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Treasury and IRS Issue Guidance Concerning Carried Interests Held Through S-Corporations

March 14, 2018

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On March 1, 2018, the Treasury Department and the IRS issued an advanced version of Notice 2018-18, stating that forthcoming Treasury regulations would provide that applicable partnership interests, commonly referred to as carried interests, held by S-corporations will be subject to the three-year holding period requirement to achieve long-term capital gain treatment under Code Section 1061. Such Treasury regulations will have a retroactive effective date, applicable to all tax years beginning after December 31, 2017.

Currently, Code Section 1061, enacted under the Tax Cuts and Jobs Act (TCJA), includes a broad exception to the three-year holding period requirement for long-term capital gain treatment in the case of applicable partnership interests held directly or indirectly by corporations. (Click ***here*** for a more detailed discussion of the new holding period rules and the corporate exception.) Such corporate exception generally is viewed as appropriate in the case of an applicable partnership interest held by a C-corporation because, if an individual holds the interest directly or indirectly through a C-corporation, the gain with respect to the interest would be subject to federal income tax in the hands of the C-corporation, and the individual shareholder would be subject to a second level of federal income tax when the C-corporation's earnings are distributed, resulting in an effective maximum federal income tax rate of 36.8% on such gain.[1] In other words, the ownership of an applicable partnership interest by a C-corporation precludes an individual shareholder from achieving a 20% federal income tax rate on gains attributable to the interest without satisfying the three-year holding period, which is the very result that Congress intended to limit by including new Code Section 1061 in the TCJA.

The language in the statute, however, does not expressly limit the corporate exemption solely to applicable partnership interests held by C-corporations, but applies to all applicable partnership interests held directly or indirectly by a "corporation." Assuming the term "corporation" also includes an S-corporation, individuals easily could evade the three-year holding period for long-term capital gain with respect to applicable partnership interests by interposing an S-corporation, which generally is treated as a pass-through entity for federal income tax purposes, as a direct or indirect owner of an applicable partnership interest. As a result, gains attributable to the applicable partnership interest would be long-term capital gain if the underlying property were held more than one year, and the individual S-corporation shareholder would be subject to tax on such gain at a 20% federal income tax rate. The practical result of including S-corporations within the scope of the corporate exception is that the application of the new three-year holding period essentially would become elective.

Although Notice 2018-18 threatens to close this potential opportunity for individual taxpayers, including fund managers, it was hardly unexpected. Almost immediately after the TCJA was enacted, commentators widely agreed that the corporate exception should apply to C-corporation owners, only, and the application of the corporate exception to S-corporations was largely perceived to be an unintended drafting error in the TCJA. In February, Steve Mnuchin confirmed this view in a public statement and promised that future guidance would close the loophole for S-corporations.

Still, despite Mr. Mnuchin's public statement and the release of Notice 2018-18, the application of the corporate exception to S-corporations remains uncertain. Treasury regulations are given the full force and effect of law only to the extent they are not in conflict with the Code. Excluding S-corporations from the term "corporation" for purposes of the corporate exemption under Code Section 1061 reasonably can be interpreted as conflicting with the plain meaning of that Code section, and therefore it may be necessary for Congress to amend the TCJA in order to effect this change. Accordingly, individual taxpayers, including fund managers, that hold applicable partnership interests directly or indirectly through S-corporations, and expect to recognize gains with respect to partnerships interest they have held for more than one than one year, but not for more than three years, may be motivated to challenge this attempt by the Treasury Department and the IRS to close the S-corporation loophole without the help of Congress.

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1 All income tax rates provided herein are exclusive of the Medicare tax on unearned income.