SBIA
SMALL BUSINESS
INVESTOR ALLIANCE

Friday, January 8, 2021

Final 1061 Carried Interest Regulations

The IRS on January 7, 2021, submitted for official publication final regulations regarding Section 1061 of the Internal Revenue Code (26 U.S.C. 1061) on the tax treatment of certain partnership interests (i.e., "carried interest") held in connection with the performance of services. This Code section extends the holding period requirements from one-year to three-years for taxpayers to receive long-term capital gains treatment for gains on carried interest in an applicable partnership interest ("API").

SBIA filed a comment letter last October with the IRS regarding its regulatory proposal, and the SBIA letter had a direct impact because the final rule incorporates several of SBIA's key recommendations:

- *Capital Interest – "in the same manner" requirement*. The final rule replaced this proposed language with a more flexible "in a similar manner" requirement for calculating capital interest for an API Holder's allocation. Specifically, the final regulations provide that capital interest allocations "must be commensurate with capital contributed in order to qualify for the capital interest exception" and "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. In this regard, the allocations and distribution rights with respect to API Holders' capital interests and the capital interests of Unrelated Non-Service Partners who have made significant aggregate capital contributions *must be reasonably consistent*." (Final Rule at 17). The SBIA's letter called on regulators to "provide additional flexibility and clarity" to limit potential negative impacts on existing partnership agreements.

- *Capital Interest Exception Exclusion – Loans by Partners/Partnerships*. The final rule doesn't eliminate the exclusion but regulators took SBIA's counsel and narrowed the scope significantly. The final rule provides that an allocation will remain under the capital interest exemption if it 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…if the individual service provider is "personally liable for the repayment" of the loan or advance. The rule includes a new three-prong test for determining "personally liable": (i) loan is fully recourse to the individual service provider; (ii) no right to reimbursement from any other person; and (iii) the loan/advance is not guaranteed by any other person. (Final Rule at 31).

Read IRS Final Rule >
Read SBIA Comment Letter >