



# Carried Interest Update

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# Presentation Topics for Carried Interest Update



- Background / basics (10 minutes)
  - What is carried interest?
  - Why is carried interest controversial?
  - Passage of Section 1061 in 2017
- “Fee waivers” and “carry waivers” (5 minutes)
  - Impact of 2015 proposed regulations on “fee waivers”
  - “Carry waivers” as response to Section 1061
- Final Section 1061 Regulations (1/19/2021) (20 min)
- Biden “Green Book” Proposals (10 min)

# Carried Interest Basics



- A carried interest is an interest in the net profits of a private investment fund that typically compensates asset managers.
- Carried interest serves a business goal of providing incentive compensation and to reward exceptional fund performance.
- Carried interest also serves a tax goal of compensating asset managers with long term capital gain.
- Carried interest is controversial because it permits the taxation of compensatory payments at capital gains rates
- Comparison to the performance bonuses of other white collar professionals – like lawyers!

# Section 1061



- Carried interest results from the normal operation of partnership tax rules of general applicability – character passes through a partnership, and partners need not put up capital to receive a partnership interest in net profits.
- “Closing the loophole” thus means making the Code more complicated.
- Section 1061 represented the first effort to target carried interest in the tax code, passed in 2017 as part of the Tax Cuts and Jobs Act.
- Section 1061 generally operates by requiring a 3-year holding period instead of a 1-year holding period for “applicable partnership interests.”
- This method of addressing carried interest is ineffectual in many cases, and so Section 1061 did not result in carry becoming less popular.

# Section 1061 (continued)



- “Applicable Partnership Interests” (APIs)
  - Transferred in connection with services in “applicable trade or business” (ATB)
  - ATB defined as regular activity of raising & returning capital and investing or disposing of “specified assets”
  - Specified assets are securities, commodities, rental or investment real estate, cash, options, and derivatives.
- Exceptions:
  - Interest held by corporation
  - Capital interests



# Fee Waivers



- Fund asset managers typically receive a management fee, which is ordinary income to the sponsor and currently not deductible for the limited partners.
- “Fee waivers” represent an effort to get carried interest treatment for the management fee itself.
- In 2015, proposed regulations (Prop. Treas. Reg. 1.707-2) on “disguised payments for services” reined these in significantly.
- Now clear you need “significant entrepreneurial risk” to respect these.
  - Irrevocably waived in written notice to LPs
  - No using built-in gain; must use true FMV (not book value) to determine post-waiver gains
  - No cherry-picking items or time periods
- Fee waivers can also be used to fund “deemed contributions” for coinvestment
- Still popular – especially given the after-tax IRR advantage for limited partners. Fee waivers achieve the equivalent of a deduction.

# Carry Waivers



- Carry waivers were designed to mitigate the effects of Section 1061 and have started appearing in many fund documents.
- Operates like a fee waiver, but for capital gain recharacterized as short-term capital gain under Section 1061
- Treasury warned that it's watching us on this “carry waiver” stuff in the preamble to the proposed 1061 regulations, but did not address them at all in final 1061 regulations.
- Probably these could work, but probably only if they parallel the fee waiver requirement (irrevocable written notice, using only post-waiver appreciation and no cherry-picking).

# Final Section 1061 Regulations



- Once an API, always an API, until unrelated third party purchase (by non-service provider).
- Confirms Section 1061 applies only to capital gain (and not, for example, qualified dividend income or 1231 gain)
- Stands ground that “corporation” in statute does not include S corporations or qualified electing funds. Litigation?
- Simplifies the capital interest exception
  - Permits capital interests to be funded with loans, as long as they are full recourse
  - Permits managers not to charge carry or fees on coinvest
  - Reinvestment of realized gain can qualify as a capital interest
  - “Carried interest freezes” may not qualify as capital interests – need realized gains.



# Final Section 1061 Regulations (Continued)



- Incentive arrangements for employees of non-ATB portfolio companies are not *per se* exempted, but as a practical matter should still be possible.
- Transfers of APIs in common estate planning circumstances are now accommodated (i.e., no acceleration on transfer to grantor trust).
- Reporting obligations may increase – need to monitor new versions of partnership forms

# Biden “Green Book” Proposals



- The Biden Administration released its fiscal 2022 tax proposals at the end of May, 2021.
- Starting in 2022, Biden would end capital gains treatment for carried interest altogether, as well as requiring self-employment taxes, but only for taxpayers making more than \$400,000.
- Relies on new term, “investment services partnership interest.” Retains some current concepts regarding the exemption of “invested capital” interests from ordinary income treatment, as well as the prohibition on certain loans to fund capital interests (Biden wouldn’t allow full recourse loans to work here).
- Section 1061 apparently would continue to apply to taxpayers making less than \$400,000?