Tax Reform Impact on Carried Interest for Investment Managers

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The federal tax reform legislation that became law on December 22, 2017 contains a provision that will impose a new limitation on investment managers with respect to capital gains derived through carried interests in investment partnerships.

Beginning on January 1, 2018, an investment manager generally will recognize long-term capital gain with respect to a carried interest in an investment partnership only to the extent that the capital asset from which such capital gain is derived was held for *more than three years* (as opposed to more than one year, under current law). Carried interest that is not attributable to "three-year property" generally will be taxable as short-term capital gain for federal income tax purposes at the applicable ordinary income rate (max. 37%). If states and localities adopt this rule, carried interest should be similarly re-tested/recharacterized for state and local income tax purposes; in other cases, carried interest could be treated differently for federal and state/local income tax purposes to the extent that a non-federal taxing jurisdiction continues to apply the one-year holding period for long-term capital gain treatment.

This change in the law should not affect carried interests in funds that hold (or plan to hold) assets for more than three years or for one year or less. Furthermore, the new law is silent with respect to gain derived from assets that yield long-term capital gain without regard to the holding period (*e.g.*, 1256 contracts). The principal focus, therefore, is on carried interests in capital gain derived from assets that are held from 1-3 years.

Importantly, the new law only applies to carried interest (defined by the new legislation as partnership interests issued in connection with the performance of services in the business of raising or returning capital or investing in or disposing of certain assets, such as securities, commodities, real estate held for rent or investment, cash and cash equivalents, options and derivatives in reference to any of the foregoing items). It generally does not change the one-year holding period for long-term capital gain treatment for federal income tax purposes in other contexts (*e.g.*, as it applies to outside investors).

At this point, there is no interpretive guidance beyond the text of the new statute (which, again, goes into effect on January 1, 2018). Congress may introduce technical corrections, and the Treasury Department and Internal Revenue Service may issue regulations and/or other guidance, but at this time, we do not know if or when such additional guidance may be issued.

Nothing herein is intended to be, or should be construed as, tax, legal or investment advice. Investment managers should consult with their own tax advisors to understand fully the potential impact of this new law based on their own circumstances, and to determine whether, and to what extent, there are any planning opportunities for the end of 2017 or going forward.

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