

# Tax Reform: Carried Interest

## *Small Change to Carried Interest Should Not Materially*

### *Dampen Cap Gains Benefit*

Last updated: June 1, 2018

## Executive Summary

- Under section 13309 of the Tax Cuts and Jobs Act (H.R. 1), signed into law in December 2017, carried interests (*i.e.*, partnership interests received in connection with the performance of services) are generally taxed at lower long-term capital gains rates (not ordinary income rates) if the investment meets a new duration test - three or more years (rather than one year under the old law).
- The new three-year holding period is effective for tax years beginning after December 31, 2017.
- Loss of long-term capital gain treatment under this rule causes such gain to be classified as short-term capital gain, but does not cause such gain to be subject to a self-employment tax.
- The three-year holding period applies notwithstanding the rules of section 83 (relating to property transferred in connection with the performance of services) or any election under section 83(b).
- A special disposition rule applies to related-party dispositions of such interests in a manner analogous to the “hot asset rules.”

### CARRIED INTEREST

#### QUICK FACTS

- Carried interests must be held for at least three years in order to qualify for tax treatment as long-term capital gain.
- The IRS has announced that it will issue regulations providing that S-corporations are subject to the longer three-year holding period.

## Next Steps

- **Implementing the New Tax Law:** H.R. 1 authorizes the Treasury Department to issue “such regulations or other guidance as is necessary or appropriate to carry out the purposes” of the new carried interest rule in the tax code. As of March 1, 2018, the IRS has announced that it will issue regulations under IRC § 1061 providing that S corporations are subject to the longer three-year holding period for carried interests. The Treasury Department may issue additional regulations or guidance that will be helpful to companies implementing the new structure.
- **Technical Corrections Legislation:** There were several technical correction issues identified in the first weeks post the law’s enactment. To address these issues legislatively, 60 votes in the Senate likely will be required. Therefore, passage of any such bill in this mid-term election year will be a difficult process. Congressional staff has started working on a corrections bill should a bipartisan deal be reached during the lame-duck Congressional session after the election.

## CREFC Policy & Strategy

To the extent CREFC members identify the need for technical corrections, regulatory guidance and/or additional clarity with respect to the carried interest provisions under the new tax law, CREFC will remain engaged throughout any regulatory and/or technical corrections processes to ensure these provisions are implemented in a clear, workable, beneficial manner.

## **Additional Background & History**

- Carried interest—income flowing to the general partner of a private investment fund (beyond any management fee)—is generally treated as capital gains for the purpose of taxation. A fund typically uses the carried interest to pass through its net capital gains to the general partner, who, in turn, passes the gains on to the investment managers. The managers pay tax on these returns as capital gains.
- Real estate partnerships frequently utilize carried-interest structures (generally called a “promote” in the real estate context). Eliminating the tax preference for carried interest would harm real estate partnerships by increasing the tax burden on managers.
- During the tax reform debate, a number of lawmakers argued that the tax preference for carried interest is an unfair “loophole”, and said it would be fairer and more efficient for carried interest to be taxed like wage and salary income. CREFC argued during the tax reform debate that long-term capital gains treatment of carried interest promotes investment in different industries, including real estate, and rewards investors for the growth they have helped foster.
- Despite intense pressure on lawmakers to totally eliminate preferential treatment for carried interest in order to offset the revenue effects of various tax reductions in HR 1, CREFC and our industry group partners were ultimately successful in preserving long-term capital gains treatment of carried interest, albeit with a three-year, rather than one-year, holding period. Preserving this important provision was key to our goal of minimizing market disruption for CREFC members and the real estate investment industry as a whole.

## CREFC Resources

[Step toe & Johnson Memo on CRE-related Tax Issues, December 4, 2017](#)

[CREFC Side-by-Side Comparing Various Tax Vehicles, December 4, 2017](#)

For further information, see CREFC’s Resource Center at: <https://www.crefc.org/library>

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