

# Update on 1061 Carry Regulations

February 26, 2021

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# Outline

- **Quick Overview of 1061**
- **Capital Interest Expansion**
  - Impact of Loans and Guarantees on Capital Interests
  - Treatment of Unrealized Gains
- **Look-Through Updates**
- **New Legislative Proposals**
- **Q&A**



# Overview of Section 1061

# History of 1061 Regulations

**December 2017:  
1061 Enacted in TCJA**

**August 14, 2020:  
Proposed 1061 Regs**

**January 7, 2021:  
Final 1061 Regs**



## Section 1061 – General Rule

- (a) In general, if one of more **applicable partnership interests (“APIs”)** are held by a taxpayer at any time during the year, the excess (if any) of –
- (1) The taxpayer’s net long-term capital gain with respect to such interests for such taxable year, over
  - (2) The taxpayer’s net long-term capital gain with respect to such interests for such taxable year computed by applying paragraphs (3) and (4) of sections 1222 by substituting “3 years” for “1 year”,
- shall be treated as short-term capital gain, notwithstanding section 83 or any election in effect under section 83(b).



## Section 1061 – API

In general, except as provided in this paragraph or paragraph (4), the term “**applicable partnership interest**” means any interest in a partnership which, directly or indirectly, is transferred to (or is held by) the taxpayer in connection with the performance of substantial services by the taxpayer, or any other related person, in any **applicable trade or business**.

The previous sentence shall not apply to an interest held by a person who is employed by another entity that is conducting a trade or business (other than an applicable trade or business) and only provides services to such other entity.



## Section 1061 – Applicable Trade or Business

The term “applicable trade or business” means any activity conducted on a regular, continuous, and substantial basis which, regardless of whether the activity is conducted in one or more entities, consists, in whole or in part, of-

(A) raising or returning capital, and

(B) either –

(i) investing in (or disposing of) specified assets (or identifying specified assets for such investing or disposition) or

(ii) developing specified assets









**Have you had gain  
recharacterized under  
Section 1061?**

A) Yes

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B) No

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C) Not yet, but expect we will

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D) N/A



# Capital Interest Expansion

# Capital Interests Under Proposed Regs

## Major change from Proposed Regs.

**The Proposed Regulations took a narrow approach in determining what qualifies as a capital interest. A capital interest allocation will only be respected if:**

1. Allocations are made in the “**same** manner” to all partners, and the terms, priority, type and level of risk, rate of return, and rights to distributions are the same as other partners;
2. Allocations must be based on the “relative capital accounts” of the partners;
3. Similar allocations must be made to unrelated non-service partners with a significant aggregate capital account balance; and
4. Allocations with respect to capital are clearly identified under the partnership agreement and the books and records as “separate and apart” from carried interest allocations.







**Do your fund use targeted allocations or do distributions track capital account?**

**A) Targeted**

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**B) Distributions track capital**

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**C) Not sure**

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# Capital Interests Under Final Regs

**The Final Regulations take a broader approach.**

**Allocations must be in a “similar manner” and “reasonably consistent”, rather than the “same manner”.**

Similar manner test can be done on an investment-by-investment basis or based on allocations made to a particular class of interests.

**Focus is on capital contributed rather than capital accounts.**

**Provides explicit exception for differences based on carry-free capital or tax distributions.**

**Still must be clearly demonstrated in the partnership agreement and books and records.**



# Impact of Loans and Guarantees on Capital Interests



# Partnership Interests Acquired With Debt Proceeds

## **Allocations not treated as capital interest allocations to the extent**

attributable to a contribution of capital that directly or indirectly results from or is attributable to a loan or advance made or guaranteed by the partnership, a partner in the partnership or a person related to such persons.

**Repayments on such loan or advance taken into account as capital contributed.**







**Does your firm (or do your clients) make or arrange for loans to be made to investment professionals to finance co-invest?**

**A) Yes**

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**B) No**

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**C) Not yet, but expect we will**

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# Loan With Personal Liability

**Above rule does not apply to loans from partners/related parties if:**

service provider has personal liability for the loan or advance.

**Service provider has personal liability if:**

the loan is fully recourse to the service provider.

the service provider has no right to reimbursement.

no other person guarantees the debt.

**No exception for loan from partnership.**



# Who is Related?

**Certain family members**

**Individual and corporation or partnership more than 50% owned by such individual**

**2 corporations in controlled group (50%)**

**Corporation and partnership with more than 50% common ownership**

**2 partnerships with more than 50% common ownership**



# Contributions by Disregarded Entities (“DREs”)

**Contributions by DRE treated as made by the owner.**

**Includes contributions of proceeds of a loan/advance made to the DRE.**

**Where debt incurred by the DRE is used:**

The service provider must have personal liability for the loan.



# Structuring Consideration When Holding Co-Invest Through DRE

**Service Partner should borrow and contribute proceeds to DRE.**

**Alternatively:**

Service partner should guarantee the DRE indebtedness.



# Meaning of Fully Recourse

## All or nothing? What if only 50% recourse?

Presumably, this is not an all or nothing test.

Note that the initial exception to capital interest treatment applies “to the extent” attributable to the proceeds of a loan.

Regulations provide that payments on debt (not only full repayment) constitute capital contributions.

Should not be in worse position.





# Partnership With Spouse Holds Co-Invest

**Service partner must have entire liability.**

**Service partner should borrow and invest cash.**



# Treatment of Unrealized Gains

# Unrealized Gains – Not a Capital Interest

There frequently are “book-ups” in the hedge fund context, which allocated unrealized gain to managers.

It was unclear whether the Proposed Regulations allowed unrealized gains allocated to a fund manager’s capital account to be treated as a capital interest.

Final Regulations clarify that allocations with respect to unrealized gain are not eligible for the capital interest exception.

The gain must be realized before it is treated as a capital interest.



# Lookthrough Rules

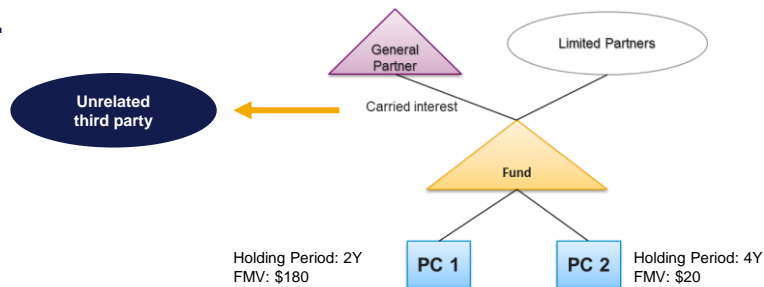
# Lookthrough Rule on Sale of Carried Interest – Proposed Regs

If 80% or more of the FMV of the assets of the fund that issued the carried interest have a holding period of 3 years or less and the sale of such assets would produce LTCG/L, then the Proposed Regulations recharacterize a pro rata portion of the gain/loss.

If more than 20% of the underlying assets of the fund have been held for more than 3 years, then this rule does not apply.

For example, if a carried interest holder sells her carried interest at a time when 90% of a fund's assets have been held for less than 3 years, then 90% of the gain will be characterized as STCG.

If the service provider holds the carried interest through intermediate entities, and any of those entities has a holding period of 3 years or less, then all of the gain on the sale will be recharacterized as STCG.

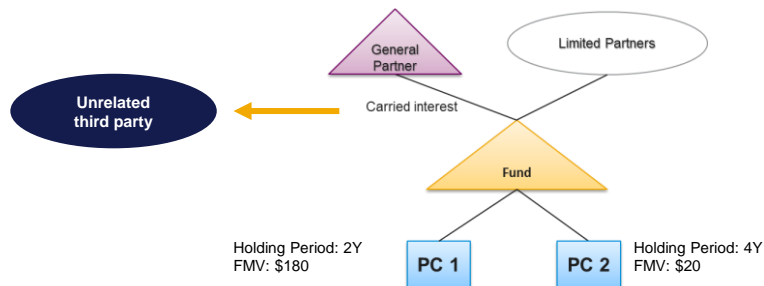


# Lookthrough Rule in Final Regs

80% look through rule from Proposed Regs removed!

Lookthrough rule targeted in Final Regs to 2 situations:

- (1) principal purpose of transaction was to avoid recharacterization or
- (2) Section 1061 would apply if using a holding period that begins on the date that unrelated non-service partners legally commit to contribute substantial capital to the partnership.



# Legislative Proposals

# Biden Plan and Democratic Proposal

## Biden

Eliminate favorable capital gain rate for individuals earning in excess of \$1m/year. (No LTCG/QDI benefit.)

Increase top individual tax rate to 39.6%

## Carried Interest Fairness Act of 2021

Codify IRS procedures providing for liquidation valuation of profits interests.

83(b) election would be default.

Treat net capital gain attributable to investment services partnership interest as ordinary income.

Treat QDI attributable to investment services partnership interest as ordinary income.

Eliminate 1202 (Qualified Small Business Stock) benefit for holders of investment services partnership interest.

Tax gain on transfer, even on tax-free transfers (other than gifts) as ordinary income.

Tax partners on distribution of property as ordinary income.

Broad anti-abuse and new 40% penalty.









**Do you anticipate changes to the treatment of carry?**

**A) Yes in 2021**

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**B) Yes in 2022**

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**C) Not for the foreseeable future**

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# Q & A



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