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Proposed Legislation Threatens to Upend Carried Interest Rules

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As widely reported, on July 27, 2022 Democratic Majority Leader Senator Chuck Schumer and Senator Joe Manchin (D-W.Va) agreed to a reconciliation bill package titled the Inflation Reduction Act of 2022. The bill contains provisions restricting the ability of carried interest holders to obtain preferential long-term capital gain treatment. The provisions are a copy of the carried interest language found in the House of Representatives proposal from September 2021 that was intended to be in (but ultimately never made it into) the then proposed Build Back Better legislation. The current bill's likelihood of passage is unclear and, as has become common recently, may hinge on the views of Senator Kyrsten Sinema (D-Ariz.).

Summary

The proposed bill, if enacted, would limit the ability of private equity sponsors to obtain preferential long-term capital gains with respect to their carried interest, including by:

- extending the required holding periods to more than five years (and, in practice, potentially to a much longer period);
- eliminating existing carve-outs for dividend income and certain business gains;
- imposing immediate gain recognition on a variety of common transfers of carried interests;
- potentially restricting the carryover of holding periods in common rollover transactions; and
- providing Treasury and the IRS more power to challenge "carry waiver" and other similar arrangements.

The bill is proposed to be effective for taxable years beginning after calendar year 2022.

A more detailed discussion of the bill's provisions follows.

Extension of the Holding Period to "Five" Years

The bill extends the holding period required to qualify for long-term capital gain treatment to more than five years (from the current more than three years). However, the five years are counted from the later of the date on which the partner acquired "substantially all" of its carried interest in a partnership and the date on which the partnership acquired "substantially all" of its assets.

> ***Observation:*** *Given that most private equity funds may not deploy "substantially all" of their assets until well into the fund's investment period, it is entirely possible that only the very last exits could qualify for the long-term capital gains rate.*

Further, the term "substantially all" is not defined. Presumably, something like 90-95% should constitute "substantially all" but guidance from other areas of tax law may suggest a smaller percentage could suffice. Nor is the manner of the term's calculation clear. For example, the proposed legislation does not explain how (if at all) investments that had been disposed of count for this purpose.[1]

> ***Observation:*** *In case of tiered partnership structures "similar" rules are to apply such that the holding period has to be met at each level. In the usual case of interest holders in a general partner entity, presumably this would require compliance at each of the interest holder, general partner, fund and, if it's a partnership, portfolio company level. In practice, such tiered structures may include many more layers. A failure to meet the test at any one level may cause the entire chain to fail the holding period requirements.*

These rules represent a drastic change to how the holding period determinations are currently made. For example, if a private equity fund has held a portfolio investment for over three years, gain realized on the sale of such investment will, under current law, generally qualify for preferential long-term rates in the hands of a member of a general partner entity even if such member has not held its own interest in the GP entity for the requisite three-year period. Likewise, under current rules if a deal professional meets the three-year holding period with respect to such person's carried interest in the GP entity, such person could, in general, sell such GP carried interest and obtain preferential capital gain treatment irrespective of the fund's holding period in the underlying assets.[2] In contrast, under the revised statute, the holding period would have to be met at every "level."[3] As a result a myriad of complications may arise.

> ***Observation:*** *For example, fund-of-fund sponsors may be particularly hard-pressed to show that they have met the relevant holding period requirements.[4] Also, junior deal professionals receiving carry at a later point in time than the more senior team may be stuck with a short-term capital gain on the same deal on which the senior sponsor members qualify for preferential long-term treatment.[5] Further, depending on the interpretation of the word "acquired", the ability to bootstrap off of the holding period of rolling investors may be curtailed. Such transactions typically use preferred shares to maximize the benefit of a carryover holding period with their viability dependent on the relative size of the rollover.*

Further, the bill's use of the word "acquired" puts into question the status of common fund level transactions that involve a tacked holding period. For example, in general, under current law a fund would not see its holding period in a portfolio company reset were such portfolio company to engage in a tax-free merger or other similar transaction. However, under the wording of the bill, a question would now arise whether the merger constitutes an "acquisition" of a new asset.

> ***Observation:*** *This could, seemingly, be the case even if the underlying transactions represented an entirely "internal" restructuring with no changes in economic ownership/exposure.*

Enhanced Reach

The current statute does not expressly extend to items of gain that, though taxed at capital gain rates, do not *technically* constitute capital gain. For example, in regulations finalized in January 2021 the IRS agreed that "qualified" dividend income, certain gains with respect to property used in a trade or

business (so-called "section 1231" gains) as well as certain other items[6] are not subject to the current three-year holding period requirements.

In contrast, the new legislation would cover such income to the extent it represents carried interest and to the extent such income would otherwise be treated either "as capital gain or [as] subject to tax at the rate applicable to capital gain."

> ***Observation:*** *Such expansion of the law's reach may affect the ability of a sponsor to obtain long-term capital gain treatment on transactions such as leveraged dividend distributions, transactions treated as pass-through asset sales*[7] *as well as certain dispositions of foreign corporations.*[8]

Statutory End to the S-Corporation "Exception"

The existing statute excludes carried interest held through "corporations" from the statute's purview. This has led some sponsors to own their carried interest through an S-corporation. The IRS has disagreed with this interpretation of the statute and in the January 2021 regulations restricted the meaning of "corporation" to taxable, i.e., so-called "C" corporations.

The current bill would reflect the IRS position in the statute itself.[9]

Enhanced Regulatory Authority

The bill expands the Treasury's authority to prevent avoidance of its provisions. In particular, it specifically references arrangements such as carry waivers and distributions of property. It does not claim that all such arrangements are abusive and leaves the question open for the Treasury.

> ***Observation:*** *Carry waivers whereby the sponsor gives up the right to receive current carry but has a right to increased participation in future gains are a recognized technique in the market to assuage the impact of the holding period rules. It does not appear that the above-described explicit grant of authority to the Treasury with respect to such arrangements should enable the Treasury to negate the arrangements' effectiveness – at least to the extent such waivers are otherwise properly structured.*[10]

As regards in-kind distributions, under present law a partner receiving a distribution of portfolio company stock from the partnership would receive a "tacked" holding period in such stock irrespective of the partner's own holding period in its partnership interest. Such a partner would, however, continue to be subject to the three-year holding period requirements with respect to such stock. It is worth noting that, at least in the context of private equity funds, delivering carry via in-kind distributions where the fund otherwise desires to dispose of the underlying portfolio company faces a menagerie of non-tax issues usually making such a strategy impractical.

Finally, the bill also requires the Treasury to look into contractual or other derivative transactions that would mimic carried interest benefits outside of the partnership context as well to look into the use of entities other than partnerships to achieve similar results.[11]

Transfers of Carried Interests

Current law contains a much-maligned provision requiring additional gain recognition on transfers of carried interest to certain related parties. However, final IRS regulations have interpreted that provision to apply only to transfers where gain otherwise has to be recognized. The proposed bill would instead require gain recognition upon a transfer to anyone (not just related parties) and whether or not such transfer would otherwise be non-taxable.

Read literally, otherwise tax-free distributions and contributions (including any "deemed" distributions and contributions) would result in gain recognition and potential recharacterization of such gain as short-term capital gain. This appears to be so even if the interest would otherwise meet the five-year holding period requirements[12] and even in cases where the economic exposure to the underlying investment is not affected by the transaction.[13] The same rule would seemingly apply to gifts and other estate transfers. No parallel rule has been proposed to cause a recognition of any loss.

> ***Observation:*** *Private equity sponsors should consider the impact of these new rules (as well as of existing law) on any transfer of carried interests or any issuance of new interests. Particular care should be given to initial plan design and grants and any changes in sharing ratios.*[14]

Other Provisions

Although the bill does not itself alter the exception found in current law for gains attributable to "capital interests" (e.g., gains on the 1% of contributions typically made by the sponsor), it does provide the Treasury with authority to limit or even eliminate such exception. If prior legislative history is to be believed, such authority would only be invoked where granting the capital interest exception would "not carry out the purposes of the carried interest" provisions.[15]

Finally, on a more positive note, the bill permits (but does not require) the Treasury to exclude from the bill's reach "any asset not held for portfolio investment on behalf third party investors".

> ***Observation:*** *This provision could enable the Treasury to address more broadly current law issues related to sponsor co-investment vehicles. However, until those issues are so addressed sponsors may want to continue to appropriately structure such co-investments. The language could also help the Treasury issue guidance excepting from the law's reach transfers where the gain triggered relates to the sponsor's goodwill or so-called "enterprise value." Again, until such guidance is promulgated sponsors should carefully structure transfers of interests in management companies and similar vehicles.*

Effective Date

The carried interest provisions of the bill are proposed to be effective with taxable years beginning after December 31, 2022. It is not clear how the new rules would apply to existing structures governed by the current carried interest provisions. ***Depending on whether this proposed legislation becomes law, sponsors may consider restructuring some of their existing arrangements.***

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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[1] Many other questions can be raised about this mechanism. For example, does it matter if the fund allows any reinvestments/recycling of proceeds? When a fund disposes of a portfolio company is the measurement done at sale or at the end of the tax year?

[2] Subject to the "hot asset" rules of section 751 and a limited "look through" exception under current carried interest regulations. See Treas. Regs. section 1.1061-4(b)(9).

[3] Whether this would result in more "separate entity/single asset" deals being done is questionable given that investors are unlikely to allow carry to be separately calculated across assets. Incidentally, a more sensible way for Congress to achieve its apparent goal would consist of a targeted approach measuring the taxpayer's exposure to the underlying asset on a look-through basis without reliance on the "substantially all" concept. See, for example, the "qualified small business stock" provisions found in section 1202(g)(2).

[4] More generally, were the bill to pass in its current form, the ability to pay carried interest at long-term capital gain rates within any stack of entities that is controlled by more than one investment group would be significantly curtailed as a result of the likely difficulties in obtaining the necessary holding period information.

[5] The bill creates a (more than) three-year holding period for individuals with adjusted gross income of less than $400,000 (presumably calculated in the year of realization though this too is unclear). However, this three-year holding period is measured in the same manner as the five-year period with all the attendant complications.

[6] For example, section 1256 contracts such as, e.g., certain exchange traded futures contracts. Such assets are more likely to be held by hedge funds than private equity funds. As a side note, the proposed changes would come close to eliminating the availability of any reduced rates on carry earned with respect to hedge funds, potentially even in cases where the carry related to a hedge fund's less liquid "side pocket" investments.

[7] The bill would also sweep into its purview carried interest with respect to those real estate funds that take the position that their real estate is used in a trade or business and, therefore, that related gains are exempt from the current three-year holding period requirements ("section 1231" gains). As consolation, the bill contains a special rule requiring a more than three-year (as opposed to five-year) holding period with respect to such real estate assets. However, all the other rules of the bill still apply to carry based on such amounts (most notably the "later of" and "substantially all" language discussed above). On the other hand, note that carried interest derived from so-called qualified REIT dividends remains outside the scope of these rules.

[8] In an exit involving a foreign corporation, absent careful structuring a sponsor may in some cases run afoul of the existing carried interest limitations even if the realized income would appear to qualify for long-term capital gain treatment. Section 1248(g)(2).

[9] This was foreshadowed by IRS Notice 2018-18. The IRS also expanded the reach of these provisions to cover certain foreign corporations whose U.S. owners are taxed under the so-called "QEF" regime. Though the present Congressional bill does not explicitly cover such corporations, it does give the Treasury the authority to apply the same rules to entities other than partnerships "to the extent necessary or appropriate to carry out the purposes" of the legislation.

[10] In picking the form of a waiver, sponsors should, for example, be mindful of the holding period rules introduced by the January 2021 carried interest regulations.

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[11] Note that the current regulations already target some such arrangements.

[12] Or, apparently, even when the built-in gain fails to meet the "regular" one-year holding period.

[13] And even if the "taint" of the carried interest rule were preserved in the hands of the transferee (such as, currently, in the case of certain in-kind distributions).

[14] A partner has a blended holding period in its partnership interest. Although it is well-known that contributions to a partnership can taint such holding period, under current regulations so can grants of profits interests. Such grants may in some cases, depending on how they are structured, include changes in carried interest sharing ratios.

[15] Such a grant of authority has even been extended to cases of carried interest issued to C-corporations.