

## Section 1061 – Carried Interest Update

The Internal Revenue Service (IRS) has released Notice 107213-18 adding much needed clarification related to IRC Section 1061 – Partnership interests held in connection with performance of services. Section 1061, introduced with the Tax Cuts and Jobs Act (TCJA) of 2017, drastically changed the taxation of “Carried Interests” and widely affects the alternative investment space. In general, Section 1061 addresses income earned by an Applicable Partnership Interest (API) via a performance allocation (Carried Interest) and recharacterizes certain long-term capital gains as short-term capital gains. **Fund administrators may need to change the way they are tracking interests to benefit from this update before the end of the year.** The tax experts at Richey May have detailed the most relevant factors from this section for investment funds below.

### **What Is Applicable Partnership Interest (API)?**

The concept of Applicable Partnership Interest (API) is not necessarily a new concept to the tax code. The principles behind an API are unchanged when referring to a partner’s “Profits Interest” in the partnership. Meaning, the partner is deemed to obtain partnership interest directly or indirectly by way of performance of services within the trade or business, typically effecting the General Partners of the partnership. Upon the enactment of 1061, this is the portion of interest that the service is deeming to be API.

### **Separately Tracking API And Proposed Regulations**

Before the service released the proposed regulations, there was ambiguity regarding an effective strategy for general partners tracking their API interest separately from their allocated capital interest. The proposed regulations clarified that in order to properly bifurcate a general partner interest between an API and a capital interest that the books and records must separately track these interests. **As a result of this clarification, it will become important for fund administrators to separately track APIs from capital interests.**

### **Can API Be Reclassified As Capital Interest?**

In short, it’s complicated. The proposed regulations do clarify that once an API, always an API. In other words, **the amount earned as a carried interest cannot be reclassified to a capital interest.** However, **proper tax planning may help to eliminate the three-year rule for future appreciation on carried interest that is re-invested into the fund.** Although such rules still lack ultimate clarity, the proposed regulations seem to allow for a strategy that would consist of recapitalizing an API into a capital interest for future appreciation. For example, if the general partner earned a \$100 API in year one and re-invested that amount into the fund, then in year two they would earn \$10 appreciation on the \$100 API. It is clear

from the proposed regulations that the entire \$100 API is subject to the three-year rule, but with proper planning, the \$10 appreciation may be subject to a one-year rule.

It is important to note that these are proposed regulations and may be subject to change. However, regardless of the changes, Section 1061 is here to stay. These rules are complicated, so reach out to your tax team at Richey May & Co. or [Steve Vlasak](#) to help determine the best solution for you and your fund before the end of the year.