STRADLEY RONON

Tax Insights

A Publication of the Stradley Ronon
Tax Practice Group

WWW.STRADLEY.COM

JANUARY 14, 2021

Stradley Ronon Stevens & Young, LLP
2005 Market Street
Suite 2600
Philadelphia, PA 19103-7018
215.564.8000 Telephone
215.564.8120 Facsimile
www.stradley.com

With other offices in:
Washington, D.C.
New York
New Jersey
Illinois
Delaware

IRS Issues Final Carried Interest Regulations

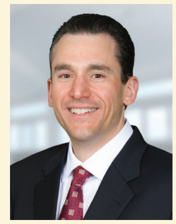
The IRS has issued final Treasury regulations under Section 1061, the carried interest rules. Section 1061 was added by the 2017 Tax Cuts and Jobs Act (TCJA) and is effective for tax years beginning after Dec. 31, 2017. (Section references are to the Internal Revenue Code of 1986, as amended (the Code) unless otherwise provided herein, and the related Treasury Regulations.) Carried interest is a form of compensation that usually is determined with regard to a share of profits. Carried interest is commonly found in private equity and hedge fund arrangements, where fund managers received a fixed fee and a second fee, a share of profits, which is received when the fund hits certain goals. Section 1061(a) recharacterizes as short-term capital gain the difference between a taxpayer's net long-term capital gain with respect to one or more applicable partnership interests (API) and the taxpayer's net long-term capital gain with respect to these APIs if paragraphs (3) and (4) of section 1222, which define the terms long-term capital gain and long-term capital loss, respectively, are applied using a three-year holding period instead of a one-year holding period. The regulations refer to this difference as the Recharacterization Amount. An API is an interest in a partnership that is transferred to or held by a taxpayer, directly or indirectly, in connection with the performance of substantial services by the taxpayer, or any other related person, in any applicable trade or business. The final regulations adopt the proposed regulations, issued in August 2020, with some modifications. (See our prior coverage here.) The revisions generally apply to four main areas, and some of the changes are discussed below (which rely heavily on defined terms).

1. **Capital Interest Exception**

   a. **Capital Interest Allocations**. Section 1061(c)(4)(B) provides that an API does not include certain capital interests. The proposed regulations provided that capital gains and losses that represent a return on an API Holder's capital invested in a Passthrough Entity were excepted from recharacterization. These amounts included Capital Interest Allocations, Passthrough Interest Capital Allocations, and Capital Interest Disposition Amounts that meet the requirements of Proposed Regulation Sections 1.1061- 3(c)(3) through (c)(6). In response to several commenters suggesting the framework for the capital interest exception in the proposed regulations was too rigid, the final regulations provide a revised and simplified rule that looks to whether allocations are commensurate with capital contributed. The final regulations provide that Capital Interest Allocations must be commensurate with capital contributed in order to qualify for the capital interest exception. The final regulations replace the requirement that allocations be made to all partners in the same manner with a requirement that an allocation to an API Holder with respect to its capital interest must be determined and calculated in a similar manner as the allocations with respect to capital interests held by similarly situated Unrelated Non-Service Partners who have made significant aggregate capital contributions. The final regulations remove the terms Passthrough Capital Allocation, Passthrough Interest Capital Allocation, and Passthrough Interest Direct Investment Allocation, and instead provide that an allocation made to a Passthrough Entity that holds an API in a lower-tier Passthrough Entity will be considered a Capital Interest Allocation if made in accordance with the principles applicable in determining Capital Interest Allocations. Under the final regulations, Capital Interest Allocations retain their character when allocated to an upper-tier partnership so long as they are allocated among the partners in the upper-tier partnership with respect to such partners' capital interests in a manner that is respected under Section 704(b) (taking the principles of Section 704(c) into account).

b. **Unrelated Non-Service Partner Requirement**. Proposed Regulation Section 1.1061-3(c)(4) specifies that Capital Interest Allocations must be made in the same manner to API Holders and to Unrelated Non-Service Partners with a significant aggregate capital account balance (defined as 5% or more of the aggregate capital account balance of the partnership at the time the allocations are made). Despite the commenters' request, the Treasury Department and the IRS kept the 5% threshold. In accordance with the provision that the similar manner test in the final regulations may be applied on an investment-by-investment or class-by-class basis, the final regulations specify that the Unrelated Non-Service Partner requirement can also be applied on an investment-by-investment basis or on a class-by-class basis. In the Capital Interest Allocation definition, the final regulations retain the requirement that allocations with respect to, and corresponding to, contributed capital be clearly identified under both the partnership agreement and in the partnership's books and records as separate and apart from allocations made to the API Holder with respect to its API, and specify that the books and records must be contemporaneous. Allocations made to an API Holder that do not meet the requirements of these final regulations will not be considered Capital Interest Allocations.

c. **Capital Interest Disposition Amounts**. The final regulations clarify the determination of an API Holder's Capital Interest Disposition Amount when the API Holder transfers a Passthrough Entity interest that is comprised of both an API and a capital interest at a gain and would be allocated only capital loss as a Capital Interest Allocation if all of the assets of the Passthrough Entity had been sold for their fair market value in a fully taxable transaction immediately before the interest transfer. The final regulations provide additional rules where a transferred Passthrough Entity interest results in a gain and the transferor would have been allocated both Capital Interest Gain and API Gain, as well as where a transferred Passthrough Entity interest results in a loss and the transferor would have been allocated both Capital Interest Loss and API Loss. Due to comments received, Example 5 in Proposed Regulation Section 1.1061- 3(c)(7)(v) has been removed because of potential implications to other sections of the Code.



Christopher C. Scarpa

Jacquelyn Gordon

For more information, contact Christopher C. Scarpa at 215.564.8106 or cscarpa@stradley.com *or Jacquelyn Gordon at 215.564.8176 or* jgordon@stradley.com.

d. **Unrealized API Gains and Losses**. The final regulations remove the mandatory revaluation rules and provide, per suggestions, that Unrealized API Gains and Losses be determined according to the existing rules governing unrealized gains and losses, including Section 704(c) principles. The final regulations continue to provide that Unrealized API Gains and Losses are not included in Capital Interest Gains and Losses and further clarify that if an API Holder is allocated API Gain by a Passthrough Entity, to the extent that an amount equal to the API Gain is reinvested in Passthrough Entity by the API Holder (either as the result of an actual distribution and recontribution of the API Gain amount or the retention of the API Gain amount by the Passthrough Entity), the amount will be treated as a contribution to the Passthrough Entity for a capital interest that may produce Capital Interest Allocations for the API Holder, provided such allocations otherwise meet the requirements to be a Capital Interest Allocation.

2. Capital interests acquired with loan proceeds. Proposed Regulation Section 1.1061-3(c)(3)(ii)(C) provides that for purposes of Proposed Regulation Sections 1.1061-1 through 1.1061-6, a capital account does not include the contribution of amounts directly or indirectly attributable to any loan or other advance made or guaranteed, directly or indirectly, by any other partner, the partnership, or a Related Person with respect to any other partner or the partnership. Repayments on the loan are included in capital accounts as those amounts are paid by the partner, provided that the loan is not repaid with the proceeds of another similarly sourced loan. The final regulations modify this rule and provide that an allocation will be treated as a Capital Interest Allocation if the allocation is attributable to a contribution made by an individual service provider that, directly or indirectly, results from, or is attributable to, a loan or advance from another partner in the partnership (or any Related Person with respect to such lending or advancing partner, other than the partnership) to such individual service provider if the individual service provider is personally liable for the repayment of such loan or advance as described in the final regulations. The final regulations apply a similar approach with respect to loans or advances made by a partner in the partnership (or a Related Person to such partner, other than the partnership) to a wholly-owned entity that is disregarded as separate from an individual service provider where the individual service provider that owns such disregarded entity is personally liable for the repayment of any borrowed amounts that are not repaid by the disregarded entity.

3. **Look-through Rule**. Proposed Regulation Section 1.1061-4(b)(9) provides a limited Look-through Rule that may apply to the sale of an API where the capital gain is recognized, and the holding period of the API is more than three years. In the case of a disposition of a directly held API with a holding period of more than three years, the proposed Look-through Rule applies, causing the gain to be recharacterized if the assets of the partnership in which the API is held meet the Substantially All Test. The final regulations retain the Look-through Rule, but instead of applying the Look-through Rule to the disposition of an API held for more than three years and where the Substantially All Test is met, the final regulations limit the application of the Look-through Rule to situations where, at the time of disposition of an API held for more than three years, (1) the API would have a holding period of three years or less if the holding period of such API were determined by not including any period prior to the date that an Unrelated Non-Service Partner is legally obligated to contribute substantial money or property directly or indirectly to the Passthrough Entity to which the API relates (this rule does not apply to the disposition of an API to the extent that the gain recognized upon the disposition of the API is attributable to any asset not held for portfolio investment on behalf of third party investors); or (2) a transaction or series of transactions has taken place with a principal purpose of avoiding potential gain recharacterization under section 1061(a). The Look-through Rule similarly applies with respect to a Passthrough Interest issued by an S corporation or a PFIC to the extent the Passthrough Interest is treated as an API. The final regulations also simplify the method for applying the Look-through Rule.

4. **Transfers to Related Parties**. Proposed Regulation Section 1.1061-5(a) provides that if an Owner Taxpayer transfers any API, or any Distributed API Property, directly or indirectly, to a Section 1061(d) Related Person, or if a Passthrough Entity in which an Owner Taxpayer holds an interest, directly or indirectly, transfers an API to a Section 1061(d) Related Person, regardless of whether gain is otherwise recognized on the transfer under the Code, the Owner Taxpayer must include in gross income as short-term capital gain, the excess of (1) net long-term capital gain with respect to such interest for such taxable year, over (2) any amount treated as short-term capital gain with respect to the transfer of such interest. The final regulations provide that the Section 1061(d) Recharacterization Amount includes only long-term capital gain that the Owner Taxpayer recognizes under chapter 1 of the Code upon a transfer through a sale or exchange of an API to a Section 1061(d) Related Person. The final regulations provide that, if section 1061(d) applies, an Owner Taxpayer's Section 1061(d) Recharacterization Amount is the Owner Taxpayer's share of the amount of net long-term capital gain from assets held for three years or less that would have been allocated to the Owner Taxpayer with respect to the transferred API if the partnership had sold all of its property in a fully taxable transaction for cash in an amount equal to the fair market value of such property immediately prior to the Owner Taxpayer's transfer of the API (or a portion of such gain if only a portion of the API is transferred). Thus, only gain that would otherwise be treated as long-term gain is recharacterized under section 1061(d).

IRS Issues Final Business Interest Expense Deduction Limitation Regulations

The IRS has issued final Treasury regulations that provide guidance on the business interest expense (BIE) deduction limitation after changes made to Section 163(j) by the TCJA, and the Coronavirus Aid, Relief, and Economic Security Act (CARES Act). Section 163(j) generally limits the amount of business interest allowed as a deduction to 30% of adjusted taxable income. The amount allowed as a deduction for BIE is limited to the sum of (1) the taxpayer's business interest income (BII) for the taxable year; (2) 30% of the taxpayer's adjusted taxable income (ATI) for the taxable year (30% ATI limitation); and (3) the taxpayer's floor plan financing interest expense for the taxable year (in sum, the Section 163(j) limitation). The CARES Act temporarily and retroactively increased the limitation on the deductibility of interest expense under Section 163(j)(1) from 30% to 50% for tax years beginning in 2019 and 2020. Under a special rule for partnerships, the increase in the limitation will not apply to partners in partnerships for 2019 (it applied only in 2020). The final regulations address proposed regulations that were issued in August 2020 (2020 Proposed Regulations). (See our prior coverage here.)

Generally, the final regulations (i) provide clarifications to the ATI computation and provide new examples demonstrating the application of such, and (ii) discuss the application of the rules to regulated investment companies (RICs) and other pass-through entities (like partnerships and S-Corporations), and to foreign corporations and U.S. shareholders.

With respect to RICs, the 2020 Proposed Regulations provide rules under which a RIC that earns BII may pay Section 163(j) interest dividends. The total amount of a RIC's Section 163(j) interest dividends for a taxable year is limited to the excess of the RIC's BII for the taxable year over the sum of the RIC's BIE for the taxable year and the RIC's other deductions for the taxable year that are properly allocable to the RIC's BII. The 2020 Proposed Regulations provide that a RIC shareholder that receives a Section 163(j) interest dividend may treat the dividend as interest income for purposes of Section 163(j), subject to holding period requirements and other limitations. The final regulations decline to extend such conduit treatment to other entities such as foreign regulated investment funds and foreign money market funds, but the Treasury Department and the IRS continue to study this issue. Additionally, the final regulations note that the Treasury Department and the IRS are still considering whether to extend this conduit treatment to REITs.

With respect to trading partnerships, the final regulations address commenter concerns about the interaction between this Section 163(j) limitation, which applies at the partnership level, and the Section 163(d) partner-level limitation on interest expense that existed prior to TJCA. The final regulations provide that interest expense at the partnership level that is allocated to non-materially participating partners subject to Section 163(d) is not included in the Section 163(j) limitation calculation of the partnership. Generally, the Section 163(d) limitation is more generous than the Section 163(j) limitation.

Lastly, with respect to foreign entities, the proposed regulations provided that the deductibility of BIE for a controlled foreign corporation (CFC) was determined in the same manner under these rules as it was for a domestic corporation. With respect to CFC groups, the final regulations provide that taxpayers may elect to apply the Section 163(j) rules to CFC groups on an aggregate basis, similar to the rules applicable to U.S. consolidated groups. As such, a single Section 163(j) limitation is computed for a CFC group by summing the items necessary for this computation (for example, current-year BIE and ATI) across all CFC group members. The CFC group's limitation is then allocated to each CFC member using allocation rules similar to those that apply to U.S. consolidated groups. The final regulations note that this consolidated approach applies only for purposes of computing the Section 163(j) limitation and not for purposes of applying any other Code provision, such as Section 951 or 951A. Additionally, the final regulations provide that the ATI of a CFC is determined without regard to a deduction for foreign income taxes that are eligible to be claimed as a foreign tax credit.

IRS Updates Guidance Based on New PPP Rules

The IRS released Revenue Ruling 2021-02, which obsoletes Notice 2020-32 and Rev. Rul. 2020-27, due to the enactment of Section 276(a) of the COVID-related Tax Relief Act of 2020 (Act), enacted as Subtitle B of Title II of Division N of the Consolidated Appropriations Act, 2021 (Dec. 27, 2020). (See our prior coverage here.) Notice 2020-32 and Rev. Rul. 2020-27 provide that certain taxpayers (eligible recipient) may not deduct certain otherwise deductible expenses to the extent that the payment of such expenses results (or is expected to result) in the forgiveness of a loan guaranteed under the Paycheck Protection Program. However, due to the changes under Section 276(a) of the Act, no amount shall be included in the gross income of the eligible recipient by reason of forgiveness of indebtedness. In addition, no deduction shall be denied, no tax attribute shall be reduced, and no basis increase shall be denied, by reason of the exclusion from gross income. This change applies to taxable years ending after March 27, 2020.

CA Updates Guidance on Changes in Accounting Periods or Methods

The California Franchise Tax Board has issued Notice 2020-04, which updates its guidelines for taxpayers requesting a change of accounting period or method. The notice clarifies that a proper election filed with the IRS will apply for California purposes without any action by the taxpayer, as long as California has confirmed to the underlying law that is being applied.

DE Court Holds DOR NOL Limitation Policy Violates the DE Constitution's Uniformity Clause

The Delaware Superior Court has held in Verisign, Inc., v. Director of Revenue, that the Delaware Division of Revenue's policy of limiting the amount of a consolidated group's net operating loss (NOL) that a consolidated group member may claim on its Delaware separate-company income tax return violates the Delaware Constitution's Uniformity Clause.
For federal income tax purposes, corporations can join with groups of affiliated corporations to file consolidated income tax returns with the Internal Revenue Service. On these consolidated returns, groups can claim consolidated NOL deductions. In Delaware, group members must file separate-company income tax returns with the Delaware Division of Revenue (the Division). If a member claims a separate-company NOL deduction, the Division limits it to the amount of the consolidated NOL deduction that the member's group claimed on its consolidated income tax return. The Delaware Superior Court held that the policy violated the Delaware Constitution's Uniformity Clause because it is treating Delaware corporate taxpayers that file separate returns differently from those Delaware corporate taxpayers that file consolidated returns.