

The background of the slide is a high-angle, close-up photograph of a workspace. In the upper left, a white computer mouse sits on a light-colored wooden desk. To its right, a silver laptop is partially visible, showing its keyboard and trackpad. A pair of white earbuds lies on the desk between the mouse and the laptop. In the bottom right corner, a white ceramic cup filled with dark coffee sits on a matching saucer. A semi-transparent blue rectangular box is overlaid on the left side of the image, containing the event title and speakers' names.

VIRTUAL COFFEE TALK:

Section 1061 Proposed Carried Interest Regulations

Kevin M. Jacobs and Drew Johnson, Alvarez & Marsal Taxand
Kevin Deyoung, Wolters Kluwer

Oct. 22, 2020 | 11:00 a.m. to 12:00 p.m. ET



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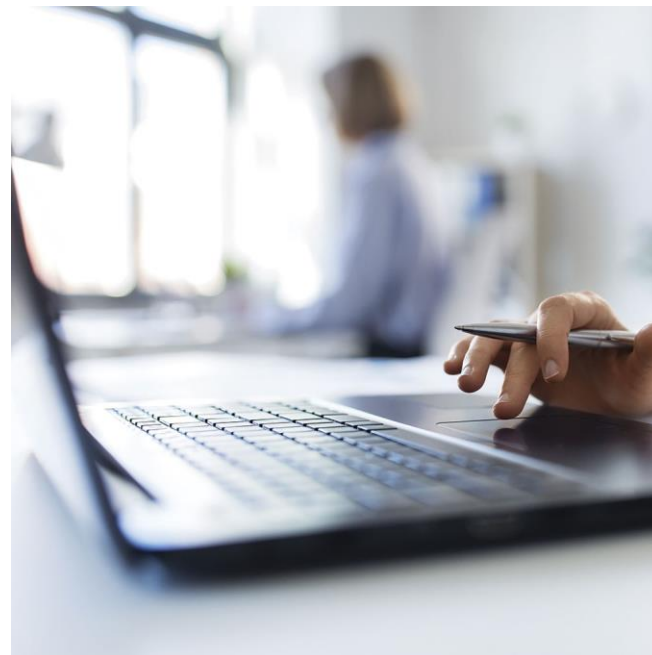
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Agenda

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The who, what and when of section 1061

2

Applicable partnership interests (API)

3

Holding period

4

Certain income excluded from section 1061

5

Related party transfers and carry waivers

The who, what and when of section 1061?

Who does section 1061 apply to

- The holder of an applicable partnership interest (API)

What happens if section 1061 applies

- Section 1061 recharacterizes API Gain or Loss
(long-term capital gains or losses with a holding period
of less than three years) as short-term capital gains or losses

When does section 1061 apply

- Section 1061 applies to tax years beginning after Dec. 31, 2017
(there is no grandfathering of interests issued prior to this date)

POLLING QUESTION

How has the section 1061 carried interest rules impacted you or your client's structure or deals?

- ☐ The extra costs have been considered in both new & old deals and structures
- ☐ The extra costs have been considered in only new deals and structures
- ☐ The rules have not had an impact yet, but things could change
- ☐ I'm trying to figure out the scope of the rules
- ☐ No impact to how I, or my clients, will be doing business

The real what: what is an API?

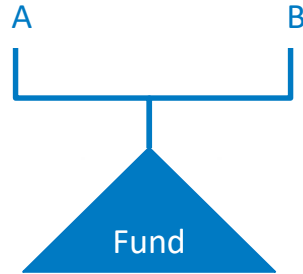
- An API is a partnership interest that is
 1. Directly, or indirectly, transferred to or held by a taxpayer
 2. In connection with the performance of substantial services by the taxpayer or a related person
 3. In any applicable trade or business (ATB)
- Once a partnership interest is characterized as an API, it remains an API unless an exception applies



Types of APIs

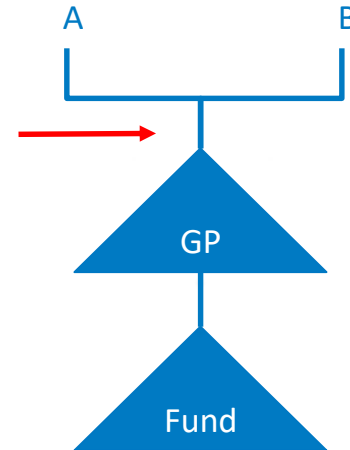
Direct API

An interest held directly in the partnership that allocates the carried or profits interest.



Passthrough API

An interest in a partnership that holds (directly or indirectly) an interest in a Direct API).



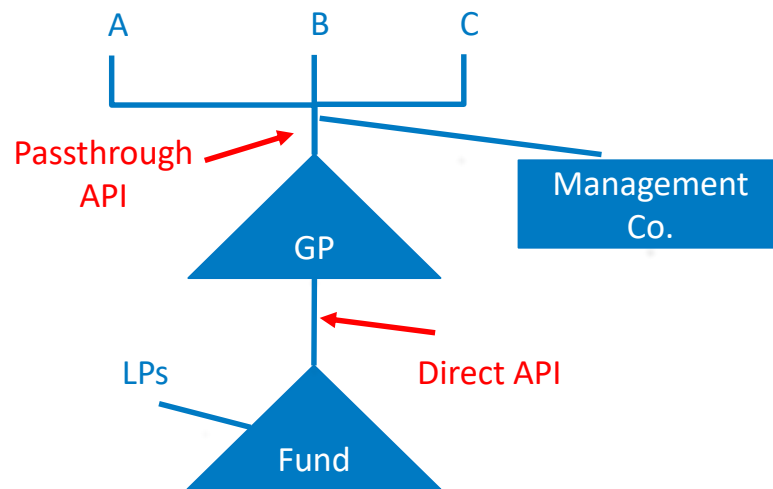
The real what: what is an ATB?

- An ATB is any activity conducted on a regular, continuous, and substantial basis, directly or through one or more entities, whose activities consist of:
 1. Raising or returning capital, and
 2. Investing in, disposing of, or identifying specified assets or developing specified assets



Tiered partnership illustration

- A, B, and C own interests in GP
- GP has to perform services to Fund
 - Received an interest in LP in connection with services
 - Delegated all services to Management Co
- Activities of Management Co are attributed to GP, which result in:
 - GP is treated as engaging in an ATB
 - GP's interest in Fund is a Direct API
 - A's, B's and C's interest in GP is a Passthrough APIs
 - Recharacterization of any API gains or losses occurs at this level



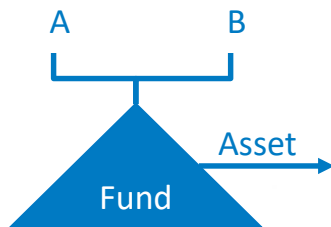
API exclusions

- Generally, a partnership interest held by a corporation
- Partnership interests held by employee of an entity conducting non-ATB services and that person provides services only to that entity
- Certain bona fide purchasers of an API

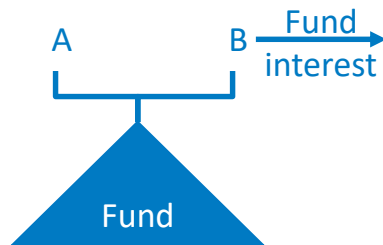


Holding period ... it's as easy as 1 ... 2 ... 3 years

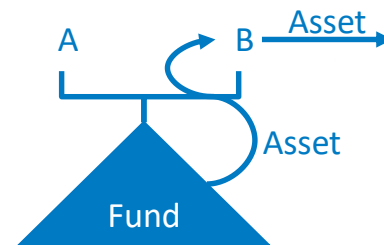
To identify the relevant holding period generally focus on what is sold.



If a partnership sells an asset, the holding period of the asset is relevant



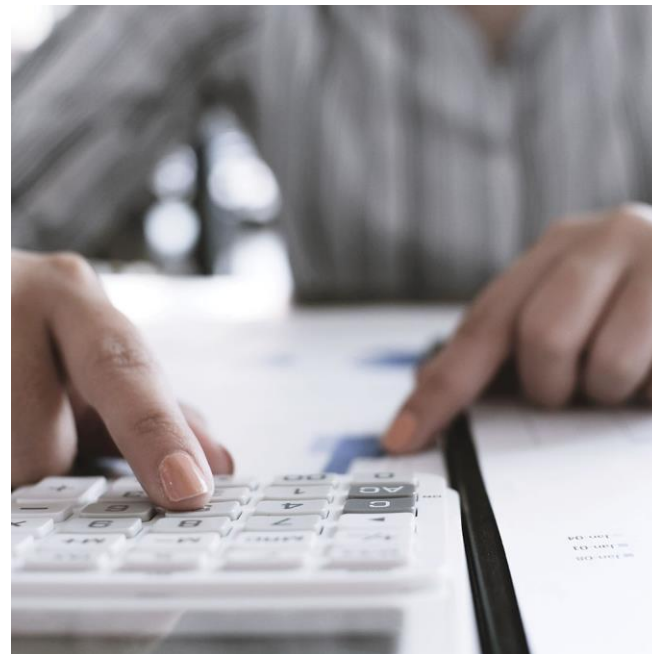
If a partner sells its API, the holding period of the API is generally relevant



If an asset is distributed and the API holder sells the asset, the asset's holding period is relevant

Holding period ... sale of an API

- Generally, if API is sold, then the holding period of the interests sold
 - How do you determine the holding period
 - Based on date acquired
 - Special rule if taxpayer acquires API over time
 - Limited look-through rule



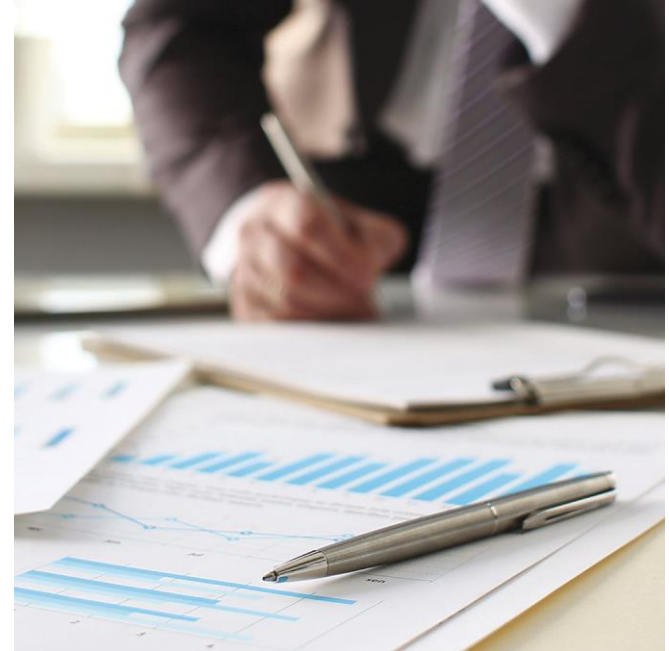
POLLING QUESTION

With the election looming, what do you think will happen to income and capital gain tax rates?

- ☐ Rates will generally remain the same over the next four years
- ☐ Rates will increase within 2021
- ☐ Rates will increase within 2022
- ☐ Rates will increase sometime after 2022

Certain income taxed at capital gain rates is excluded from section 1061

- Short-term capital gains and losses
- Section 1231 gains
- Gains on section 1256 straddles
- Qualified dividend income
- Capital gains and losses characterized without regard to holding period

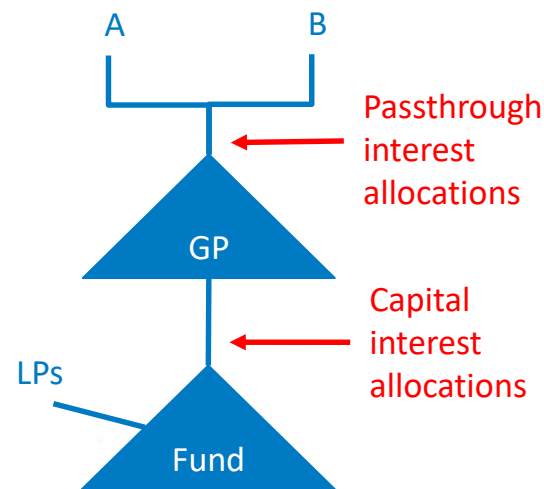


Capital Interest Allocations

- Exempt from carried interest rules
- Narrowly defined
 - Based on respective capital account balances
 - Service provider's contributed capital cannot be borrowed from or guaranteed by another partner or related party
 - Generally must track allocations to partnership interests owned by significant non-service provider partners
 - Should be clearly identified in partnership agreement

Passthrough Interest Allocations

- Exempt from carried interest rules
- Passthrough capital allocations
 - Allocations of capital interest allocations made up the chain
- Passthrough interest direct investment allocations
 - Allocations of LTCG or LTCL that are made in the same manner based on each direct owner's capital account and that are derived from a non-API asset that is held directly by Passthrough entity



Recharacterization of gain or loss from dispositions of API

If partner sells a partnership interest that includes right to Capital Interest or Passthrough Interest Allocations then portion that is Capital Interest Disposition Amount may be exempt.



Capital Interest Disposition Amount calculation

Three “easy” steps to determine the Capital Interest Disposition Amount

1. Determine the long-term capital gain or loss that would be allocated to the interest sold if all assets were sold at FMV immediately before the disposition (including section 1231 and 1256 gains and capital gain and loss determined at lowest tier)
2. Determine the gain or loss that would be allocated to the interest that would be characterized as a Capital Interest or Passthrough Interest Allocation if all assets were sold at FMV immediately before the disposition (excluding Section 1231 and 1256 gain and capital gain and loss determined at lowest tier)
3. $\text{LTCG/LTCL on the disposition} * \left(\frac{\text{Step 2 amount}}{\text{Step 1 amount}} \right)$
 - If Step 2 produces a gain but the sale produces a LTCL, that loss is all API
 - If Step 2 produces a loss, but the sale produces LTCG, that gain is all API

Related Party Transfers of APIs

- Upon a transfer to a related party, the transferor must take into account STCG = net built-in LTCG in assets held for three years or less attributable to transferred interest – LTCG already treated as STCG under section 1061
- “Transfers” include both taxable transactions and nonrecognition transactions such as contributions (except contribution to a partnership), distributions, and gifts trigger section 1061

Carry waivers

- Definition
 - Provision that allows sponsor to waive its right to allocations with respect to its carried interest of gain from the sale of capital assets held for three years or less and receive in the future allocations of such gain from the sale of capital assets held for more than three years
- Response
 - No regulatory change
 - Preamble: Taxpayers should be aware that these and similar arrangements may not be respected and may be challenged under section 707(a)(2)(A), §§1.701-2 and 1.704-1(b)(2)(iii), and/or the substance over form or economic substance doctrines

POLLING QUESTION

How do you communicate regulatory updates with your clients, if you are a practitioner, or within your company or portfolio company?

- ☐ Personally created email
- ☐ Newsletter
- ☐ Third-party created content
- ☐ I don't communicate these changes

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Virtual Coffee Talk: Section 1061 Proposed Carried Interest Regulations

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Kevin M. Jacobs

Kevin M. Jacobs is a Managing Director with Alvarez & Marsal Taxand in Washington D.C. and the National Tax Office Practice Leader. He brings more than 15 years of experience in tax matters in both the public and the private sector.

Prior to joining A&M, Mr. Jacobs was a Senior Technician Reviewer (TCJA) with the IRS Office of Associate Chief Counsel (Corporate) for more than six years, where he advised on tax issues such as corporate re-organizations and corporation-shareholder issues, earning and profits, recovery and allocation of stock basis, liquidations, redemptions, bankruptcies, spin-offs and consolidated returns.

Mr. Jacobs was the principal Associate Chief Counsel (Corporate) attorney on several regulatory projects including the proposed section 382(h) regulations on built-in gains and losses, the global intangible low-taxed income regulations, and debt-equity regulations. He provided substantial contributions to numerous other guidance projects, such as the limitation on interest deductions regulations, and assisted in overseeing the Corporate Division's response to TCJA, including the coordination with Treasury's Offices of Tax Legislative Counsel and International Tax Counsel. Previously, Mr. Jacobs spent more than nine years at law and certified public accounting firms (Ropes & Gray LLP, Latham & Watkins LLP, Dewey Ballantine LLP and Arthur Andersen LLP).

Mr. Jacobs earned a bachelor's degree in accounting, a master's degree in accounting (with a concentration in taxation), a J.D. (magna cum laude) from the University of Florida and an LL.M. in taxation from New York University. He is admitted to practice before multiple courts, including the Supreme Court of the United States, the U.S. Tax Court and the U.S. Court of Federal Claims. He is admitted to the District of Columbia and Florida Bars and is a licensed Certified Public Accountant (CPA) in Florida and Colorado. Mr. Jacobs is a member of several organizations including the American Bar Association and the New York State Bar Association. He is also a frequent speaker on numerous corporate transaction tax matters.



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Drew Johnson

Drew Johnson is a Managing Director with Alvarez & Marsal's Global Transaction Tax practice in Washington DC.

With almost 20 years of experience, Mr. Johnson advises clients in planning for complex transactions and provides a full range of tax services that encompass transaction diligence, structuring, implementation and preparation of the related tax returns. In particular, Mr. Johnson has worked with companies regarding partnership tax issues, sports tax issues, real estate and infrastructure issues. He also has expertise in responding to Internal Revenue Service (IRS) audits and preparing GAAP income tax provisions.

Mr. Johnson's practice is focused on transaction diligence and structuring for private equity clients. Most recently, he has provided technical partnership on a wide range of mergers and acquisitions activity across A&M's transaction practice.

Outside of his transaction practice, Mr. Johnson's notable assignments include: advising a professional sports league on tax issues relating to the relinquishment of its tax exempt status; preparing the income tax return for a professional sports league; assisting on certain partnership issues relating to a major contribution of railcars to a shipping company; helping an international energy company on tax issues relating to the division of one of the largest oil refining and distribution joint venture partnerships in the United States; serving in a tax-director-equivalent role for a private equity fund, where he was responsible for managing its tax compliance and audit defense functions; advising a high-net worth family on its real estate and hotel investments.

Prior to joining A&M, Mr. Johnson spent seven years with Covington & Burling, where he served as a member of its tax and insurance practice groups. Previously, he was a law clerk for the Honorable Emilio M. Garza of the U.S. Court of Appeals for the Fifth Circuit. Before law school, Mr. Johnson spent three years with the tax practice of Arthur Andersen.

Mr. Johnson earned a bachelor of business administration degree (summa cum laude) from the College of William & Mary. He earned a law degree from the University of Virginia, where he was an Articles Editor of the Virginia Law Review and a member of the Order of the Coif, and earned an Executive LL.M. in taxation from the NYU School of Law. Mr. Johnson is a Certified Public Accountant (CPA) in Virginia and is a member of both the Virginia State Bar and the District of Columbia Bar.



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