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Locke Lord QuickStudy: Proposed Changes to Code Section ??1061 Contemplate Significant Changes for Real Estate Funds ?and Developers

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The “Inflation Reduction Act of 2022” recently announced by Senators Manchin and Shumer to be added to the 2022 Budget Reconciliation bill proposes several significant changes to Section 1061 of the Internal Revenue Code of 1986, as amended (the “*Code*”). These proposals will impact a wide array of taxpayers including real estate funds and developers operating through partnerships or other vehicles (such as limited liability companies) that are treated as partnerships for Federal income tax purposes. Current Code Section 1061 (which was added to the Code in 2017 by the Tax Cuts and Jobs Act) provides for a 3-year (rather than a 1-year) holding period for long-term capital gains treatment relating to certain partnership carried (or “profits”) interests referred to as “applicable partnership interests” (“*APIs*”). These API rules specifically apply to interests in partnerships holding real estate for rental or investment. In general, however, APIs do not include the portion of partnership interests issued for capital contributions which are treated pari passu with third party investor capital (non-service provider equity).

Notwithstanding the increased 3-year holding period set forth in the existing Code Section 1061, many real estate developers and operators are currently able to rely on Code Section 1231 to achieve long-term capital gain treatment as long as the underlying improved real property has been held for at least 1-year. Existing Code Section 1061 does not apply to income allocated by a partnership from the sale of a Code Section 1231(b) asset which is held by the partnership. As background, Code Section 1231(b) assets are not technically “capital assets” for tax purposes but are able to benefit from capital gains rates upon disposition if certain requirements are met. Code Section 1231(b) assets include real property (including improvements) used in a trade or business and held for more than 1-year. The new bill does not change the general treatment of Code Section 1231(b) assets outside of the Code Section 1061 context, but the bill does affect the treatment of APIs for purposes of Code Section 1061 even when the underlying partnership sells a Code Section 1231(b) asset.

The following highlights some of the more impactful changes proposed to Code Section 1061:

- ***General holding period required for carried interests is increased from 3-years to 5-years (but practically speaking, the proposed changes may result in longer than 5-year holding period requirements).***
  - This is accomplished by providing that for any APIs all “net applicable partnership gain” (which is basically all gain or income which would otherwise enjoy long-term capital gain treatment in respect of any API(s) held during the applicable tax year) will be treated as short-term capital gain (taxed at ordinary rates) unless a

specific exception applies.

- *First Exception 5-Year Holding Period* — The first exception provides for interests and assets held for a 5-year holding period.
  - *Change to Beginning of Holding Period* – One of the more significant impacts of the bill is that it would change when a holding period for these purposes is deemed to begin.
  - The 5-year holding period may not begin when the partnership interest is acquired (which is how current holding periods for purposes of the Code are determined). Instead the holding period is deemed to begin at the later of (1) the date the partner acquired "substantially all" of the API and (2) the date the partnership acquired "substantially all" the assets held by the partnership.
  - While ambiguous, these standards effectively seem to be designed to prevent the holding period starting on the date a partner acquires its API when the applicable partnership has not yet acquired most of its assets (*e.g.*, in the context of a newly launched investment fund, this may mean that most of the committed capital needs to be deployed before the long-term holding period in any related API begins);
    2. The start of an API's holding period that is subject to vesting (*e.g.*, time or performance vesting) prior to the time that substantially all of the API has vested to the partner; or
    3. A partner acquiring an API followed by the partnership thereafter selling an asset which has been held by the partnership for at least 5-years but at a time which is less than 5-years after the partner acquired substantially all of the partner's API.
  - For purposes of Code Section 1061, as revised by the bill, (i) special elections under Code Section 83 to treat a partnership interest as (in effect) fully vested will not affect the treatment of APIs under Code Section 1061, and (ii) special rules can apply when "tiered" partnerships are involved.
- *Second Exception 3-Year Holding Period for Real Estate Partnerships* – Under a second exception, the 5-year holding period noted in context of the first exception is shortened to a 3-year period in certain circumstances which include:
  - For taxpayers with less than $400,000 adjusted gross income; and
  - With respect to any API that is attributable to a real property trade or business within the meaning of Code Section 469(c)(7)(C) (generally, any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business).

- ***Specific types of income are no longer excluded from the API rules resulting in a 5– year holding period (subject to a 3-year holding period, as noted above in the second exception) for all API-related income including from the sale of a Code Section 1231(b) asset by the partnership.***
  - This is effectively accomplished with the new definition of "net applicable partnership gain" discussed above, which effectively encompasses gains and income from all property, including good will and certain other special categories of property for which a 1-year holding period requirement is still available under current law (*i.e.*, income that, under current law, avoids the Code Section 1061 taint), such as:
    - gain determined under Code Section 1231 treated as long-term capital gains;?
    - ?gain determined under Code Section 1256 treated as long-term capital gains;?
    - ?qualified dividends included in net capital gain for purposes of Code Section 1(h)(11)(B); and?
    - ?capital gains and losses that are characterized as long-term or short-term without regard to the ?holding period rules in section 1222, such as certain capital gains and losses characterized under the ?mixed straddle rules described in Code Section 1092(b) and Treasury Regulations Sections 1.1092(b)-3T, 1.1092(b)-4T, and 1.1092(b)-6?.

- ***Any transfer (including otherwise non-recognized transfers) of an API will trigger the gain described***

above.

- This provision is particularly troublesome as it would pick up transfers which are otherwise tax-free or tax-deferred including gifts, contributions to partnerships and corporations and distributions from partnerships.
- A partnership restructuring transaction after the issuance of an API may cause gain recognition even if the transfer otherwise would have been a non-taxable event. This may lead to a liability for taxation when no cash is actually received. To avoid or mitigate this unintended result, alternatives will need to be reviewed prior to implementing a partnership restructuring transaction, which historically would not have raised any concerns.?
- The current language in Code Section 1061(d) references potential gain recognition with respect to certain related party transfers but is and remains unclear. Instead of providing clarification for these types of transfers, the bill simply provides that gain recognition will apply to all transfers (not just related party transfers). This gain recognition will apply regardless of whether or not the underlying transaction would have otherwise been tax-free. Code Section 1061(d), as revised by the bill, very clearly provides that "[i]f a taxpayer transfers an [API], gain shall be recognized notwithstanding any other provision of this subtitle." Even so, the language does not address whether indirect transfers would be deemed to be a "transfer" that would trigger taxation.
- On its face, it appears the transfer provisions in the bill may apply to cause gain recognition even after the 3-year or 5-year holding period (presumably at long-term rates if the applicable 3 or 5-year holding period is otherwise met) since it applies simply to any transfer of an API (regardless of when it occurs).

- ***The bill contemplates the issuance of Treasury Regulations to prevent waivers and other contractual arrangements to circumvent short term capital gain treatment.***
  - The reference to additional guidance from the Treasury is presumably included to prevent work around structures including partners waiving rights to distributions in order to circumvent the 5/3-year holding period requirement.
- ***Effective Date – December 31, 2022***
  If enacted as currently drafted, the bill will likely cause the following consequences for many real estate developers:
  - A real estate developer will be taxed at ordinary rates with respect at least to its carried interests if either the partnership interest or the underlying assets are sold prior to the expiration of a 3-year holding period (with an unclear start date).
  - For many single asset real estate developments, the relevant holding period start date would likely be no earlier than substantial completion of the relevant improvement (*i.e.*, the acquisition of "substantially all" of the partnership's assets).
  - The relevant partnership and real estate developer would be limited with respect to restructuring transactions. Although it is unclear of the scope of any exceptions or limitations, transfers which would have previously been non-recognition transfers may result in current taxation.

It is important to note that the bill is currently just a proposal. Any of the foregoing may change prior to the bill's enactment. In particular, as of the date of this QuickStudy, it is not clear whether the bill will have enough support to pass in its current form. Senator Sinema has recently indicated that she will seek changes to the tax proposals contained in the bill and that she is in favor of preserving the current treatment of carried interests. Her support will be necessary to get the bill passed.

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