

Structuring Sales of Investments by Funds After the Proposed Section 1061 Regulations

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Introduction

Gain of a fund or other investment partnership from a capital asset sale held for over one year is taxed to the fund's partners at favorable long-term capital gains rates. Until 2018, this general rule extended to the gain allocated by funds to their general partners pursuant to their carried interests. However, the Tax Cuts and Jobs Act of 2017 enacted Section 1061 of the Code, which requires a three-year holding period to achieve favorable long-term capital gains taxation for carried interests issued by funds and other investment partnerships. If the three-year holding period is not met, then a carried interest holder's capital gain is taxed as short-term capital gain, which is generally taxed at ordinary income rates. Treasury and the IRS issued long-awaited proposed regulations on July 31, 2020 under Section 1061 of the Code (Proposed Regulations).

The Proposed Regulations are quite complex in certain respects and leave several unanswered questions.^[1] However, they make clear that with proper planning, the scope of Section 1061 can be relatively narrow. This article addresses potential sales structuring strategies that private equity and real estate funds may consider to mitigate the more significant impacts of Section 1061 to their general partners.^[2]

Important Clarifications Regarding Holding Period and Excluded Income

Two important acknowledgements by the Proposed Regulations drive the suggested planning for the structuring of sales: First, subject to certain exceptions that aren't discussed in this article, the required three-year holding period pertains to the asset being sold. This means that if a fund sells a portfolio company, the fund's holding period in the portfolio company (rather than the carried interest holder in his/her carried interest) is the relevant holding period. Second, while Section 1061 applies to capital gains, it does not apply to certain gains accorded the favorable long-term capital gains tax rate, which are not in fact capital gains. Specifically, for this article, the Proposed Regulations confirm that qualified dividend income (QDI) and Section 1231 gains and losses are excluded from the application of Section 1061.^[3]

QDI includes dividends from U.S. corporations and qualified foreign corporations with respect to shares that meet a specified holding period.^[4]

Section 1231 gains include gains from the sales of the following property:

- **Real property** (other than inventory) used in a trade or business held for more than one year. Examples include land and rental real estate.
- **Depreciable property** used in a trade or business and held over one year. Examples include buildings, machinery, and perhaps most importantly, goodwill. A substantial part of the gain on asset sales of many businesses is attributable to goodwill.

A seemingly simple technique to maximize Section 1231 gain or QDI, rather than capital gain, is by structuring sales of pass-through portfolio companies by real estate and private equity funds as asset sales rather than equity sales. While the gains from corporate stock sales or partnership interests^[5] are generally capital gains, gains on portfolio company asset sales will often fall under largely Section 1231 gain.

Example to Illustrate Structure

Consider the following facts: GP is a general partner of the Fund and holds a carried interest. Fund owns interests in two portfolio companies — X, a corporation engaged in developing technology with an insubstantial amount of tangible assets, and Y, a partnership that owns and manages a mature office building. Thus, both X and Y own significant amounts of Section 1231 property:

Sale of Portfolio Company That is a Partnership

If Fund sells the interests in Y, the gain likely will be mostly comprised of capital gain, and thus subject to recharacterization under Section 1061 as short-term capital gain. If, however, the sale of Y is structured as a sale by Y of its assets, followed by a liquidating distribution by Y of all the sales proceeds, the gain will be largely

Section 1231 gain, and therefore not subject to recharacterization under Section 1061.

Sale of Portfolio Company That is a Corporation

If the Fund sells the stock of X, all the gain will be capital gain and subject to recharacterization as short-term capital gain if the shares of X have been held for three years or less. Because X is a corporation, however, structuring the sale as an asset sale will not be as optimal a solution as in the case of the sale of Y, resulting in any gain being recognized as subject to double taxation. This would likely make the asset sale prohibitively expensive.

This brings us to the other category of income discussed above that is taxed at long-term capital gains rates but is not capital gain — QDI. Given that a dividend that is QDI will not be subject to recharacterization by Section 1061, it should be explored whether a distribution by X to its shareholders out of excess cash or the proceeds of a borrowing (*i.e.*, a leveraged recapitalization) would be QDI.

Several issues should be considered in structuring a QDI that precedes a sale of the corporate stock. For example:

- Does the corporation have enough current or accumulated earnings and profits such that a distribution by it would be considered a dividend for tax purposes? Distributions are taxed as dividends only if they come out of a corporation's current or accumulated "earnings and profits" — a concept similar to retained earnings, but computed using tax law rather than GAAP or accounting rules. Many technology or health science companies may not have these earnings and profits, so the distributions would not be QDI. If this is the case, then structuring a QDI is not a feasible option.
- Dividend treatment may not be viewed favorably by some categories of shareholders, such as certain foreign shareholders, since it may result in a larger tax burden than a stock sale. Thus, if the sale is that of a blocker corporation, for example, consideration must be made for the foreign shareholder(s) of blocker and any applicable tax treaties.
- "Step transaction" and "substance over form concepts" may be raised by the IRS and thus, pre-sale dividends could be subject to re-characterization by the IRS and courts as capital gains if viewed as substitutes for sales proceeds.[\[6\]](#)

Troutman Perspective

As discussed, in cases with favorable facts, the gain from the disposition of a corporate portfolio company may be restructured to escape Section 1061. Since Section 1061's enactment, there has been considerable discussion of how to mitigate the application of Section 1061 — including through the intricate structuring of carried interest waivers, where a general partner of a fund would waive its right to income from a fund investment that was subject to Section 1061, and instead receive a right to be allocated an equal amount of gain realized at a later time by the fund from an investment not subject to Section 1061 (either because the income is not capital gain or the three-year holding period is satisfied with respect to the investment). Treasury's and the IRS's stance on all the different variations of the waiver is not clear. While waivers should certainly continue to be considered in the planning phase of a transaction, restructuring sales of portfolio companies that are partnerships as asset sales, and of corporations so as to maximize QDI, are relatively simple techniques. Thus, taxpayers may want to consider this approach first during the sales planning to enhance the taxpayer's desired position that income allocated to the holder of a carried interest in a real estate or private equity fund will not be subject to Section

[1] See <https://www.troutman.com/insights/proposed-regulations-shed-light-on-three-year-holding-period-requirement-for-carried-interest.html>.

[2] The Proposed Regulations are not effective until finalized. However, generally, taxpayers may rely on them before their finalization if followed in their entirety and in a consistent manner.

[3] The Proposed Regulations also clarify that the following categories of income (not addressed in this article) are also not subject to the reach of Section 1061:

- Section 1256 gain and losses: Section 1256 contracts (generally including regulated futures contracts, foreign currency contracts, and nonequity options) held by a hedge fund at the end of each taxable year are treated for income tax purposes as if they were sold for their fair market value, and any gain or loss is treated as 60% long-term capital gain or loss and 40% short-term capital gain or loss, regardless of the holding period. Thus, a significant portion of the income of many hedge funds is not subject to the three-year holding period of Section 1061.
- Section 1092(b) mixed straddle rules that characterize gain as capital gains also fall outside the scope of Section 1061.
- Dividends from a regulated investment company (RIC) or a real estate investment trust (REIT) are designated by the paying RIC or REIT as a capital gains dividend if such gain is attributable to capital assets of the RIC or REIT have been held for more than three years or to assets not subject to Section 1061.

[4] Generally, for dividends on stock to qualify as qualified dividend income, the taxpayer must hold the stock for at least 61 days during the 121-day period, beginning 60 days before the ex-dividend date. Foreign corporations are generally qualified foreign corporations if they are publicly traded, incorporated in a U.S. possession, or eligible for benefits under a comprehensive income tax treaty with the U.S.

[5] LLCs that have more than one member, and that otherwise have not made an election to be treated as associations taxable as corporations, are considered partnerships for U.S. federal income tax purposes. Under Section 741 of the Code, gain on the sale of partnership interests is generally capital gain, except to the extent attributable to unrealized receivables and inventory items of the partnership.

[6] See *Waterman Steamship Corp.*, 70-2 USTC para. 9514 (5th Cir. 1970), rev'g 50 T.C. 650 (1968); *Litton Industries, Inc.*, 89 T.C. 75 (12/3/87).

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