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KPMG report: Initial impressions of "carried interest" provision in draft Senate reconciliation bill

Update: The carried interest provisions, described below, were removed from the legislation during Senate consideration of the reconciliation bill, and were not included in the version of the bill passed by the Senate on August 7, 2022.

As previously reported, Senator Joe Manchin (D-WV) on July 27, 2022, announced that he had reached an agreement with Senate Majority Leader Chuck Schumer (D-NY) on tax, climate change, energy, and health care provisions to be included in the *Inflation Reduction Act of 2022*.

The draft Senate bill includes a proposed amendment to section 1061, which was enacted as part of the 2017 tax legislation commonly known as the "Tax Cuts and Jobs Act" (TCJA), regarding certain partnership interests held in connection with the performance of services—or carried interest.

This report provides high level preliminary observations regarding the proposed amendment to section 1061 based on the draft legislative text for the proposed Senate bill released on July 27, 2022. **Keep in mind that legislative text could be modified during the legislative process and that the ultimate outcome of the legislative process is inherently uncertain.**

Read ***TaxNewsFlash*** for more detail and a link to the draft legislative text.

In general

The proposal would amend section 1061 in a number of significant ways and is identical, except with respect to the effective date, to a proposal the House Ways and Means Committee approved as part of its recommendations for budget reconciliation legislation in September 2021. See pages 143 – 145 of KPMG's TaxNewsFlash special report [PDF 2.3 MB] on the Ways and Means recommendations for a description of the Ways and Means proposal.

According to a one-page summary [PDF 95 KB] of the proposed Senate bill released on July 27, 2022, the current proposal is expected to raise approximately $14 billion over a 10-year period.

It is important to note that, as currently drafted, the proposed amendment to section 1061 **would apply to tax years beginning after December 31, 2022**. Potentially affected taxpayers, therefore, may want to pay close attention to the legislative process as the proposal, if enacted in its current form, might affect decisions regarding the timing of any transfers of applicable partnership interests (including nonrecognition transfers) and acquisitions or divesture of partnership interests or partnership assets. Lastly, the proposal highlights the need to consider how future partnership interests for services are structured to manage potential tax issues that could result if the proposal is ultimately enacted.

Modification of rules for certain partnership interests held in connection with the performance of services

Under current law, section 1061 recharacterizes long-term capital gain allocated with respect to an applicable partnership interest (API) or recognized upon the disposition of an API as short-term capital gain unless the asset sold has a greater than three-year holding period. Under current law, section 1061 applies only to gain recognized with respect to the disposition of a capital asset. Section 1061 also does not apply to section 1231 gain and other capital gain items and items taxed at capital gain rates that are not generated from the disposition of a capital asset (e.g., qualified dividend income, section 1256 gain, etc.).

As a threshold matter, under the proposed Senate bill, amended section 1061 would no longer operate by reference to the holding period of the asset sold. Instead, the general rule would recharacterize long-term capital gain as short-term capital gain, subject to a new "holding period exception."

Under the proposal, amended section 1061 would create a concept of "net applicable partnership gain" that would be recharacterized as short-term capital gain for the relevant tax year. Under the general rule, net applicable partnership gain would include **all long-term capital gain items or items taxed at capital gains rates** recognized with respect to an API. Under this rule, the scope of long-term capital gain items subject to recharacterization no longer would be limited to gain from the disposition of a capital asset. Instead, section 1231 gain, qualified dividend income, section 1256 gain, and potentially other long-term capital gain items could be recharacterized as short-term capital gain.

The "holding period exception" in amended section 1061 would be more of a multi-pronged waiting period. Where the holding period exception applies, an API holder's net long-term capital gain with respect to an API would be determined the same as for any other taxpayer. Specifically, the relevant draft statutory language in amended section 1061 states that:

> *…net applicable partnership gain would be determined without regard to any amount which is realized after the date that is 5 years after the latest of (i) [t]he date on which the taxpayer acquired substantially all of the applicable partnership interest with respect to which the amount is realized, [or] (ii) [t]he date on which the partnership in which such applicable partnership interest is held acquired substantially all of the assets held by such partnership.*

Thus, any long-term capital gain recognized with respect to an API generally would not be subject to recharacterization provided that the gain was realized **five years after the API holder acquired substantially all of its API in the partnership <u>and</u> five years after such partnership acquired substantially all of its assets**. The proposed amendment provides no guidance as to the meaning of "substantially all." In tiered situations, when interests in lower-tier partnerships are acquired and when such lower-tier partnerships acquired their assets would also be relevant.

KPMG observation

The "holding period exception" (i.e., waiting period test) in the proposal is a "latest of" test.

> *Example*
>
> *Assume that Partner A acquired an API in Partnership on January 1, 2020, and Partnership did not acquire "substantially all" of its assets until January 1, 2025. If Partner A sold its API in*

2027, the gain would be short-term gain capital under the proposed amendment.

Regulations or other guidance would need to define "substantially all" for purposes of the proposal. The Internal Revenue Code and Treasury regulations do not have a consistent definition of "substantially all." Certain provisions use a standard of 80%, 85% or 90%.

The approach in the proposal would depart from traditional holding period determinations which look to when each asset was acquired and which generally consider tacking rules for nonrecognition transfers, and instead would look to when partnership interests and assets were "acquired." Thus, for example, the clock (as measured for purposes of the holding period exception of the proposal) would generally restart upon the contribution of a material amount of assets to a partnership.

The approach in the proposal could be viewed as creating a disincentive for the sponsors of an existing fund to acquire material additional assets as the acquisition of such additional assets could restart the waiting period.

Note that, under the proposal, some of the long-term capital gain items that would be recharacterized with respect to an API holder would not be holding-period dependent (e.g., qualified dividend income and section 1256 gain), and it may have been necessary to adopt an approach that ignores the holding period of specific assets to capture these items. Clearly, however, the approach adopted by the proposed amendment would have the effect of extending the period for selling most assets to well beyond five years.

The five-year period would be reduced to three years in certain instances. The shorter holding period would apply to taxpayers (other than trusts or estates) with adjusted gross income (determined without regard to sections 911, 931, and 933) of less than $400,000. The three-year period also would apply to income with respect to any API that is attributable to a real property trade or business within the meaning of section 469(c)(7)(C).

KPMG observation

It appears that the real property trade or business would be determined at the partnership level without regard to the participation of the API holder.

Beyond alteration of the rules providing for the recharacterization of long-term capital gain, the proposed amendment would make another very significant change—that is, the transfer rules of section 1061(d) would be amended to provide that **any transfer of an API would result in gain recognition without regard to any nonrecognition provisions** that might otherwise apply to the transaction.

KPMG observation

The impact of this proposed amendment cannot be overstated. If enacted, the rule would affect gifts of APIs, transfers upon death, restructuring transactions to divide carry and management operations in anticipation of a "GP Stakes" transaction (i.e., a partial sale of the sponsor business), and partnership merger transactions when partners in the target partnership hold APIs, among others.

Application of proposed section 1061(d) to otherwise nonrecognition transfers raises the question of what the basis would be of the transferred API in the hands of the transferee. Current section 1061(d) applies to taxable transfers to persons that are related, as defined under those rules. When application of current section 1061(d) was thought to apply to all transactions, including nonrecognition transfers such as gifts, a proposed regulation was drafted that provided that for purposes of basis, the basis of the transferred API was increased for the gain recognized under section 1061(d), and that such basis was increased immediately prior to the transfer. This regulation was proposed, but not incorporated into final regulations as it was considered unnecessary.

This makes a difference, for example, in application of the deduction available for charitable donations under section 170. Section 170 generally allows a donor a charitable contribution deduction equal to the fair market value of the property donated. However, a donor is required to reduce a charitable contribution deduction by the amount of gain which would not have been long-term capital gain if the property contributed had been sold by the taxpayer at its fair market value. The effect of the rule is that the deduction is limited to the adjusted basis of the property. The application of this rule to a donation in 2022 under current section 1061 versus 2023 under proposed section 1061(d) could potentially lead to starkly different results, depending on whether rules are written to allow for an increase in basis for the transferred property.

> *Example*
>
> *Assume that Partner A acquired an API in Partnership on January 1, 2019, and Partnership acquired "substantially all" of its assets before or on January 1, 2019. Further assume that all Partnership's assets are capital assets with a 3-year holding period. Further assume that, on and after August 1, 2022, Partner A's API has a basis of $100,000 and a FMV of $500,000. If Partner A makes a charitable donation of the API to a charitable organization (other than a private non-operating foundation) on August 30, 2022, Partner A would not include any amount in income and would be eligible for a charitable deduction equal to the $500,000 fair market value of the API under the rules of section 170. Under the proposal, however, if Partner A makes the same donation on January 1, 2023, A would pick up $400,000 in short-term capital gain because proposed section 1061's five-year waiting period was not attained. The proposed legislation does not address basis consequences. If a rule similar to the proposed regulation would apply, Partner A's basis in the API would be increased to $500,000 and A's charitable donation would be $500,000. Partner A's benefit would net to a $100,000 deduction. If, however, no similar basis rule applies, it would appear that Partner A's deduction would be limited to $100,000. In such case, Partner A would benefit from selling the API and then donating the cash proceeds to charity or may consider waiting until January 2, 2024 to donate the API.*

Furthermore, as currently drafted, the proposed amendment would continue to be applied to transfers by "taxpayers"—a broader group than individuals.

The proposed amendment also would make minor changes to the definition of an API, most significantly providing regulatory authority to address certain situations.

First, regulatory authority would be provided to modify the rule treating a partnership interest as a specified asset by reference to specified assets held by the partnership. According to the Joint Committee on Taxation (JCT) technical explanation of the substantially identical proposal previously approved by the Committee on Ways and Means (**JCX-43-21**), this regulatory guidance may "define a de minimis direct or indirect interest of a partnership in an asset that is not taken into account for this purpose."

Second, regulatory guidance may override the exceptions to API treatment for capital interests as well as partnership interests held by C corporations. The JCT technical explanation to the prior Ways and Means proposal indicates that this regulatory authority could be invoked "when the application of an exception would not carry out the purposes of section 1061."

The proposed amendment would continue to provide regulatory authority to exclude from recharacterization "income or gain attributable to any asset not held for portfolio investment on behalf of third-party investors."

KPMG observation

Treasury and the IRS did not invoke this regulatory authority in the regulations that were finalized earlier this year. As a result, issues relating to enterprise value and family partnerships remain unaddressed. These issues would take on added importance if the proposed new holding-period rules were enacted.

Finally, the proposed amendment would add specific grants of regulatory authority "to prevent the avoidance of the purposes of [section 1061], including through the distribution of property by a partnership and through carry waivers" as well as to provide for the application of section 1061 "to financial instruments, contracts or interests in entities other than partnerships to the extent necessary or appropriate to carry out the purposes of [section 1061]."

KPMG observation

Interestingly, existing regulations under section 1061 address distributions of property and treatment of financial instruments, contracts, and interests in non-corporate entities, so the regulatory authority provided in the proposed amended version of section 1061 would seem only to confirm the validity of those regulations. Carry waivers would seem to be much harder (if not impossible) to accomplish under the proposed new holding-period regime, so it is not clear how prevalent carry waivers would be after the amendment and whether regulations addressing such waivers would have significant impact.

If enacted as currently drafted, the proposal would be effective for tax years beginning after December 31, 2022.

KPMG observation

The possible effective date obviously is relevant as parties determine when to dispose of investment fund assets. Given the provision overriding nonrecognition, the possible effective date is also highly relevant to completing gifting transactions, internal restructurings, transfers pursuant to family and estate planning, and other nonrecognition transactions that could involve the disposition of an API. It is worth highlighting that an API transferred to a related person prior to the effective date of the legislation (if enacted), as defined for purposes of section 1061(d), or transferred in a nonrecognition transaction, would generally remain an API in the hands of the transferee. Under the proposal, such transfer would appear to restart the waiting period. As such, pre-effective date transactions involving APIs much be carefully evaluated. Lastly, the proposal highlights the need to consider how future partnership interests for services are structured to manage potential tax issues that could result if the proposal is ultimately enacted in its current form.

For more information, contact tax professional with KPMG's Washington National Tax:

Debbie Fields | dafields@kpmg.com
Jim Sowell | jsowell@kpmg.com
Sarah Staudenraus | sarahstaudenraus@kpmg.com
Sean Austin | seanaustin@kpmg.com
Monisha Santamaria | monishasantamaria@kpmg.com
Matt Busta | mbusta@kpmg.com

kpmg.com/socialmedia

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