



IRS Provides Insight for Long Term Capital Gain Treatment Under Section 1061

Summary

On Thursday, March 1, 2018, the Internal Revenue Service (IRS) issued Notice 2018-18 (the “Notice”) announcing the intention on the part of Treasury and the IRS to publish regulations on the application of Section 1061 of the Internal Revenue Code as enacted by the Tax Cuts and Jobs Act. The Notice announces that Treasury and the IRS intend that the forthcoming regulations will provide that the term “corporation” as used in Section 1061 does not include an S corporation.

Details

Partnership interests transferred in exchange for management services (so called “carried interests”) were the target of the recent tax reform laws. The apparent intent of the new law was to prevent carried interests from being taxed at long-term capital gains rates unless the interest was held for at least three years. A loophole was identified by some taxpayers to allow for long-term capital gain treatment only after one year if the carried interest was transferred to an S corporation rather than directly to an individual. The Notice and forthcoming regulations are the government’s attempt to close this loophole; however, it may take a further act of Congress to do so.

Discussion of Notice 2018-18

Under general income tax rules, gain recognized by a partnership upon disposition of a capital asset held for more than one year will be characterized as long-term capital gain. Additionally, the sale of a partnership interest held for more than one year results in long-term capital gain, except to the extent section 751 applies. Under Section 1061(a), for taxable years beginning after December 31, 2017, long-term capital gain will only be available with respect to “applicable partnership interests” to the extent the capital asset giving rise to the gain has been held for more than three years.

Section 1061(c)(1) defines the term applicable partnership interest to include any partnership interest transferred, directly or indirectly, to a partner in connection with the performance of services by the partner, provided that the partnership is engaged in an “applicable trade or business.”¹ Section 1061(c)(4)(A), however, provides that the term “applicable partnership interest” shall not include any interest in a partnership directly or indirectly held by a corporation.

Section 1361(a)(1) provides in general that the term “S corporation” means, with respect to any taxable year, a small business corporation for which an election under Section 1362(a) is in effect for such year. Section 1361(a)(2) provides in general that the term “C corporation” means, with respect to any taxable year, a corporation which is not an S corporation for such year. Section 1361(b)(1) defines a “small business corporation” as a domestic corporation which is not an ineligible corporation and which does not (A) have more than 100 shareholders, (B) have as a shareholder a person (other than an estate, a trust described in Section 1361(c)(2), or an organization described in Section 1361(c)(6)) who is not an individual, (C) have a nonresident alien as a shareholder, and (D) have more than one class of stock.

Notice 2018-18 states that the anticipated regulations will provide that the term “corporation” in Section 1061(c)

¹ An applicable trade or business means any activity that is conducted on a regular, continuous, and substantial basis consisting of raising or returning capital and either (1) investing in, or disposing of, specified assets (or identifying specified assets for such investing or disposition) or (2) developing such specified assets. For purposes of this provision, specified assets include securities, commodities, real estate held for rental or investment, cash or cash equivalents, options or derivative contracts with respect to any of the foregoing, and an interest in a partnership to the extent of the partnership’s proportionate interest in any of the foregoing.



(4)(A) does not include an S corporation. Section 1061 is effective for taxable years beginning after December 31, 2017. Treasury and the IRS intend that the forthcoming regulations will be effective for taxable years beginning after December 31, 2017.

Although not cited in the Notice, Section 1363(b) provides that, with certain exceptions not relevant here, the taxable income of an S corporation is computed in the same manner as that of an individual. This provision likely provides the strongest authority for Treasury and the IRS to conclude that, when used in Section 1061, the term “corporation” does not include an S corporation. Although there is some uncertainty regarding the scope of Section 1363(b), it is likely that Treasury and the IRS will ultimately rely on this provision as its authority for the intended regulations, unless Congress steps in to enact a technical correction.

Important Considerations

Taxpayers who may be subject to Section 1061 should increase their focus on carried interest allocations and whether these allocations will result in long-term capital gain. When Section 1061 is applicable, long-term capital gain is available only where the disposed asset has been held for more than three years. Accordingly, proper tracking of the holding period attributable to the disposed asset is critical. Where a fund (or its portfolio company) intends to grow through acquisition or is classified as a flow-through entity (i.e., partnership) for U.S. income tax purposes, a possible “trap for the unwary” should be considered.

This change in the required holding period and the potential for ordinary income taxation is causing fund managers to reassess the structure (and financing) of potential add-on investments, tax classification of portfolio companies, structure of monetization events, and the terms of their carried interest, including incremental interests granted under management fee waiver or cashless contribution arrangements.

Consider the following example:

Fund, LP raises \$100M of capital with commitments of \$1M to be contributed by the general partner (GP) and

\$99M to be contributed by the limited partners (LPs). Depending on overall performance of the fund, the GP will be entitled to an allocation of up to 20 percent of gains recognized on investment assets.

On January 1, 2017, Fund, LP invests \$50M in the acquisition of a portfolio company (PortCo). Fund, LP raises additional capital and contributes these funds to PortCo:

6/30/2017:	\$10M
12/31/2017:	\$25M
3/31/2018:	\$15M

On July 1, 2020, Fund, LP sells the interest in PortCo for \$175M recognizing long-term capital of \$75M (\$175M disposition proceeds less \$100M total invested capital). Under the terms of the Fund, LP operating agreement, GP is allocated 20 percent of this gain, or \$15M.

Of the \$15M long-term capital gain allocated to the GP, \$5.7M will be recharacterized as short-term capital gain.

Sale Proceeds	\$175,000,000
Less: Total Basis	(100,000,000)
Long-Term Capital Gain	\$75,000,000
GP Carried Interest Allocation Percentage	20%
GP Carried Interest Allocation²	\$15,000,000
Percent Allocable to Short-Term Holding Period³	40%
Short-Term Capital Gain	\$6,000,000

Consider an alternative whereby PortCo obtained debt-financing on December 31, 2017, and March 31, 2018, instead of equity financing from Fund, LP. Structuring these subsequent investments as debt-financing would have prevented PortCo from issuing new stock to Fund, LP, which would have been a disposed asset with a holding period of less than three years. This change in financing structure for these investments could result in all of the carried interest allocation being subject to the more favorable long term capital gain rate.

² GP will also be allocated \$600,000 of gain attributable to its \$1M capital investment (\$75,000,000 - \$15,000,000 = \$60,000,000 * 1% = \$600,000). The recharacterization rules under Section 1061, however, do not apply to gain allocable to a capital interest.

³ Each time Fund, LP invested in PortCo, a new holding period was created with respect to that investment. Since Fund, LP invested \$40M within three years of the disposition, 40 percent (\$40M divided by \$100M) is treated as gain from the sale of an asset held less than three years.