Legal Update Article

Carried Interest/Promote in 2022: Action Items for Investment, Private Equity, Real Estate Fund Managers

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Investment, private equity, and real estate fund managers should consider becoming familiar with the complex final regulations on the preferential tax treatment of "carried interest" under Section 1061 of the Internal Revenue Code (Code) that are generally effective for taxable years beginning on or after Jan. 1, 2022.

Preferential Treatment of Carried Interests

Frequently referred to as "promote" in the real estate investment fund industry, a "carried interest" is a profits interest in an investment-focused partnership or limited liability company taxed as a partnership for federal income tax purposes (each, an "Investment Pass-Through Entity") held by the manager providing investment management services to such entity for a fee (Fund Manager) (*e.g.,* the general partner of the partnership or the managing member of the limited liability company).

For the Fund Manager, the principal advantage of a carried interest/promote lies in the preferential federal income tax treatment on distributions from the Investment Pass-Through Entity: If the assets in the Investment Pass-Through Entity are held for the requisite holding period (currently, more than three years; prior to 2018, more than one year), gains from the sale of such assets are passed through to the Fund Manager — and, by extension, to employees of the Fund Manager directly or indirectly, through the Fund Manager, holding equity interests in the Investment Pass-Through Entity — as capital gains, rather than as gains subject to ordinary income taxation. Accordingly, in exchange for providing investment management services to the Investment Pass-Through Entity, the Fund Manager (and its employees holding direct or indirect equity interests in the Investment Pass-Through Entity) receive *investment* income, taxed at a capital gains rate of up to 23.8%, rather than *compensation* income, taxed at an ordinary income tax rate of up to 37%.

Tax Cuts and Jobs Act

In 2017, Congress passed the Tax Cuts and Jobs Act (TCJA), which was signed into law by President Donald Trump. The TCJA attempted to rein in the deemed preferential treatment of carried interest/promote by requiring the assets held by the Investment Pass-Through Entity to be held for more than three years (instead of more than one year) in order for the capital gains triggered by the sale of such assets (and passed through to the general partner or managing member, as applicable) to qualify for long-term capital gains treatment.

Section 1061 of the Code, the carried interest/promote statute added by the TCJA, applies only to an "applicable partnership interest" (API). The statute defines an API generally as an interest in a partnership (including a limited liability company taxed as a partnership for federal income tax purposes) qualifying as an "applicable trade or business" that, directly or indirectly, is transferred to (or is held by) a taxpayer in connection with the performance of substantial services by the taxpayer.

An “applicable trade or business,” in turn, generally means a business engaged, on a regular, continuous and substantial basis, in raising or returning capital *and* either:

1. Investing in (or disposing of) specified assets (or identifying specified assets for such investing or disposition); or
2. Developing such assets.

Investment Pass-Through Entities generally will qualify as applicable trades or business. Accordingly, unless an exception applies, the carried interests/promotes held by the Fund Manager (and its employees holding equity interests in it) generally will qualify as APIs subject to the more-than-three-year holding rule (API Holding Rule).

Exceptions

The statute provides three exceptions. First, under certain circumstances, the API Holding Rule does not apply to income or gain attributable to any asset not held for portfolio investment on behalf of third-party investors.

Second, an API does not include (therefore, the API Holding Rule does not apply to) an interest in a partnership (or a limited liability company taxed as a partnership for federal income tax purposes) directly or indirectly held by a corporation.

Third, an API does not include certain capital interests.

Final Regulations

In January 2021, the Treasury Department issued final regulations under Section 1061 of the Code. These Final Regulations (which followed proposed regulations issued in July 2020) clarified the requirements for the capital interest exception to apply, required loans made by partners or members of the Investment Pass-Through Entity to employees seeking to purchase capital interests therein to carry *personal liability* for the employee (while prohibiting loans from the Investment Pass-Through Entity itself), scaled back the “look-through” with respect to sales of APIs, under which APIs held for more than three years could be subjected to short-term capital gains treatment (generally, ordinary income tax rates would apply), and clarified the statute’s reach with respect to transfers of APIs to related persons.

Action Items

The Final Regulations are complex. From the standpoint of a Fund Manager seeking to incentivize its key employees/equity holders with respect to carried interests/promotes and capital interests in Investment Pass-Through Entities, consideration should be given to taking the following actions in 2022:

1. *Determine whether the Investment Pass-Through Entities are applicable trades or businesses.* One cannot have an API unless the interest is held in an applicable trade or business. A key determination is whether the Investment Pass-Through Entities are engaged in activities otherwise giving rise to applicable trade or business status on a “regular, continuous and substantial basis.”

2. *Inventory the sales history of the assets held by the Investment Pass-Through Entities* If the assets held by the Investment Pass-Through Entities are typically held for more than three years (frequently the case in the real estate development and investment space), Section 1061 of the Code should not be as big an issue.

3. *Review partnership agreements and operating agreements in connection with granting capital interests*. The Final Regulations generally require capital interests to receive allocations determined and calculated in a similar manner to the allocations with respect to capital interests held by similarly situated unrelated non-service partners and members who have made significant aggregate capital contributions.

4. *Structure loans to acquire capital interests with care.* Few key employees will be happy with a loan from a partner or member carrying personal liability. (The requirement extends to loan guarantees.) Moreover, loans from the Investment Pass-Through Entities themselves are prohibited. In applying these rules, certain "related person" concepts apply.

5. *Scrutinize the holding period of sales of APIs held more than three years.* The Final Regulations recategorize the holding period as three years or less if: (1) the holding period does not include any time prior to the time an unrelated partner or member not providing substantial services to the Investment Pass-Through Entity becomes legally obligated to contribute cash or property to the Investment Pass-Through Entity; or (2) the sale of the API is part of a transaction or series of transactions a principal purpose of which is to avoid the application of Section 1061 of the Code.

The carried interest/promote tax rules require careful planning and, almost always, expert legal analysis applying Section 1061 of the Code and the Final Regulations to the particular facts. This analysis is perhaps even more important when tiered partnerships and limited liability companies are involved.

Jackson Lewis attorneys can help you navigate these complex rules and structure compensation arrangements that comply with these rules, including the exemptions.