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ASSET MANAGEMENT **INSIGHTS**

INSIGHTS FROM THE BDO FINANCIAL SERVICES PRACTICE

IRS ISSUES PROPOSED REGULATIONS ADDRESSING HEDGE FUND CARRIED INTERESTS

By Joe Pacello

BACKGROUND

The Tax Cuts and Jobs Act of 2017 included new Internal Revenue Code Section 1061, which impacted the tax treatment of "carried interests." Section 1061 generally provides that certain long-term capital gains may be recharacterized as short-term capital gains if the holding period associated with the property triggering the gains is not more than three years. Thus, Section 1061 may operate to recharacterize long-term capital gain where the typical one-year holding period requirement has been satisfied, but the disposed property has not been held for more than three years. Following enactment of Section 1061, taxpayers and their advisors raised many questions regarding the operation of Section 1061 in practice, particularly for hedge fund managers. On July 31, 2020, the U.S. Department of the Treasury (Treasury) and Internal Revenue Service (IRS) issued proposed regulations that provide much needed guidance and raise new questions.

Below we have listed key highlights of the proposed regulations that are most relevant to hedge fund managers.

HIGHLIGHTS

- The IRS clarified that the three-year holding period requirement does not apply to income and gains attributable to Section 1256 contracts, qualified dividends, Section 1231 gains that are otherwise eligible for long-term capital gains treatment, or any other capital gain that is characterized as long-term or short-term without regard to the holding period rules under Section 1222, e.g., gains under the Section 1092(b) mixed straddle rules.

BDO'S ASSET MANAGEMENT PRACTICE

BDO's Asset Management practice provides assurance, tax and advisory services to asset management entities, comprising hedge, private equity and venture capital funds as well as regulated funds. The practice services over 600 advisors nationwide with funds ranging from start-up funds to those with billions of dollars under management.

- Consistent with the position described in Notice 2018-18, Treasury and the IRS proposed rules that would confirm that S corporations will not be eligible for the exception in Section 1061 for partnership interests held by "corporations." In other words, if the carry vehicle (general partner, or GP, entity) is a C corporation, Section 1061 will not apply and long-term capital gains will not need to satisfy the three-year holding period requirement. However, if the carry vehicle is an S corporation, Section 1061 and the three-year holding period to qualify long-term capital gain for allocations attributable to the carried interest apply. The proposed regulations also state that GP entities incorporated offshore and treated as passive foreign investment companies, with respect to which the shareholder has a qualified electing fund election in effect, will need to satisfy the three-year holding period requirement, just like S corporations.
- If a member of a GP entity has held their interest for not more than three years but is allocated gain attributable to an asset held by the underlying fund for more than three years, the member's carried interest allocation will not be subject to Section 1061 recharacterization and should continue to be eligible for long-term capital gain treatment. A look-through rule may apply to convert gain to short-term in some circumstances where an interest in the GP entity itself is sold.
- The proposed regulations contain transition rules for assets held more than three years as of January 1, 2018, the effective date of Section 1061.
- Certain transfers of GP interests to related parties can trigger a taxable event to the transferor based on the GP interest's share of the fund's assets held for not more than three years. Transfers potentially giving rise to gain recognition include contributions, distributions, sales and exchanges, and gifts.
- The proposed regulations contain new and administratively complex reporting and record-keeping requirements for fund managers. For example, they modify the aggregation rules under Section 704(c) to require separate tracking of gains and losses for purposes of Section 1061.

The proposed regulations are expected to generally be effective in 2021. However, fund managers can adopt them earlier if they so choose. Note that the rules regarding S corporations are expected to be effective retroactively to 2018.

CONCLUSION

The proposed regulations address several open questions for hedge fund managers and contain some favorable guidance. However, other aspects of the proposed regulations, if adopted, may have unfavorable consequences as well as additional compliance burdens.

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