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PROPOSED REGULATIONS ON CARRIED INTEREST TAXATION

THOUGHT LEADERSHIP PERSPECTIVES

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BE AWARE THAT 'CARRIED INTEREST' WILL BE TAXED AT A HIGHER RATE AS PART OF THE TAX CUTS AND JOBS ACT.

When the Tax Cuts and Jobs Act (TCJA) was passed in 2017, most people, including me, focused on the SALT (State and Local Tax) cap and the major increase in the estate and gift tax exemption. However, the TCJA also quietly added a provision to tax certain 'carried interests' at a higher tax rate. That addition—Internal Revenue Code Section 1061 (IRC 1061)—taxes certain carried interests at the ordinary income tax rate. Simply stated, carried interest is the right for the manager of a private investment fund to share in a fund's profit.

THE POTENTIAL EFFECT ON INVESTORS

Taxation has both direct and indirect consequences. Changes in tax law can cause ripple effects. When a tax rate changes in one area, behavior will likely change in another. With higher tax rates, hedge fund managers and private equity managers may take action by raising fees or changing investment strategies.

In general terms, IRC 1061 increases the required holding period for a gain to be considered a long-term capital gain. Normally, for a gain to be considered 'long-term', the asset must be held for at least one year. Under the new code section, the minimum holding period is three years, instead of one, in order to be treated as long-term. The effect is significant and may increase the effective tax rate by 10 or 15%.

Recently, on July 31, the IRS issued proposed regulations for the new code section. Currently, they are requesting comments from practitioners before the regulations will be finalized. The proposed regulations will not apply until the final regulations are published in the Federal Register; however, certain taxpayers may choose to rely upon the proposed regulations if they apply the proposed regulations in a consistent manner.

TOP FIVE HIGHLIGHTS FROM THE PROPOSED REGULATIONS

There's no question that the application of the Code Section 1061 and the new proposed regulations are complex; however, we thought you'd like to review the highlights.

1) AN API REMAINS AN API

IRC Section 1061 applies to partners who have exchanged substantial services for a partnership interest in an 'applicable trade or business. This interest is called the 'applicable partnership interest', or API. Once an interest in a partnership is considered an API, it is hard to shake the designation. The API gains and losses retain the API character as they flow through tiered pass-through entities. For this purpose, this includes grantor trusts, S corporations, passive foreign investment companies when the shareholder has a qualified electing fund election, single member LLCs, and partnerships.

2) CAPITAL INTEREST EXCEPTION

IRC Section 1061 only applies to partnership interests that have been exchanged for substantial services. If a partner contributes money for a partnership interest, the partner receives a capital interest. The income allocated to the capital interest will retain capital gain character.

3) ONLY CAPITAL GAIN INCOME

The proposed regulations specifically state that IRC 1061 only applies to capital gain income. Income that is not capital gain is not subject to recharacterization. Income not considered capital gain income includes 1231 gains, 1256 gains, qualified dividends included as capital gain income under IRC 1(h)(1)(B), and mixed straddles gains.

4) CALCULATIONS AT THE PARTNER LEVEL

The proposed regulations illustrate the nitty-gritty mechanics of the statute. The calculation of the recharacterization is computed at the partner level. A partner with multiple APIs combines all APIs with the less than three-year designation and the more than three-year designation. The calculation includes pass-through gains, the disposition of property received from the API, and the disposition of the API.

5) RELATED PARTIES TRANSFER

Special rules apply when a partner transfers API to a related person by contribution, sale, exchange, or gift. If a partner transfers API to a related person, by gift for example, the partner is treated as selling the API at the time of the gift. The partner must include the recharacterization amount in income at the time of the gift. The basis of the asset in the hands of the transferee is increased by the gain realized by the partner.

IF THIS OR ANY OTHER TAX COMPLEXITY ISSUE HAS YOU SCRATCHING YOUR HEAD, WE'D LOVE TO HEAR FROM YOU. PLEASE REACH OUT TO YOUR FAIRMAN GROUP FAMILY OFFICE PROFESSIONAL OR CONTACT OUR OFFICE TODAY.

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