Updates

New development: The IRS has issued guidance that the exception to the new 3-year hold requirement for carried interests held by "corporations" does not apply to S corporations.

As previously discussed, the 2017 Tax Cuts and Jobs Act creates a new Code Section 1061, which provides that if one or more "applicable partnership interests" are held by the taxpayer at any time during the year, then any capital gains attributable to such "applicable partnership interest" are taxed at short-term capital gains rate unless the underlying asset is held for more than three years.

Section 1061 does not apply to carried interests held by corporations, so it was discussed whether managers could form an S corporation to avoid the three-year hold rule.

On March 1, 2018, the Internal Revenue Service issued Notice 2018-18, which provides that for purposes of Code Section 1061, **the exception for interests held by corporations only applies to C corporations and does not apply to S corporations**. Thus, any entity which has elected to be treated as an S corporation, regardless of whether such entity is a state-law corporation, limited liability company, trust or other, will not qualify for the exception to the three-year hold rule.

For more background on the three-year hold requirement, please see the original update from January 22, 2018 below:

The 2017 Tax Cuts and Jobs Act (the Act), signed by President Trump last month, significantly affects the ability of the managers of investment funds to receive long-term capital gains with respect to their carried interest. Under current law, the manager of an investment fund (whether directly or through another flow-through entity) can receive a "profits interest" (also known as a "carried interest" or a "promoted interest") tax-free. In addition, the manager receives long-term capital gain on the sale of an investment asset by the investment fund as long as the investment fund has held such asset for more than one year.

Under the new law, the receipt of a "profits interest" is still tax-free. However, the investment fund must now hold the underlying asset for three years before the manager can receive the benefit of the long-term capital gains rate with respect to its carried interest.

New Code Section 1061

The Act redesignates existing Code Section 1061 as 1062 and inserts a new Code Section 1061. New Code Section 1061 provides that if one or more "applicable partnership interests" are held by the taxpayer at any time during the year, then any capital gains attributable to such "applicable partnership interest" are taxed at short-term capital gains rate unless the underlying asset is held for more than three years. This rule is to apply only to gains attributable to assets held for portfolio investment on behalf of "third party investors." Also, this rule applies regardless of the impact of any election or lack of an election pursuant to Section 83(b) of the Code.

- An **"applicable partnership interest"** is any interest in a partnership, which directly or indirectly, is transferred to the manager in connection with performance of substantial services by the manager or a person related to the manager in any "applicable trade or business.

Exceptions to "applicable partnership interest" include:

- Any interest in a partnership held by a corporation

- Any interest which provides the right to share in profits commensurate with the capital contributed

- An **"applicable trade or business"** means any activity, whether conducted in one or more entities, which consists of, in whole or in part, raising or returning capital and either (i) investing or disposing of "specified assets" or (ii) identifying "specified assets" for acquisition or disposal.
- **"Specified assets"** means securities (e.g., stocks bonds), commodities, real estate held for rental or investment, cash or cash equivalents, options or derivative contracts with respect to the foregoing and an interest in a partnership to the extent of the proportionate interest in any of the foregoing.
- A **"third party investor"** means a person who holds an interest in a partnership which does not constitute property held in connection with an applicable trade or business (as defined above), and is not related to a person who is conducting an "applicable trade or business" (as defined above).

The statute also provides that a transfer of an "applicable partnership interest" to a related person causes the transferor to recognize any unrealized capital gains with respect to assets not held for more than three years over any short-term capital gains recognized in the transfer.

Impact of New Code on Fund Managers

New Code Section 1061 takes effect for years beginning on or after January 1, 2018. There is no grandfathering for assets currently held by an investment fund. Thus, the provision applies to any asset sold by an investment fund after December 31, 2017, unless such asset has been held more than three years at the time of sale.

Given the exemption for interests in partnerships held by corporations, managers could consider forming S corporations to hold their profits interests. However, converting an existing entity into an S corporation may be problematic because of the one class of stock rule applicable to S corporations, i.e., no preferred interests and no special allocations of amount allocable to capital and to carry; all shareholders must receive the same pro rata amount of all types of income received by the S corporation manager. Moreover, despite Code Section 1361 (b)(1) defining "small business corporation" as a "domestic corporation …," the precedents as to the treatment of an "S corporation" as a "corporation" are varied depending upon the issue being decided.

As drafted, the statute appears to allow the holder of a profits interest to avoid this rule by causing the investment fund to distribute assets out to the carried interest holder, who would then sell the assets. An immediate sale by the holder of the profits interest would seem to still receive long-term capital gain treatment even if the fund has not held the assets for more than three years. Upon passage of a major tax bill, there is often a subsequent technical corrections bill by Congress to correct or clarify provisions in the original law. A technical corrections bill may prevent such a work around.

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