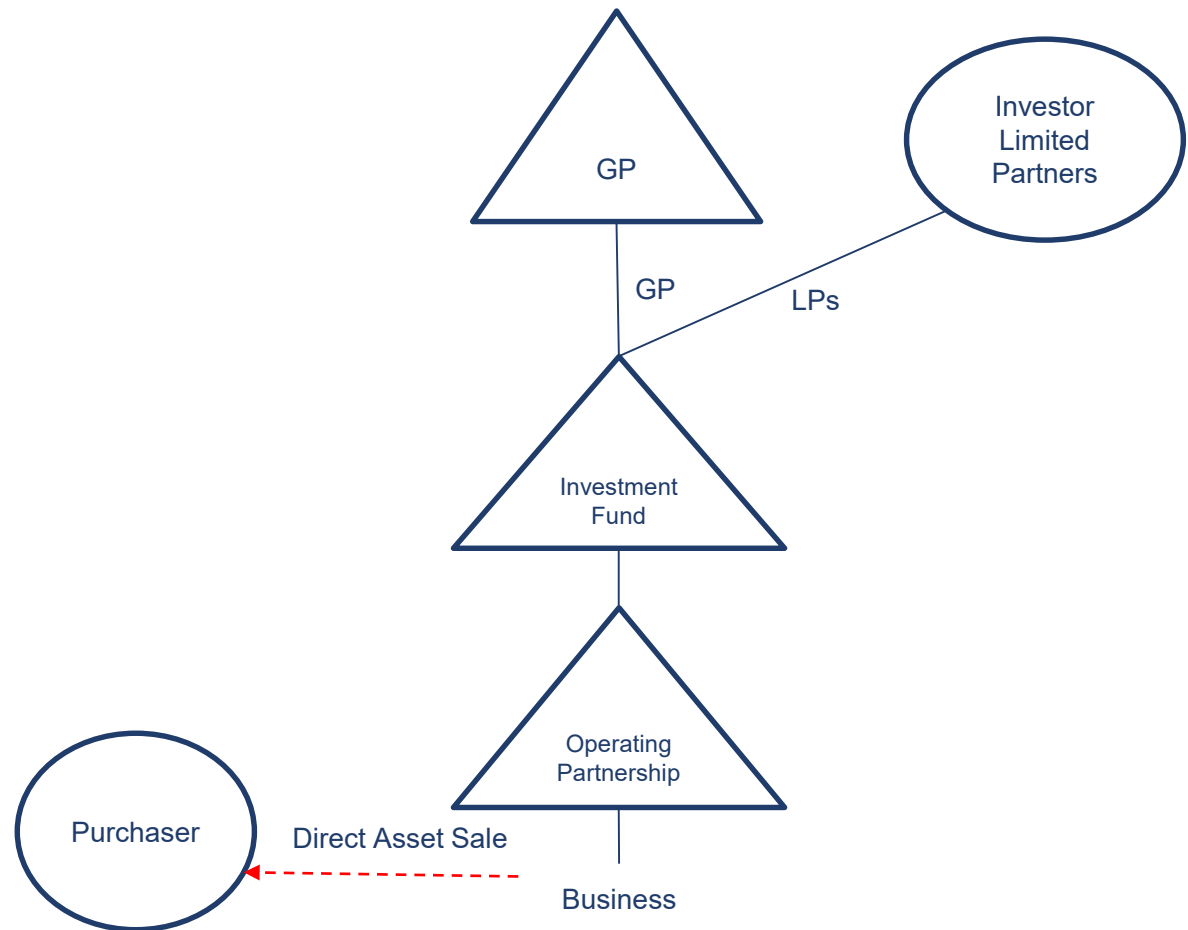
- The final regulations confirm that section 1061 does not apply to section 1231 gains.
- In general, section 1231 gains are gains realized on the sale or conversion of depreciable property, held for more than one year, used in a trade or business. Inventory, property held for sale to customers in the ordinary course of a trade or business, self-created intangibles, etc. are generally excluded from section 1231.
- Examples of property subject to section 1231 include, but are not limited to:
  - **Real estate used in a trade or business**
  - Machinery
  - Acquired patents
  - Acquired licenses
  - Amortizable goodwill (e.g., purchased goodwill/self-generated goodwill)
- The ability to capitalize on the exclusion of section 1231 gains from section 1061 depends on whether there is a direct sale of the business property or an indirect sale of the business property via the sale of an interest in the entity holding such property.



## Calculating API Gains and Losses: 1231 Gains and Losses—Examples

### Example 1: Direct Asset Sale by the Operating Partnership

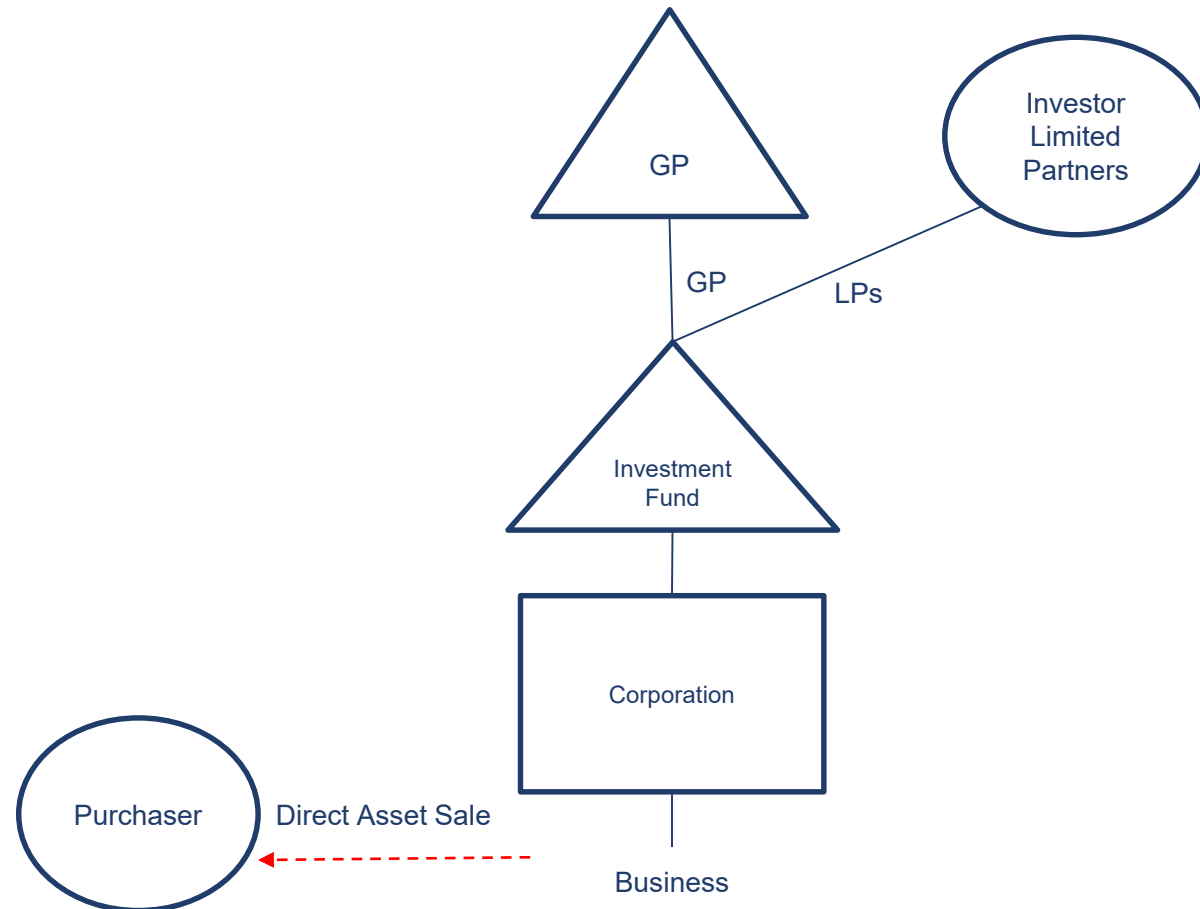
- Assume that the Investment Fund owns an interest in the Operating Partnership (not engaged in an ATB). The Operating Partnership itself has depreciable business property that it has held for greater than one year but for less than three years, and thus, such property meets the requirements to be eligible for section 1231 gain upon disposition (the “Assets”).
- If the Operating Partnership directly sells the Assets, the direct sale will give rise to section 1231 gains and, accordingly, such gains will be free from section 1061, notwithstanding that such Assets have not been held for more than three years.



## Calculating API Gains and Losses: 1231 Gains and Losses—Examples

### Example 2: Direct Asset Sale by a Corporation

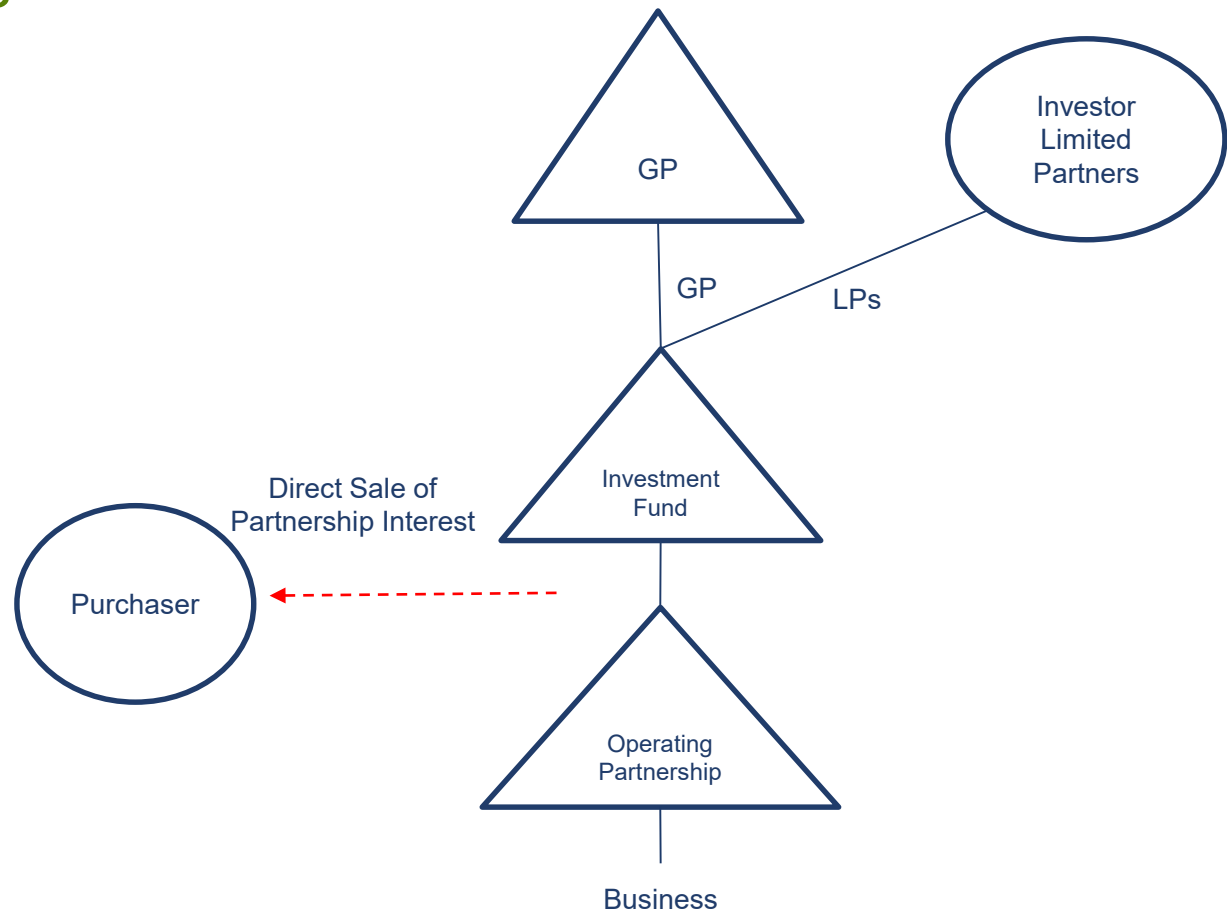
- Same facts as Example 1, except that a Corporation holds the Assets rather than the Operating Partnership.
- Because the entity selling the Assets is taxed as a corporation, gains recognized from the sale therein will not be allocated to the Investment Fund, but rather trapped in the Corporation, which will be taxed at 21%.
- Dividends from the Corporation to the Investment Fund will be excluded from section 1061 if they are qualified dividends as provided under section 1(h)(11).



## Calculating API Gains and Losses: 1231 Gains and Losses—Examples

### Example 3: Direct Sale of Interests in the Operating Partnership

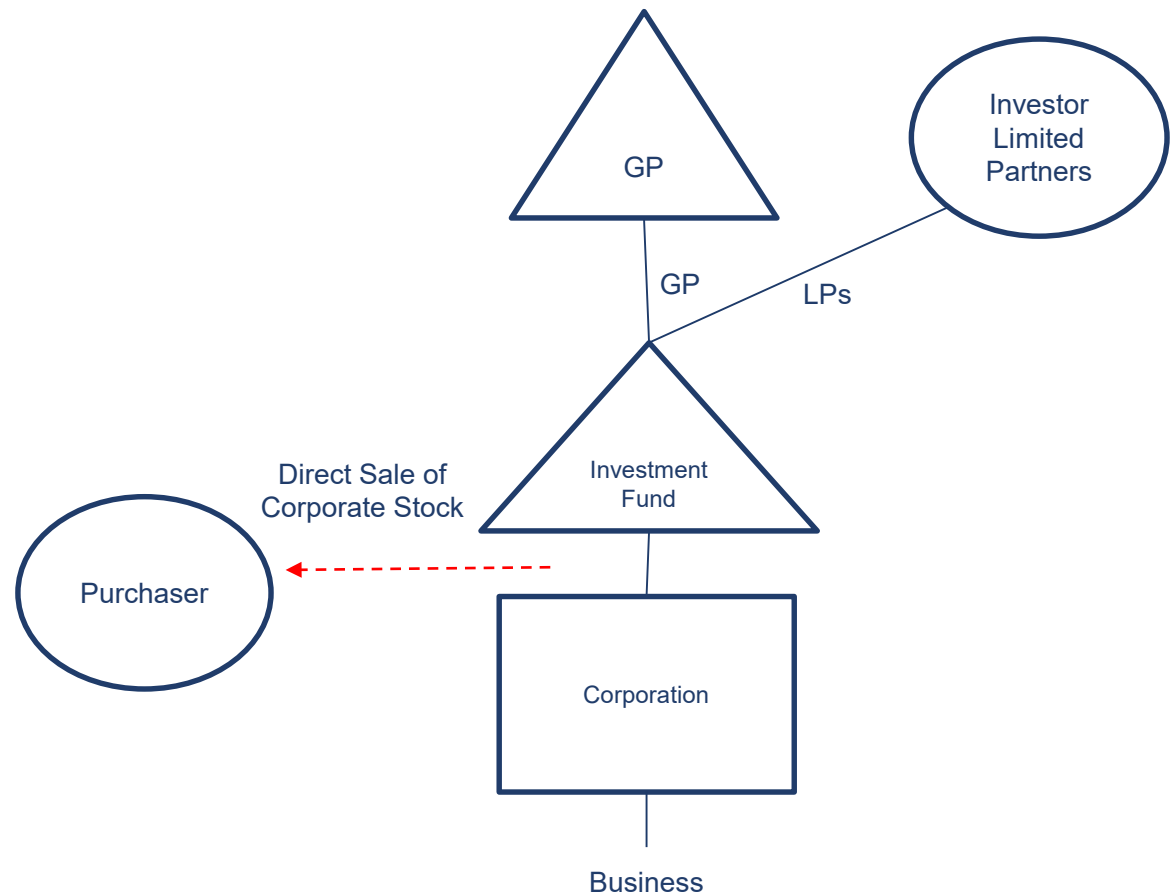
- Same facts as Example 1, except the Investment Fund sells its interest in the Operating Partnership to the Purchaser.
- In this case, the interest in the Operating Partnership is not section 1231 business property and thus the gain recognized therein is not eligible for section 1231 treatment. Consequently, the capital gain realized on the sale will be subject to section 1061's three-year holding period.



## Calculating API Gains and Losses: 1231 Gains and Losses—Examples

### Example 4: Direct Sale of Stock in the Corporation

- Same facts as Example 3, except that the Corporation holds the Assets rather than the Operating Partnership.
- In this case, the stock in the Corporation is not section 1231 business property and thus the gain recognized on the sale is not eligible for section 1231 treatment. Consequently, the capital gain realized on the sale will be subject to section 1061's three-year holding period.



## General Calculation Rules: Holding Period and Lookthrough Rule

- Holding Periods Used
  - Subject to the application of the “lookthrough rule” (discussed on the next Slide), the regulations provide that it is the holding period of the **asset** sold that controls the analysis. For example, if a partnership disposes of an asset, it is the partnership’s holding period in the asset that matters; conversely, if the taxpayer disposes of its applicable partnership interest, it is the holding period of such interest that matters. In other words, the taxpayer’s holding period in the API is only relevant if the API is being sold.

**Query:** Can the three-year holding period be avoided by distribution of partnership assets in-kind to the general partner?

**Answer:** Only if the general partner holds those assets for three years until the API taint wears off. *See Calculating API Gains and Losses: Distributed API Property.*

# General Calculation Rules: Split Holding Period Considerations

- Investment funds frequently tend to make follow-on investments in existing portfolio companies. Such follow-on investments could affect a fund's holding period in any given portfolio company interest.
- Whether the portfolio company is a corporation or an entity taxed as a partnership may make a difference in the investment fund's holding period in its portfolio company interest.
- *Holding Period of Corporate Stock – Meaningless Gesture Doctrine (IRS AUM 2020-005)*
  - Section 351:
    - Section 351 of the IRC is a nonrecognition provision that applies when property is transferred by one or more persons to a corporation solely in exchange for that corporation's stock, and immediately after the exchange, such person or persons are in control of the corporation.
    - If the property transferred is a capital asset, then the transferor has a holding period in the stock received that includes the holding period of the property transferred.
  - Meaningless Gesture Doctrine
    - A contribution of capital (of cash or property) to a corporation by its shareholder, without the issuance of stock, still may qualify as a section 351 exchange. This is particularly pertinent with respect to section 351 transactions taking place *after* such contributing shareholder has obtained stock in the corporation.
    - After a subsequent transfer of capital to the corporation in a transaction to which section 351 applies, even if no stock is issued pursuant to such transfer, the shareholder's stock in the corporation has a split basis and a split holding period to reflect the initial transfer and the subsequent transfer.
    - The holding period of the portion of each share of the shareholder's stock is determined generally by referring to the fair market value of the property contributed to the corporation relative to the value of the taxpayer's stock in the corporation immediately after such contribution.

# General Calculation Rules: Split Holding Period Considerations

- *Holding Period of Partnership Interests – Divided Holding Period (Treas. Reg. Sec. 1.1223-3)*
  - In general, a partner's partnership interest has a single unitary holding period unless (1) the partner acquired portions of an interest at different times; or (2) the partner acquired portions of the partnership interest in exchange for property transferred at the same time but resulting in different holding periods.
  - Each time that a partner contributes property to a partnership, such partner has a new holding period in the portion of such partner's interest in the partnership that is attributable to the contribution.
  - The portion of a partnership interest to which a holding period relates shall be determined by reference to a fraction, the numerator of which is the fair market value of the portion of the partnership interest received in the transaction to which the holding period relates, and the denominator of which is the fair market value of the entire partnership interest (determined immediately after the transaction).
  - Generally, partial dispositions of a partnership interest will generally include a pro rata share of each tranche of partnership interest (including older and new holding periods).
- **Partial Sale of Partnership Interests & Corporate Stock:**
  - To the extent the portfolio company is classified as a corporation for U.S. federal income tax purposes, the seller may identify specific blocks of stock to sell (for example, stocks with longer holding periods may be sold first in such partial exit).
  - On the other hand, a partial disposition of a partnership interest will generally require the taxpayer to include a pro rata share of each tranche of partnership interest (including older and new holding periods) held by such taxpayer at the time of the disposition.
- **Takeaway:** Because the holding period of the asset sold controls for purposes of section 1061, investment funds need to consider (1) the type of asset(s) being disposed of and (2) the holding period(s) of such asset(s). Further, to the extent that follow-on investments are made in a portfolio company, fund managers should take into account the tax classification of such entity (*i.e.*, corporation *v.* partnership) and potential section 1061 planning and/or pitfalls associated therein resulting from potential split holding periods with respect to such company's interests.

# General Calculation Rules: Holding Period and Lookthrough Rule

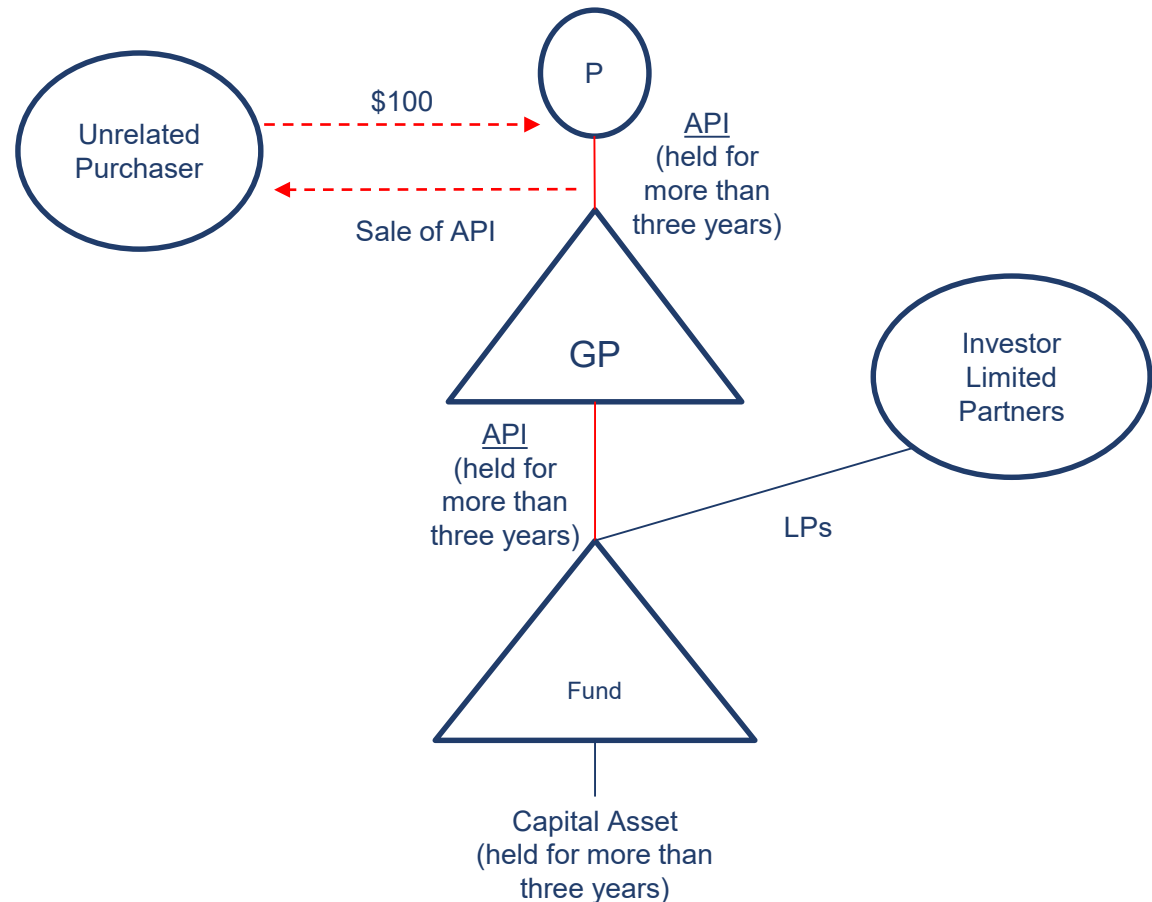
- Lookthrough Rule on Sale of APIs
  - The proposed regulations provided a limited lookthrough rule that would have required a taxpayer disposing of its API with a holding period of greater than three years to look through to the assets of the underlying partnership(s).
    - The proposed lookthrough generally applied if 80% or more of the assets of the partnership in which the API was held, based on fair market value, were assets that would produce capital gain or loss that were not generally exempt from section 1061 if disposed of by the partnership and had a holding period of three years or less.
  - The final regulations significantly pared back the lookthrough rule set forth in the proposed regulations.
  - Under **the final regulations**, the lookthrough rule will apply if either (1) the taxpayer's holding period in the API would be three years or less if it did not include any period before the date on which any Unrelated Non-service Partners were legally obligated to contribute substantial amounts of money or property to the partnership, or (2) a series of transactions has taken place with a principal purpose of avoiding the recharacterization rules of section 1061.
    - In the context of a private investment fund such as a private equity fund, limited partners become "legally obligated to contribute" money or property on the date such limited partners make a binding commitment to make capital contributions to the fund, not the date of the capital contributions are made.
  - Under the final regulations, a substantial legal obligation to contribute money or property is an obligation to contribute a value that is at least 5 percent of the partnership's total capital contributions as of the time of the API disposition.



## Examples: Holding Period and Lookthrough Rule

### Example 1: All APIs and Assets are Held for More Than Three Years

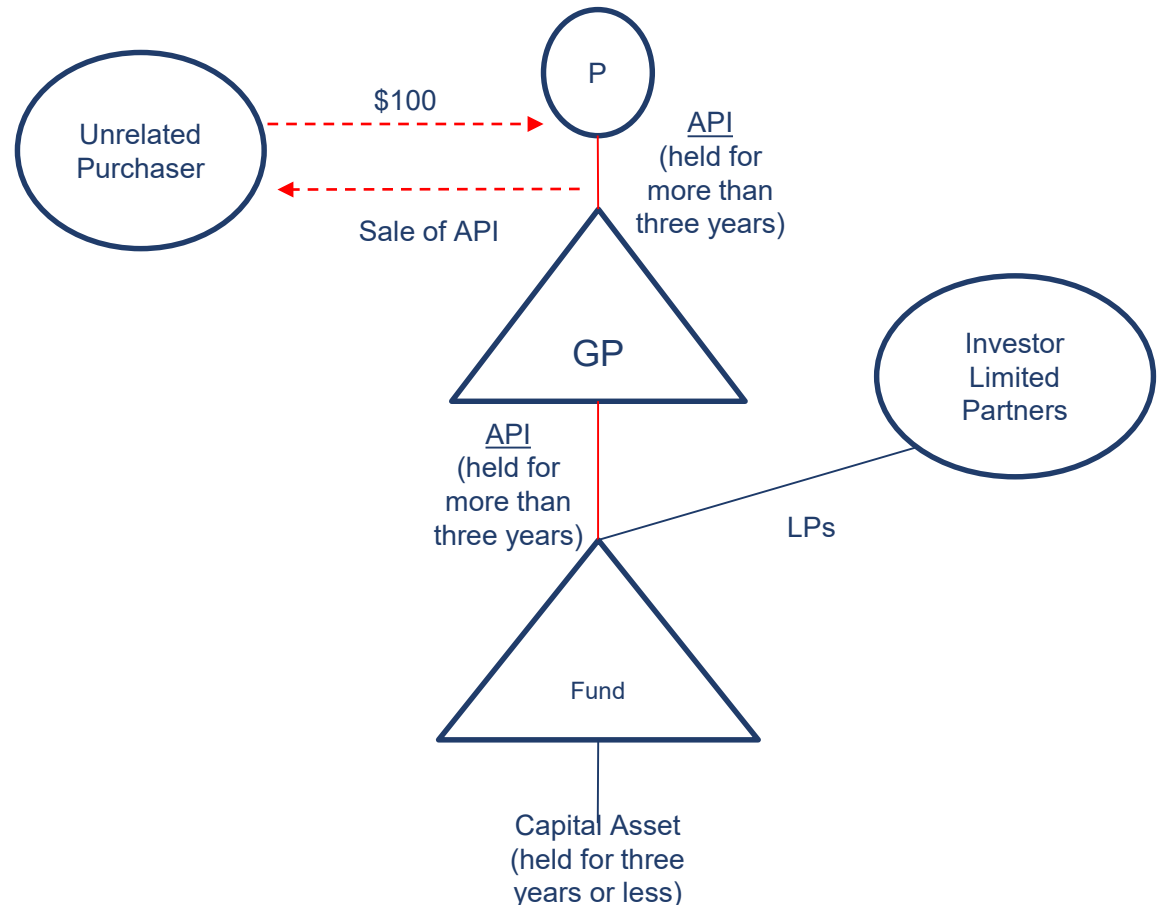
- P, an individual taxpayer, holds an API in GP, an entity taxed as a partnership. GP's sole asset is an interest in an investment partnership (Fund), which holds one capital asset (Capital Asset). Capital Asset is not exempt from the application of section 1061. P has held its API in GP for more than three years, GP has held its interest in Fund for more than three years, and Fund has held Capital Asset for more than three years. P sells its API in GP for a \$100 gain.
- Because it is the holding period of the owner of the asset that controls, P's \$100 gain on the sale of its API is long-term capital gain under section 1061.**



## Examples: Holding Period and Lookthrough Rule

### Example 2: Application of the Lookthrough Rule When P Sells API with Holding Period of More Than Three Years and Fund Holds Capital Asset for Three Years or Less

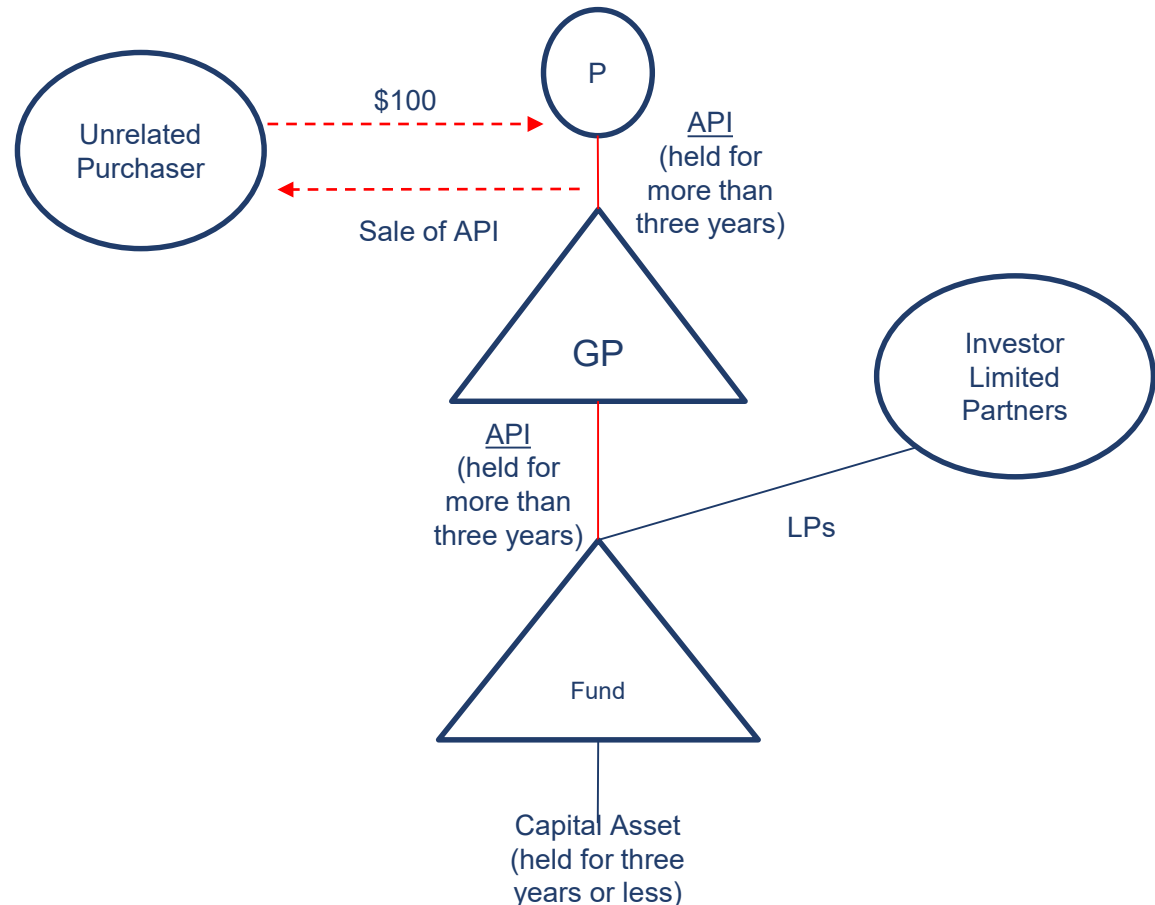
- Same facts as Example 1, except that Fund has held Capital Asset for three years or less.
- Because GP has held its interest in Fund for more than three years, P must determine whether the lookthrough rule applies to Capital Asset. The lookthrough rule will generally apply if either (1) the holding period in the API would be three years or less if it did not include any period before the date on which any unrelated non-service partners were required to commit substantial amounts of money or property to the partnership, or (2) a series of transactions has taken place with a principal purpose of avoiding the recharacterization rules of section 1061.
- **In this instance, assuming neither (1) or (2) above is applicable, the lookthrough rule will not apply to the sale of P's API interest in GP.**



## Examples: Holding Period and Lookthrough Rule

### Example 3: Application of the Lookthrough Rule When P Sells API with Holding Period of More Than Three Years and Fund Holds Capital Asset for Three Years or Less

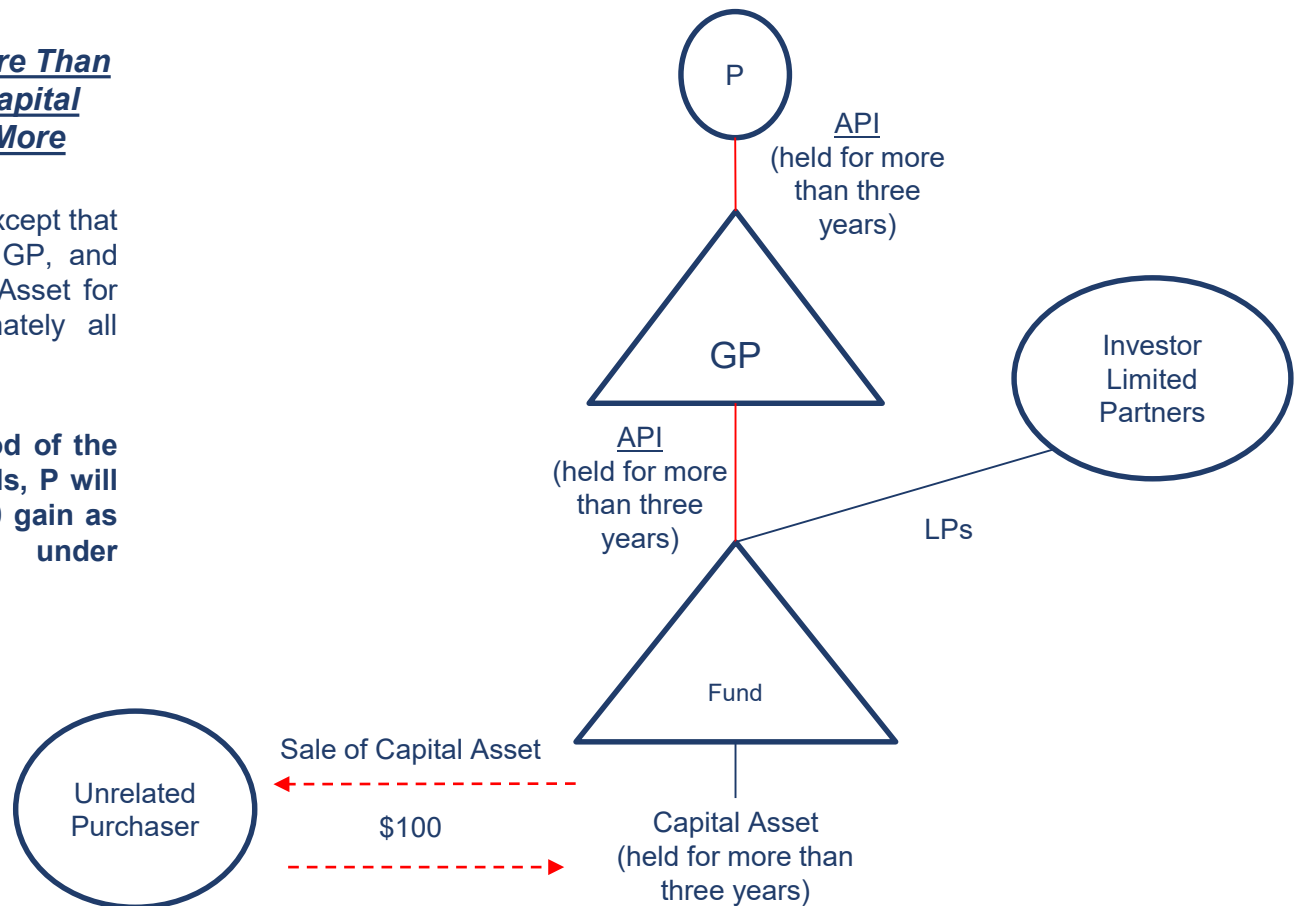
- In Year 1, P organized GP, and in turn GP organized Fund with the intention of launching Fund sometime in the future. On the first day of Year 3, unrelated – limited partner investors make binding commitments to contribute to Fund greater than 5% of Fund’s total capital contributions. On the last day of Year 3, the limited partners make their capital contributions to Fund. On such date, with the capital contributed by such investors, Fund purchased Capital Asset. In Year 5, P sells its interest to an unrelated purchaser.
- Because P has held its interest in GP (and in turn, indirectly in Fund) for more than three years, P must determine whether the lookthrough rule applies to P’s sale of its interest in GP. Under prong (1) of the lookthrough rule, GP’s holding period in its interest in Fund effectively begins on the date the unrelated – limited partner investors were legally obligated to contribute to Fund greater than 5% of the Fund’s total capital contributions (*i.e.*, the commitment date). Consequently, upon P’s sale of its API, the lookthrough rule will apply to the sale of its interest in GP. Upon application of the rule, P’s \$100 gain will be re-characterized as short-term capital gain.
- Takeaway:** The lookthrough rule under the final regulations is intended to prevent sponsors from setting up a dormant carry vehicle in advance of raising capital in order to claim a longer holding period in the interests issued by the vehicle.



## Examples: Holding Period and Lookthrough Rule

### Example 4: API Is Held for More Than Three Years and Fund Sells Capital Asset with Holding Period of More Than Three Years

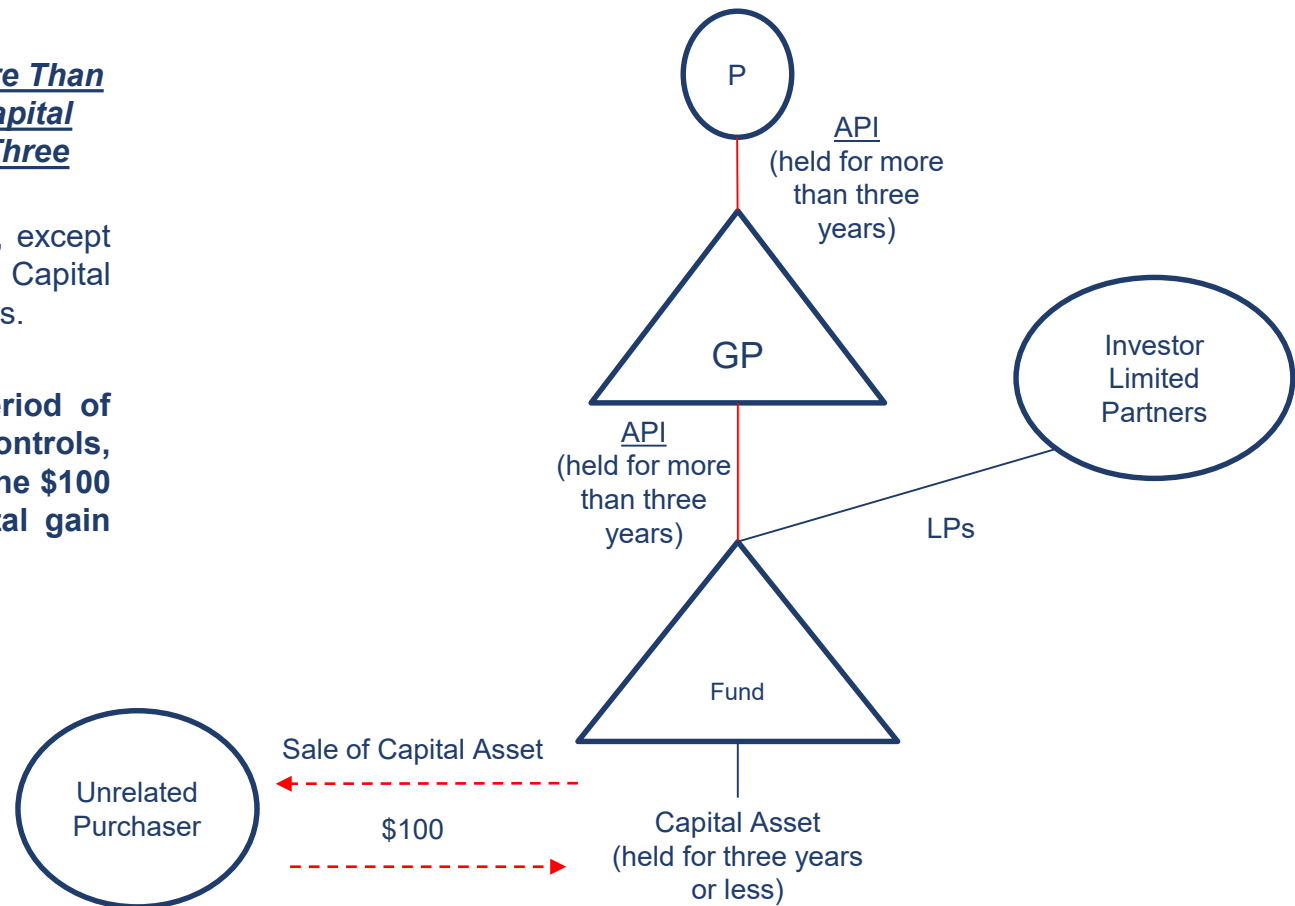
- Same facts as Example 1, except that P does not sell its API in GP, and instead, Fund sells Capital Asset for \$100 gain (which is ultimately all allocable to P).
- **Because the holding period of the owner of the asset controls, P will take into account the \$100 gain as long-term capital gain under section 1061.**



## Examples: Holding Period and Lookthrough Rule

### Example 5: API Is Held for More Than Three Years and Fund Sells Capital Asset with Holding Period of Three Years or Less

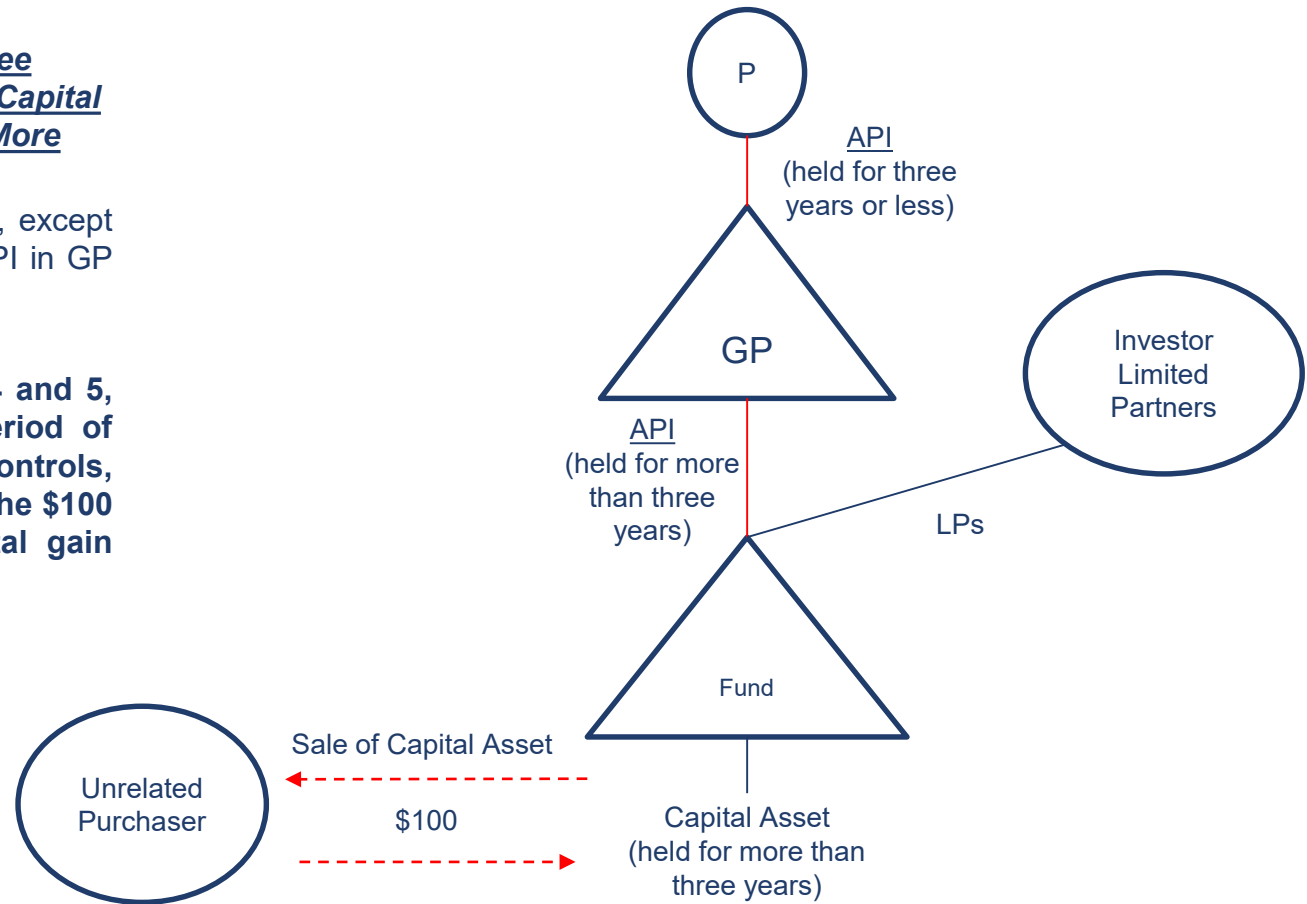
- Same facts as Example 4, except that Fund has only held Capital Asset for three years or less.
- **Because the holding period of the owner of the asset controls, P will take into account the \$100 gain as short-term capital gain under section 1061.**



## Examples: Holding Period and Lookthrough Rule

### Example 6: API Is Held for Three Years or Less and Fund Sells Capital Asset with Holding Period of More Than Three Years

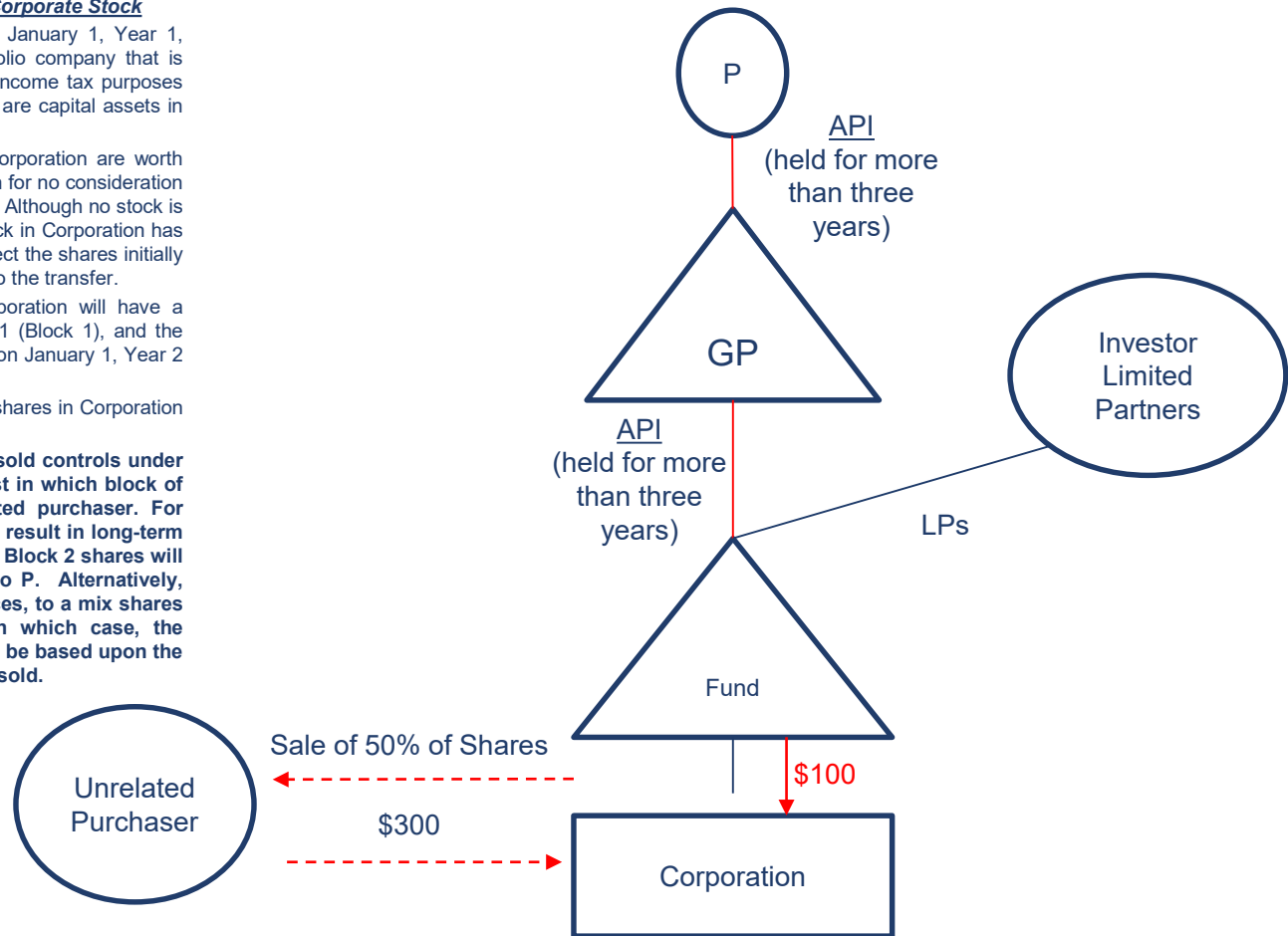
- Same facts as Example 4, except that P has only held its API in GP for three years or less.
- **As stated in Examples 4 and 5, because the holding period of the owner of the asset controls, P will take into account the \$100 gain as long-term capital gain under section 1061.**



# Examples: Holding Period and Lookthrough Rule

## Example 7: Split Holding Period – Application to Corporate Stock

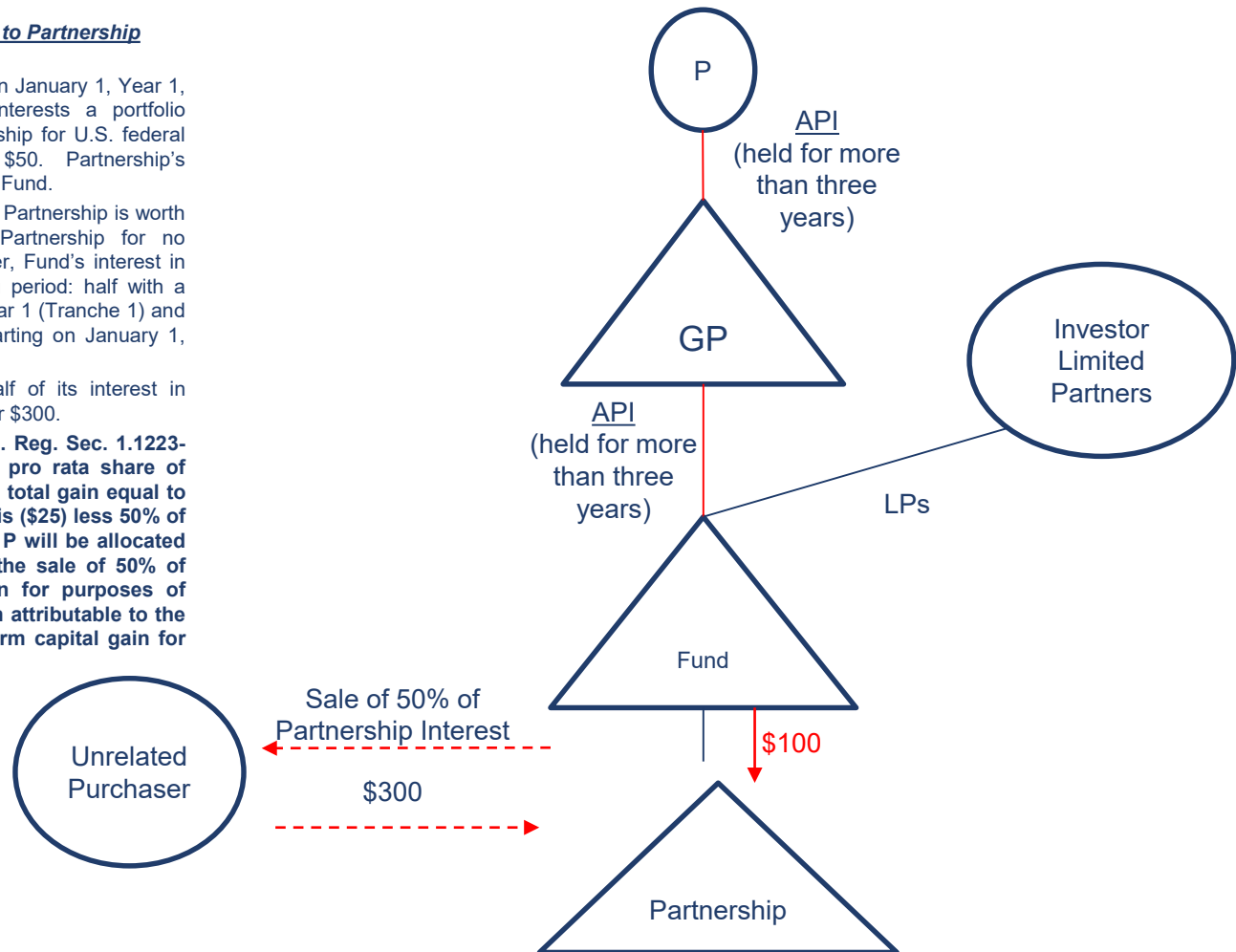
- Same facts as Example 4, except that on January 1, Year 1, Fund purchases all of the stock in a portfolio company that is classified as a corporation for U.S. federal income tax purposes (Corporation) for \$50. Corporation's shares are capital assets in the hands of Fund.
- On January 1, Year 2, Fund's shares in Corporation are worth \$100 and Fund transfers \$100 to Corporation for no consideration in a transaction to which section 351 applies. Although no stock is issued pursuant to such transfer, Fund's stock in Corporation has a split basis and a split holding period to reflect the shares initially purchased and capital contributed pursuant to the transfer.
- Accordingly, half of Fund's shares in Corporation will have a holding period starting on January 1, Year 1 (Block 1), and the other half will have a holding period starting on January 1, Year 2 (Block 2).
- On January 1, Year 4, Fund sells half of its shares in Corporation to an unrelated purchaser for \$300.
- **Because the holding period of the asset sold controls under section 1061, P will have a vested interest in which block of shares that Fund sells to such unrelated purchaser. For example, a sale of the Block 1 shares will result in long-term capital gain allocated to P, while a sale of Block 2 shares will result short-term capital gain allocated to P. Alternatively, Fund may choose, in certain circumstances, to a mix shares from each of Block 1 and Block 2, in which case, the character of the gain allocated to P would be based upon the holding period attributable to each share sold.**



# Examples: Holding Period and Lookthrough Rule

## Example 8: Split Holding Period – Application to Partnership Interests

- Same facts as Example 4, except that on January 1, Year 1, Fund purchases a majority of the interests a portfolio company that is classified as a partnership for U.S. federal income tax purposes (Partnership) for \$50. Partnership's interest is a capital asset in the hands of Fund.
- On January 1, Year 2, Fund's interest in Partnership is worth \$100 and Fund transfers \$100 to Partnership for no consideration. As a result of the transfer, Fund's interest in Partnership will have a divided holding period: half with a holding period starting on January 1, Year 1 (Tranche 1) and the other half with a holding period starting on January 1, Year 2 (Tranche 2).
- On January 1, Year 4, Fund sells half of its interest in Partnership to an unrelated purchaser for \$300.
- **Under the rules set forth under Treas. Reg. Sec. 1.1223-3, Fund will be treated as selling a pro rata share of Tranche 1 and Tranche 2 (50/50) for a total gain equal to \$225 (\$300 less 50% of Tranche 1 basis (\$25) less 50% of Tranche 2 basis (\$50)). Accordingly, P will be allocated (A) \$125 of the gain attributable to the sale of 50% of Tranche 1 as long-term capital gain for purposes of section 1061, and (B) \$100 of the gain attributable to the sale of 50% of Tranche 2 as short-term capital gain for purposes of section 1061.**





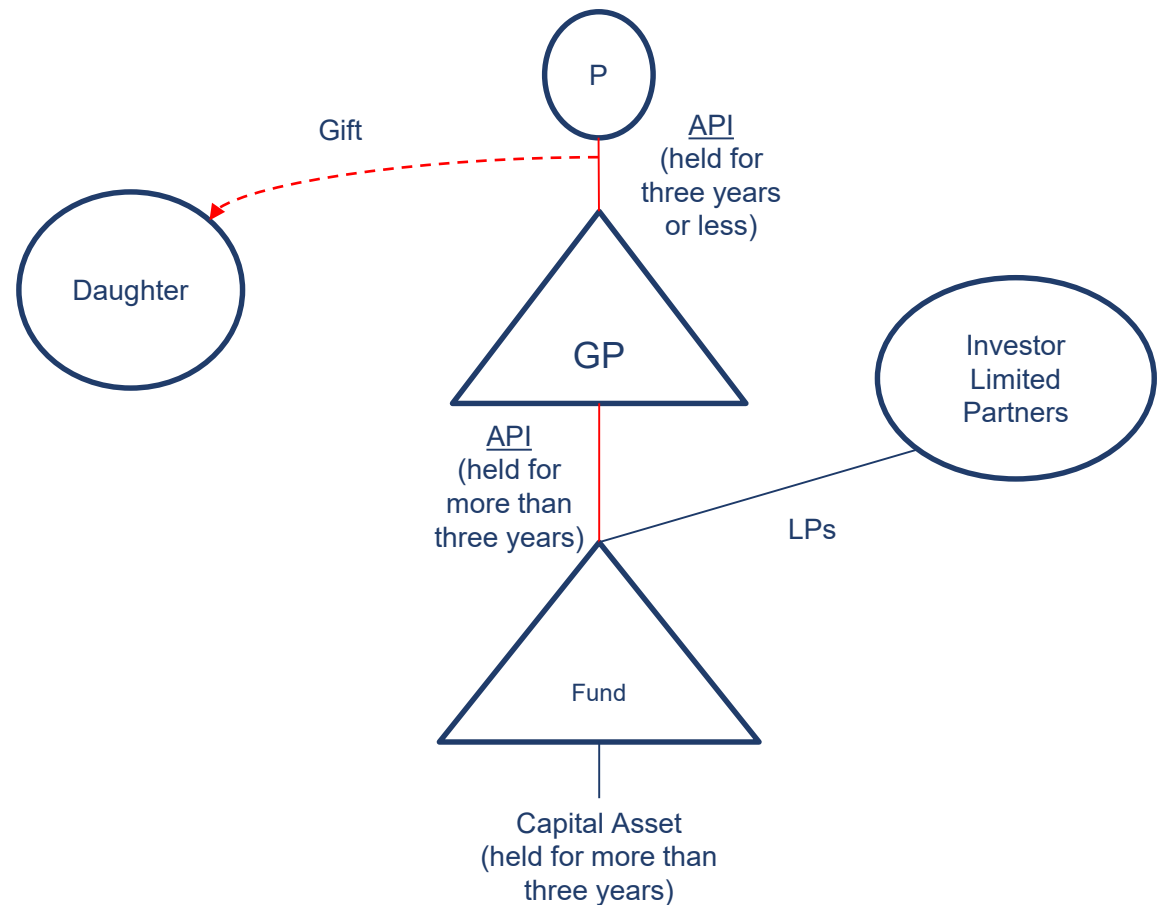
## Related Party Transfers

- Section 1061(d) applies to transfer of APIs to certain related persons.
- Can the three-year holding period be avoided by transferring an API to a related party?
- The proposed regulations interpreted section 1061(d) as not only a gain recharacterization provision, but also a gain acceleration provision—in other words, the proposed regulations could have triggered short-term capital gains in related-party transfers that were otherwise eligible for nonrecognition treatment for U.S. federal income tax purposes.
- The final regulations provide that section 1061(d) is not a gain acceleration provision, but merely a gain recharacterization provision.
- Although the proposed regulations initially broadened the definition of a transfer to include contributions, distributions, sales and exchanges and gifts, **the final regulations narrowed the definition to mean a sale or exchange in which gain is recognized by the Owner Taxpayer under chapter 1 of the Internal Revenue Code .**
- The final regulations broadened the definition of related persons for purposes of section 1061(d) by expanding the definition of “Passthrough Entity” to include trusts and estates. Thus, under the final regulations, section 1061(d) may apply to an otherwise taxable transfer of an API by an individual to a non-grantor trust for members of the individual’s family.

## Related Party Transfers: Example

### Example: Gift to Child

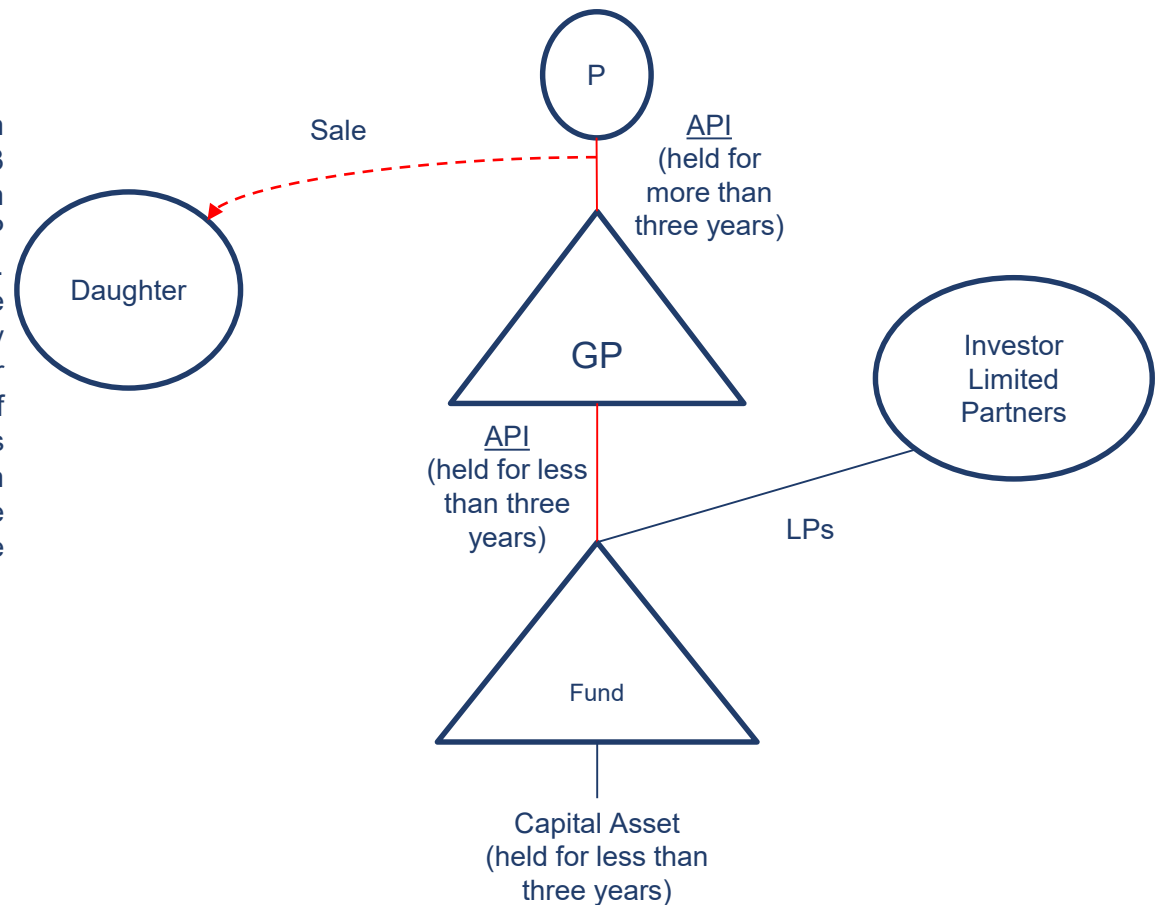
- For example, imagine that P has held his API for three years or less and had a \$100 built-in gain in its API. As part of his estate planning, P gifts his API to his daughter. Under the final regulations, the gift does not trigger section 1061.
- Takeaway: section 1061 will generally not be applicable to certain nonrecognition transactions related to the transfer of an API to a Related Person.**



## Related Party Transfers: Example

### Example: Sale to 1061(d) related person

- For example, imagine that P holds an API in GP which P has owned for more than 3 years. P sells the interest to his daughter in exchange for \$100 of cash, resulting in P recognizing long-term capital gain of \$100. However, if, immediately prior to the transfer, GP sold all of its assets in a fully taxable transaction for cash equal to the fair market value of all its assets, P's share of the net long-term capital gain from assets held for three years or less would have been \$120. Thus, P's \$100 gain on the sale of the interest to his daughter would be recharacterized as short-term capital gain.



## Reporting Requirements

- Passthrough Entities (including investment funds, funds of funds, and fund GPs) must report section 1061 information to Owner Taxpayers on an attachment to the Schedule K-1.
- Typically, information reported by a Passthrough Entity will include: API Distributive Share amounts; items specifically excluded from API calculations; Capital Interest gains and losses; and, upon request, any information required for an API Holder to properly take into account a disposition of an interest in a Passthrough Entity; etc. Penalties will apply if a Passthrough Entity fails to timely comply (e.g., section 6698, *Failure to File Partnership Returns*, and section 6722, *Failure to Furnish Correct Payee Statements*).
- If an Owner Taxpayer is not furnished API information by a Passthrough Entity and cannot otherwise substantiate required amounts, then the Owner Taxpayer must generally treat all API distributive share amounts as subject to recharacterization under section 1061.

# Market Strategies

- **Carried Interest Waivers**
  - Prior to the release of the proposed regulations, many investment fund managers drafted “carried interest waivers” in their partnership agreements. Similar to management fee waivers, carried interest waivers permit investment fund managers to waive their rights to an allocation of the partnership’s capital gains that are realized for assets held for three years or less, while simultaneously increasing their allocable share of capital gains for assets that are held for more than three years. The proposed regulations did not bar the use of “carried interest waivers,” but instead specifically stated that such waivers may be challenged pursuant to the existing guaranteed payment/entrepreneurial risk rules of section 707 of the IRC, the partnership anti-abuse rules, the substantial economic effect doctrine, the substance over form doctrine, and other tools that the IRS has at its disposal.
- **Asset Sale**
  - As provided in Slides 24 – 28, section 1231 gains are excluded from section 1061. As such, in the case of an investment fund’s decision to exit its investment in an *operating business* that is held in a passthrough entity, depending upon the nature of the business, it may be worthwhile to consider an asset sale rather than a disposition of an interest in the entity holding such business. The former alternative may remove the gain from the sale from section 1061’s gambit, while gain from the latter alternative will likely be subject to section 1061.
- **In-Kind Distributions to Avoid Section 1061**
  - Some investment professionals have taken to receiving in-kind distributions of partnership property (which they will later dispose of) rather than being allocated gain from the sale of capital assets that are held for three years or less. While the distributed property will constitute Distributed API Property and still be subject to section 1061’s three-year holding period requirement, this technique is particularly helpful for private equity and/or hedge fund GPs that would rather receive API Distributed Property than be allocated short-term capital gains from the sale of underlying partnership property as they exist their investments.
- **Separating the Capital Interest and the Carried Interest**
  - In an effort to remove the potential application of section 1061’s taint to a carried interest holder’s invested capital, investment fund managers may consider investing their capital through separate interests in the investment fund (*i.e.*, investing capital through an LP interest rather than a GP interest) or structuring capital interests in underlying investments as co-investment vehicles that participate alongside the fund in the underlying investment. The goal with the foregoing techniques is to separate the capital interest and carried interest to avoid some of the additional requirements imposed on capital interests and remove the potential application of section 1061 to such invested capital.

## Glossary of Terms

- “API” is generally defined as any interest in a partnership which is transferred to a taxpayer in connection with the performance of substantial services by the taxpayer (or any other related person) in (or to) any ATB.
- “API Holder” means a person who holds an API. An API Holder may be an individual, partnership, trust, estate, S corporation, or a PFIC with respect to which its U.S. shareholder has made a QEF election.
- “API One Year Disposition Amount” includes the long-term capital gains and losses that the Owner Taxpayer recognizes from the direct taxable disposition of an API that has been held for more than one year plus long-term capital gain or loss recognized on the disposition of Distributed API Property by an Owner Taxpayer.
- “API One Year Distributive Share Amount” is determined as follows: (1) the partnership determines the long-term capital gains and losses that are allocated to the Owner Taxpayer under the partnership agreement, (2) the partnership reduces this amount by amounts that are not taken into account for purposes of calculating the Recharacterization Amount and (3) the partnership reduces the amount determined under the second step by any amounts that are treated as capital interest gains and losses.
- “API Three Year Disposition Amount” includes only the long-term capital gain or loss from the direct taxable disposition of an API held by the Owner Taxpayer for more than three years.
- “API Three Year Distributive Share Amount” is equal to the Owner Taxpayer’s One Year Distributive Share Amount less amounts that would not be treated as long-term capital gain and loss if such amounts were computed by applying a three-year holding period rather than a one-year holding period.
- “ATB” or “Applicable Trade or Business” means 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 (1) raising or returning capital, and (2) either (i) investing in (or disposing of) Specified Assets (or identifying specified assets for such investing or disposition), or (ii) developing Specified Assets.

## Glossary of Terms

- “Capital Interest Allocations” are allocations of long-term capital gain and loss made under the partnership agreement to the API Holder and Unrelated Non-Service Partners based on such partners’ capital contributed with respect to the partnership to the extent the allocation to the API Holder with respect to its capital interest is determined and calculated in a similar manner as the allocations with respect to capital interests held by similarly situated Unrelated Non-Service Partners who have made significant aggregate capital contributions to the partnership. For these purposes, Unrelated Non-Service Partners will be treated as having made significant aggregate capital contributions to the partnership provided such partners possess five percent or more of the aggregate capital contributed to the partnership at the time the allocations are made.
- “Capital Interest Disposition Amounts” are the amount of long-term capital gain and loss recognized on the sale or disposition of all or a portion of a Passthrough Interest that may be treated as a capital interest gain or loss.
- “Distributed API Property” means property distributed by a Passthrough Entity to an API Holder with respect to an API if the holding period in the API Holder’s hands is three years or less at the time of the disposition of the property by the API Holder.
- “One Year Gain Amount” is made up of (1) the combined net API One Year Distributive Share Amount from all APIs held during the taxable year, and (2) the API One Year Disposition Amount.
- “Owner Taxpayers” are the ultimate beneficial owners of an API that are subject to tax. Owner Taxpayers includes individuals, simple and complex trusts, and estates.
- “Passthrough Entity” means an API held indirectly through one or more passthrough entities.

## Glossary of Terms

- “Passthrough Taxpayer” means a Passthrough Entity in a tiered structure. Generally, if an interest in a partnership is transferred to a Passthrough Taxpayer in connection with the performance of its own services, the services of its owners, or the services of persons related to either the Passthrough Entity or its owners, the interest is an API as to the Passthrough Taxpayer.
- “Recharacterization Amount” is the amount that the Owner Taxpayer must treat as short-term capital gain and not as long-term capital gain under section 1061(a). The Recharacterization Amount equals (1) the Owner Taxpayer’s One Year Gain Amount, less (2) the Owner Taxpayer’s Three Year Gain Amount.
- “Related Person” for purposes of section 1061(d) includes a person or entity who is treated as related to another person or entity under sections 707(b) or 267(b).
- “Specified Actions” include both raising and returning capital and investing in (or identifying for investment) or developing Specified Assets.
- “Specified Assets” are defined as certain securities, certain commodities, 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.
- “Three Year Gain Amount” is made up of (1) the combined net API Three Year Distributive Share Amount from all APIs held during the taxable year, and (2) the API Three Year Disposition Amount.
- “Unrelated Non-Service Partners” means partners who do not (and did not) provide services in the relevant ATB and who are not (and were not) Related Persons with respect to any API Holder in the partnership or any person who provides or has provided services in the relevant ATB.