



CLIENT ALERT: IRS ISSUES PROPOSED REGULATIONS ON TAXATION OF CARRIED INTEREST UNDER IRC 1061

August 9, 2020

On July 31, 2020, the Internal Revenue Service issued proposed regulations regarding taxation of an “Applicable Partnership Interest” or API, under Internal Revenue Code (IRC) section 1061, clarifying and elaborating on the taxation of API (including items such as carried interest). In 2017, under what is commonly known as the Tax Cuts and Jobs Act, Congress enacted IRC 1061. Section 1061 defined an API as a partnership interest that is transferred in connection with the performance of services to an applicable trade or business. Section 1061 increased the holding period required to receive long-term capital gain treatment on API, such as carried interest, from one year to three years. Carried interest on investments held for less than three years is subject to ordinary income tax rates.

The proposed regulations provide the following highlights:

- The increased holding period does not apply to items of income that are separately entitled to long term capital gain treatment, such as qualified dividends.
- The preamble to the proposed regulations warns against the use of “carry waivers” which essentially allow sponsors to waive carry distributions and as a result, income allocations; however, the proposed regulations themselves do not provide additional clarification on the topic.
- The proposed regulations make clear that partnership interests held by S corporations as well as those held by passive foreign investment companies that have a qualified electing fund election in effect do not fall within the “corporate exception” under IRC 1061, which provides that corporations that directly or indirectly own partnership interests are not considered API.
- The proposed regulations include detailed requirements that must be met for an interest to be treated as a capital interest rather than an API and clarify that once an interest is considered an API, it will always be treated as an API unless it meets one of the two exceptions (i.e., the capital interest exception and the corporate exception). An API will still be considered an API even after the service-provider taxpayer retires or ceases to provide services to the partnership, and it is not possible to avoid Section 1061 by distributing property.
- Lastly, the proposed regulations treat the transfer, including the gift within the three year holding period, of an API or any distributed API property to a related party, such as a family member, as a taxable event. Therefore, there must be careful consideration when planning with the transfer of interests of API including a “vertical slice”.

If you have any questions, please contact your Cummings & Lockwood LLC attorney.