

Shouldering Carried Interests Under New IRC Section 1061

E. John Wagner, II

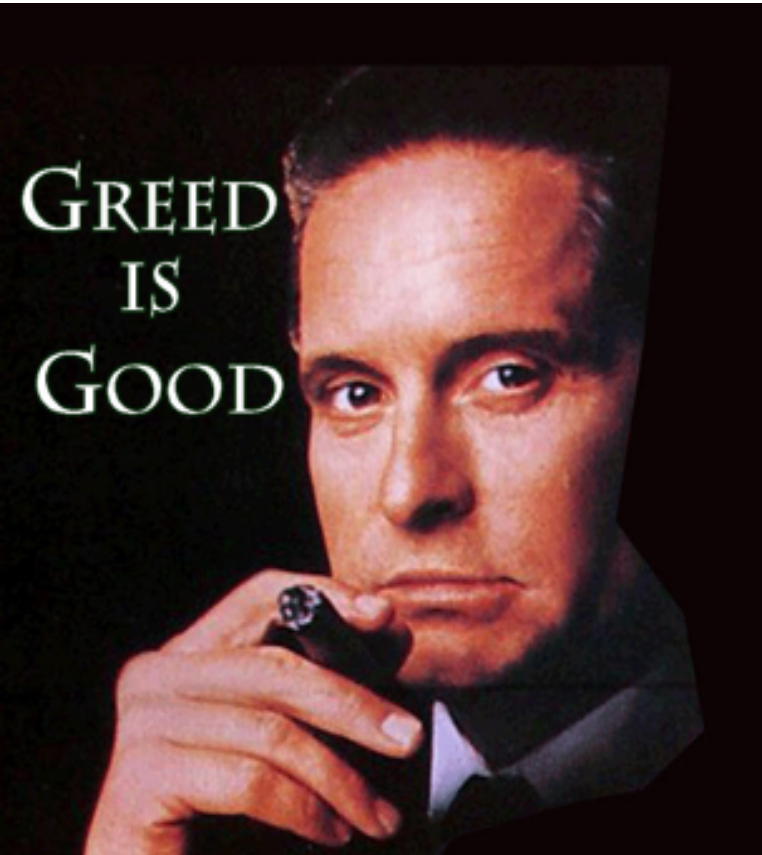
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Compensation or Long-Term Capital Gain?

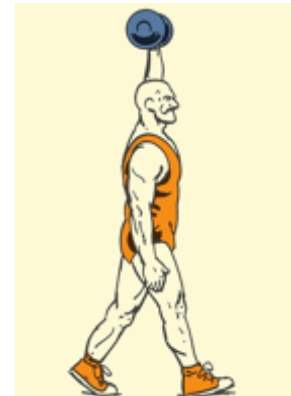




- New IRC Section 1061 changes the long-term capital gain holding period for partnership interests classified as “carried interests” from one year to three years.
- It also deems related party transfers of carried interests gain recognition events if the taxpayer’s holding period is not more than three years.
- Don’t worry unless all the following are true:
 - You have a tax partnership with a carried interest.
 - The carried interest holding period is not more than three years.
 - The holder of the carried interest wants to recognize long-term capital gain passing through from the partnership or arising from the sale of the partnership interest.

What is a “Carried Interest”?

- Partnership interest.
- Transferred to taxpayer or held in connection with performance of substantial services.
- The services relate to a trade or business which:
 - Is a regular, continuous, and substantial activity, and
 - The activity consists at least in part:
 - Raising/returning capital, and
 - Investing in or developing securities, investment or rental real estate, cash, cash equivalents, options regarding the foregoing.
- Capital interest not proportionate to either the partner’s capital contribution or the Section 83 income recognized on receipt or vesting.
- Not held by a corporation or under “one job” exception.



Section 1061 Swiss Cheese and Loopholes

- Statutory language does not clearly apply to pass-through capital gain income.
- “Corporation” exclusion include S corporations?
 - IRS says “no,” but statutory language says “yes.”
- To-be-written IRS regulations may exclude partnerships which do not hold assets for portfolio investment by third parties, but “regular, continuous, and substantial” raising or returning of capital requirement arguably excludes most “non-investment fund” partnerships anyway.



More Swiss Cheese and Loopholes...



- One job exclusion arguably could apply to a management partnership even if the partnership manages investment funds.
- The proportionate capital requirement arguably only requires the partner to have a capital account in proportion to the capital contributed. It says nothing about proportionate interests in profits, arguably excluding almost all partnership interests.
- Section 1061 should not apply to a proportionate capital interest funded by a nonrecourse loan from the other partners.

Have a great day!

