

Reproduced with permission from Daily Tax Report, 38 DTR 20, 2/26/18. Copyright © 2018 by The Bureau of National Affairs, Inc. (800-372-1033) <http://www.bna.com>

Carried Interest

The New Three-Year Holding Period for Carried Interests

Elizabeth McGinley and Steven Lorch of Bracewell LLP discuss the extension of the holding period for carried interests from more than one year to more than three years and the aspects of the new rules that are in need of guidance.

BY ELIZABETH L. MCGINLEY AND STEVEN J. LORCH

Tax code Section 1061, enacted by Pub. L. No. 115-97 (2017 tax law), modifies the holding period for gains attributable to applicable partnership interests, commonly known as carried interests, to qualify as long-term capital gains from more than one year to more than three years. If the gains meet the holding period, they are subject to federal income tax at a rate of 20 percent plus the 3.8 percent Medicare tax on unearned income, if applicable.

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 percent plus the 3.8 percent Medicare tax on unearned income, if applicable. Section 1061(a). The three-year holding period applies to gains from the sale or redemption of an applicable partnership interest, as well as gains attributable to such partnership's direct or indirect sale of assets to the extent allocated to the owner of the applicable partnership interest. An applicable partnership interest is an interest in a partnership transferred to a taxpayer in exchange for services performed in connection with the raising or returning of capital, and either investing in (or disposing of) or developing, specified assets. Section 1061(c)(1).

Elizabeth McGinley is chair of Bracewell LLP's tax department in New York and regularly advises clients on acquisitions, dispositions, restructurings, joint ventures and debt and equity investments in the upstream and midstream oil and gas and power industries. Steven Lorch is an associate in Bracewell's tax practice in New York.

The definition of specified assets, defined for this purpose in Section 475(c)(2), includes securities, commodities, real estate assets, cash, and derivatives. An applicable partnership interest does not include a partnership interest held by a corporation, nor does it include a partnership interest, commonly referred to as capital interest, that constitutes a right to share in capital based on the amount of the taxpayer's contributed capital or the value of the interest taxable to the taxpayer upon receipt or vesting. Section 1061(c)(4).

The three-year holding period applies to capital gains the taxpayer recognizes on or after Jan. 1, 2018, regardless of when the taxpayer acquired the applicable partnership interest to which the gains are attributable. In other words, there is no grandfathering rule for applicable partnership interests issued to a taxpayer prior to 2018.

Several aspects of the new holding period rules are unclear. An example is whether the exclusion from the definition of applicable partnership interest for interests held by corporations is intended to exclude interests held by S-corporations as well. If so, fund managers could circumvent the holding period rule, but without sacrificing the benefits of pass-through taxation on their carried interests, simply by holding their interests indirectly through S-corporations. This opportunity may, however, be eliminated as Steve Mnuchin recently acknowledged before the Senate Finance Committee that the loophole was unintended and would be addressed shortly.

In addition, the definition of specified assets does not include an interest in a closely-held partnership operating a trade or business, which could allow gain from the sale of a portfolio partnership or LLC by a fund to avoid the new holding period rule. Section 475(c)(2). The 2017 tax law conference report, however, indicates that such a partnership interest should, in fact, be treated as

a specified asset. Accordingly, the failure to specifically include closely-held partnership interests within specified assets appears to be a drafting error in the legislation. Finally, while it is clear that the three-year holding period does not apply to gain attributable to a capital interest, the 2017 tax law is silent on the treatment of partnership interests issued in consideration of both contributed capital and services, and profits interest with a capital component (for instance, a catch-up allocation).

Unfortunately, guidance resolving these issues, beyond addressing the loophole for carried interests held

by S-corporations, is unlikely to be issued this year. Guidance relating to the holding period for carried interests is not mentioned in the Internal Revenue Service's 2017-2018 Priority Guidance Plan. Moreover, the IRS has indicated, on an informal basis, that guidance on the scope of this rule is not a top priority, in part, because the rule will affect a small percentage of taxpayers relative to other new rules under the 2017 tax law, particularly the deduction for qualified business income, the limitation on interest deductibility, and the opportunity for 100 percent immediate expensing.