

Final Section 1061 Carried Interest Regulations

Similar to Proposed, Only Better | February 4, 2021

Background

- Section 1061 passed as part of the Tax Cut and Jobs Act
- Effective for tax years beginning after Dec. 31, 2017
- Section 1061 extends the holding period from one to three years for certain capital gains for service partners on their “carried interest”
- Potential Impact
 - Currently 40.8% tax rate vs. 23.8% tax rate
 - Legislative Proposals to bring even broader and more harsh carried rules or possibly raise all capital gain rates to ordinary income rates

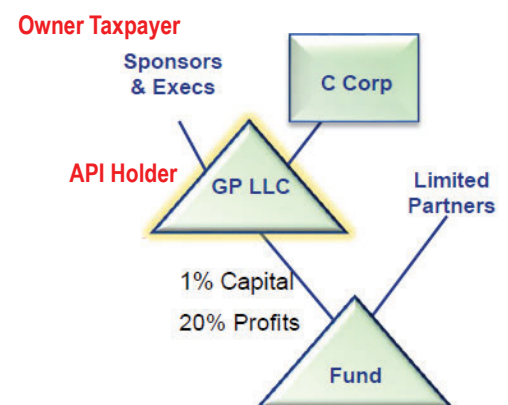
What to Look For

- Carry . . . Promote . . . Profits Interest . . . Performance Fee
- If a partner has a share of profits greater than its share of capital in exchange for services.
- Section 1061 is most clearly directed at funds and mandates a three-year holding period to measure long-term capital gains.
- Section 1061 is generally limited to funds . . . or is it???

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Who is Affected?

- Applicable partnership interest **and** applicable trade or business
- Exceptions
 - C-Corporations (not S Corp/PFIC-QEF)
 - Capital Interest (with restrictions)
 - PE Employees of the Portfolio Company (below the ATB)
 - Certain Family Office
 - Bona Fide Unrelated Purchaser



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What's New and Better?

- Capital Interest exception broadened
 - Capital Interest Allocations must be made in a “similar manner” instead of the “same manner.”
 - Allows related party loans to the service partner IF such loans are fully recourse
- Transfers to related parties under Section 1061(d) are no longer “acceleration” events and apply instead when gain is otherwise recognized under Chapter 1.
- The Lookthrough Rule was materially narrowed and now only applies to abusive transactions, allowing easier three year holding period testing.
- Unrealized API Gains and Losses are no longer subject to mandatory revaluation rules and instead follow the existing Section 704(b) and (c) rules.

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What's Didn't Get Changed

- Definition of API still very broad, no carve out for “one off” partnerships.
- “Raising and Returning Capital” requirement still a very low threshold.
- No addition of clear “family office” carve out, but implied. Continuing to study Section 1061(b) (which is the provision allowing the IRS to carve out gain on assets not held as a portfolio investment for third party investors).
- The basic limitation on lending to service partners to acquire capital interest is still disallowed (only carved out recourse loans).
- Entities such as REITs and RICs are required to disclose in tax returns three-year capital gains in order for service partners to claim three-year holding period.

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