CARRIED INTEREST PROPOSED REGULATIONS OFFER LONG-TERM CAPITAL GAIN PLANNING OPPORTUNITIES FOR PRIVATE EQUITY AND REAL ESTATE FUND SPONSORS AND MANAGERS

Recently enacted Section 1061 of the U.S. Internal Revenue Code (the "**Code**") generally requires that capital assets be held for more than three years in order for individuals, trusts or estates ("**individual taxpayers**") who are associated with sponsors and managers of investment partnerships, and who dispose of or are entitled to receive allocations of gain from those partnerships, to benefit from the reduced rate of U.S. federal income tax that is imposed on long-term capital gains (the "**Carried Interest Rules**"). For persons who are not subject to the Carried Interest Rules, gains on capital assets that are held for more than one year generally are treated as long-term capital gains.

On July 31, 2020, the Department of Treasury ("**Treasury**") released proposed regulations concerning the Carried Interest Rules (the "**Proposed Regulations**"). Taxpayers generally may apply and rely on the Proposed Regulations (as long as they do so in their entirety and in a consistent manner) until final regulations are adopted. The Proposed Regulations modify and clarify the scope and operation of the Carried Interest Rules in many important respects. Some key developments affecting sponsors and managers of private equity funds and real estate funds are set out below.

The Three Year Holding Period Does Not Apply to Business Assets or to Stock Paying "Qualified Dividends"

The Carried Interest Rules only apply to amounts that would be treated as long-term capital gains under Section 1222 of the Code. They generally do not apply to other amounts that are taxed at long-term capital gain rates, including for example, gains from the sale of business assets that receive long-term capital gain treatment under Section 1231 of the Code. In general, gains from the sale of rental real estate are subject to Section 1231 of the Code, not Section 1222 of the Code (though gains attributable to the recapture of depreciation of rental real estate would be subject to Section 1250, and Treasury has requested comments regarding the treatment of these gains).

The Carried Interest Rules also do not apply to "qualified dividends" that generally are subject to a reduced rate of tax for individual taxpayers. For example, if a portfolio company that is a "C corporation" organized in the U.S., or in certain cases outside the U.S., engages in a leveraged recapitalization, the Carried Interest Rules will not apply to the portion of the distribution that is treated as a dividend. However, the Carried Interest Rules may apply to any portion of the distribution that is treated as gain with respect to the portfolio company's stock because such distribution exceeds both the earnings and profits of the portfolio company and the relevant fund's basis in the stock of the portfolio company.

Capital gain dividends paid by a RIC or a REIT are treated in the same manner as if the underlying gains derived by the RIC or REIT had been derived directly by the relevant fund if applicable information reporting requirements are satisfied, and are otherwise subject to recharacterization in their entirety. This means that if a REIT generates capital gains from rental real estate subject to Section 1231 of the Code, a distribution of these capital gains to shareholders of the REIT would not generally be subject to the Carried Interest Rules.

The Exception for Carried Interest Received by a Corporation Does Not Apply to an "S Corporation" or to a "Qualified Electing Fund", But Does Apply to a RIC or a REIT

The Carried Interest Rules only apply to capital gains derived through or with respect to an interest in an entity treated as a partnership for U.S. federal income tax purposes that is held by an individual taxpayer associated with a business of raising or returning capital and developing or investing in investment assets (an "**applicable partnership interest**" or "**API**"). The Proposed Regulations extend the rules to capital gains that are derived through a "Passthrough Entity" that in turn holds an API. Passthrough Entities include partnerships, trusts, S corporations and foreign corporations that are treated as "passive foreign investment companies" ("**PFICs**") with respect to which the individual taxpayer has made a "qualified electing fund" ("**QEF**") election and thereby is attributed his or her share of the relevant PFIC's long-term capital gains, whether or not distributed. Therefore, an individual taxpayer associated with a fund's sponsor or manager cannot avoid the Carried Interest Rules by holding his or her carried interest entitlement through an S corporation, or through a QEF.

The Proposed Regulations do not treat a RIC or REIT as a Passthrough Entity. This means that if an individual taxpayer associated with a fund's sponsor or manager directly holds shares in a RIC or a REIT that in turn holds an interest in a partnership that would generally be treated as an API, the Carried Interest Rules appear not to apply to capital gain dividends paid by the RIC or REIT to the individual taxpayer. The Carried Interest Rules would apply, however, if the individual taxpayer holds an interest in a partnership that holds shares of a RIC or REIT. In that case, as discussed above, the capital gain dividends would have the same character as the gains derived by the underlying fund that are allocated as carried interest to the RIC or REIT (if applicable information reporting requirements are satisfied). As a result, fund sponsors may be able to avoid the application of the Carried Interest Rules if carried interest vehicles are structured as RICs or REITs instead of as partnerships. It should be noted, however, that an award of carried interest in the form of RIC or REIT shares could have different tax consequences to the recipient from those that apply to an award of carried interest in the form of a partnership interest.

Allocations With Respect to Sponsor Capital Must be Carefully Structured to Avoid the Carried Interest Rules

The Proposed Regulations except certain "Capital Interest Gains and Losses" from the Carried Interest Rules. In general, allocations will be treated as Capital Interest Gains and Losses if they are made to the holder of an API and to other partners based on their respective capital account balances, provided that among other things the allocations (i) are made in the same manner to the holder of an API and to other partners (i.e., the terms, priority, type and level of risk, rate of return, and rights to distributions are the same) and (ii) are clearly identified in both the partnership agreement and its books and records as separate and apart from the allocations made with respect to the API.

The Proposed Regulations provide that an allocation will not fail to qualify for the Capital Interest Gains and Losses Exception solely because it is subordinated to an allocation to an unrelated non-service partner or because it is not reduced by the cost of services provided by that holder or a related person. For these purposes, "cost of services" presumably covers management fees, but it is not clear whether it also covers allocations of carried interest.

Funds frequently have distribution "waterfalls" that provide for distributable cash initially to be apportioned among partners based upon their capital contributions. The distributable cash apportioned to investors that are not associated with the fund sponsor or fund manager are then apportioned between the investor and the general partner based on a set of sequential targets; this allocation to the general partner typically represents the carried interest. Those targets generally include a return of the investor's capital contributions and a preferred return on those capital contributions, followed by tiers of distributions split between the investor and the general partner generally intended first to "catch up" the distributions to the general partner to the agreed carried interest ratio, and thereafter to reflect the agreed carried interest ratio. Frequently, different carried interest ratios are agreed to with different investors.

In a fund with a distribution waterfall along the foregoing lines, the sponsor capital will receive distributions based upon the initial apportionment that is based on each partner's contributions and not based on an apportionment between the sponsor in respect of its capital and the general partner in respect of its carried interest (i.e., sponsors typically do not self-charge carried interest). Also, frequently management fees paid to the fund manager will reduce the distributable cash that is apportioned to the third party investors, but will not reduce the distributable cash that is apportioned to the sponsor in respect of its capital contributions. Although the Proposed Regulations are not entirely clear, we believe that these "fee-free and carried interest-free" distributions in respect of the sponsor capital, and the associated allocations of taxable gains, normally ought to qualify as Capital Interest Gains and Losses. Nevertheless, if the IRS were to successfully challenge this position, it is possible that all the allocations in respect of the sponsor capital may be subject to the Carried Interest Rules. There also is a risk that allocations in respect of the sponsor capital may be subject to the Carried Interest Rules if allocations to any investors differ from those in respect of the sponsor capital for any other reason (for example, if the investor is excused from making certain investments). Such risk may be mitigated by careful structuring, and hopefully the final regulations will specifically address this point.

Effectiveness of Carried Interest Waivers

Some sponsors have sought to avoid the application of the Carried Interest Rules by waiving their entitlement to allocations and distributions attributable to gain from the sale of assets that have been held for three years or less in exchange for future allocations and distributions attributable to gain from the sale of assets that have been held for more than three years. The Proposed Regulations do not address the effectiveness of any such waiver in avoiding the application of the Carried Interest Rules. In the preamble to the Proposed Regulations, however, Treasury acknowledges the use of such waivers and cautions that they may be challenged under other tax principles, including the fee waiver regulations under Section 707 of the Code, the partnership anti-abuse rules, the substantiality requirement under Section 704(b) Code and/or the substance over form or economic substance doctrines.

The Proposed Regulations Require Complex Calculations and Detailed Reporting

The Proposed Regulations require complex calculations and detailed reporting by partnerships and other passthrough entities (and RICs and REITs that want all or a portion of their capital gain dividends to not be subject to recharacterization) to implement the Carried Interest Rules. Governing documents and internal processes for investment vehicles should be reviewed to ensure that they address these additional responsibilities and burdens, and that costs of compliance are properly allocated.

The Proposed Regulations address numerous other points, and include, for example, rules that require the recognition of gain on certain transfers of an API to related persons. We would be happy to discuss any questions you may have regarding these provisions.

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