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New Holding Period Rules for Carried Interests and the Impact on Upstream Oil and Gas

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The Tax Cuts and Jobs Act (the TCJA) modifies the holding period necessary for gains attributable to applicable partnership interests, commonly known as carried interests, to qualify as long-term capital gains, subject to federal income tax at a rate of 20%[1] (the Holding Period Rules). Instead of greater than one year, the holding period for such interests now is greater than three years. If the three-year holding period is not met, such gains are treated as short-term capital gains and, therefore, subject to tax at federal ordinary income tax rates at a maximum rate of 37%. Please click ***here*** for a general description of the Holding Period Rules.

With the enactment of the TCJA, practitioners in the oil and gas industry have been focused on whether carried interests in connection with upstream oil and gas partnerships would be subject to the Holding Period Rules. A carried interest will be subject to these rules if it is transferred to a holder in exchange for regular, consistent and substantial services related to (1) raising or returning capital, and (2) investing in or developing specified assets. For this purpose, "specified assets" means securities, commodities, real estate for rental or investment, cash or cash equivalents, options or derivative contracts with respect to any of the foregoing.

In the typical upstream structure, private equity funds engage in joint development projects with a local development team. The fund generally forms a partnership, or another entity classified as a partnership for U.S. federal income tax purposes, and, pursuant to its initial commitment, contributes significantly all of the project's capital in exchange for a capital interest in the partnership. The partnership then acquires working interests in oil and gas properties and incurs exploration, drilling, development and operation costs that it pays using the fund's initial contributions. Members of the development team oversee the day-to-day operations of the partnership in exchange for a carried interest in the partnership, which usually entitles the holder to a share of the project's return after the fund has received its capital back plus a fixed return. The fund's economic strategy is to develop the oil and gas working interests, thereby generating value for its investors in connection with the ultimate sale of its developed and proven working interests. Incidental to its development activities, the partnership also will sell any oil and gas produced from the developed working interests.

Practitioners generally have taken the view that these upstream oil and gas partnerships, which tend to exit by selling a package of working interests in a single transaction, should not be viewed as raising or returning capital on a regular, consistent and substantial basis, and thus should not be subject to the Holding Period Rules. However, without further guidance, it is difficult for such a partnership to predict with certainty whether or not its activities would rise to this level. Similarly, without further guidance, it is not entirely clear whether or not the partnership should be treated as investing in or developing specified assets. However, although

the scope of specified assets is broad, including even real estate held for rental or investment, an upstream working interest should fall outside of this definition. Working interests should not be characterized under any theory as a security or commodity and, in contrast to investment real estate, which typically is a passive investment, working interests are actively managed by members of the development team.

Funds and practitioners should observe that oil and gas minerals, once extracted and severed from the underlying oil and gas properties, are likely to be treated as specified assets. These minerals probably would qualify as actively-traded property, and therefore a commodity, for purposes of the specified asset definition. That said, such mineral extraction typically would be an incidental activity to the partnership's primary objective of developing oil and gas properties in advance of an exit event. As a result, it seems unlikely that this level of production is sufficiently extensive to cause a carried interest in an upstream oil and gas partnership to be classified an applicable partnership interest.

Another aspect of the Holding Period Rules where guidance is particularly needed is the application of these rules to Code Section 1231 gains. As defined in the Code, the Holding Period Rules specifically apply to gains from the sale or exchange of capital assets described in Code Section 1222. By their terms, however, the Holding Period Rules do not apply to gains that are calculated under Code Section 1231, despite the fact that such gains can be treated as capital in nature under certain circumstances. Code Section 1231 gains are gains from the sale or exchange of real or depreciable business property, which could include upstream oil and gas properties, held by the taxpayer for more than one year. As a result, gains from these oil and gas properties may not be subject to the three-year holding period, even if they are attributable to an applicable partnership interest. Many commentators believe that Congress did not intend to exclude Code Section 1231 gains from the scope of the Holding Period Rules in this way, and that it was a result of hasty drafting. Nonetheless, absent a technical correction to the TCJA or other further guidance, the exclusion for Code Section 1231 gains appears to be defensible on a plain reading of the statute.

For reasons described above, practitioners are guardedly optimistic that carried interests of upstream oil and gas partnerships will escape the application of the Holding Period Rules. As with many aspects of the TCJA, however, most practitioners are hesitant to take on aggressive positions in this space without additional IRS or Treasury guidance.

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[1] *All income tax rates provided herein are exclusive of the Medicare tax on net investment income.*