



Carried interest and accredited investor update

Muhammad Akram of Akram Assurance addresses the IRS restricting carried interest of preferential tax treatment and the SEC expanding the 'accredited investor' definition earlier this year

The IRS proposed guidance under section 1061, often referred to as the 'carried interest' rules. The IRS proposed regulations to restrict a beneficial tax break for hedge fund managers.

Proposed regulations amend existing regulations on holding periods to clarify the holding period of a partner's interest in a partnership that includes applicable partnership interest and/or profits interest. An applicable partnership interest (API) is an interest in a partnership that is held by a taxpayer in connection with the performance of substantial services.

An API resulting from the performance of investment services, carried interest, is to be held for more than three years to qualify for long-term capital gain treatment. The proposed regulations clarify how to apply the holding period when a partner holds an API for fewer than three years, but the partnership sells an asset it held for more than three years. The proposed regulations provide that once a partnership interest is characterised as an API, it remains an API and never loses that characteristic. If the retired partner continues to hold the partnership interest, it remains an API.

Section 1231 gain, Section 1256 gain, and qualified dividends are not subject to the recharacterisation rules of Section 1061.

An S corporation is not a corporation

An API does not include any interest in a partnership directly or indirectly held by a corporation. The IRS notified taxpayers that, for purposes of Section 1061, the term 'corporation' does not include an S corporation. Carried interests held by an S corporation are subject to the three-year holding period requirement.

Investment partnerships are required to provide taxpayers with the information necessary in which a taxpayer holds an API. This information includes:

- The API one-year distributive share amount
- Three-year distributive share amount
- Long-term capital gains and losses allocated to the

taxpayer that are excluded from IRC Section 1061

- Capital interest gains and losses allocated to the taxpayer.

The Securities and Exchange Commission (SEC) recently adopted amendments to the 'accredited investor' definition. Individual investors who did not meet net worth or income tests, no matter their financial situation, were denied investment opportunities.

These amendments are a way for the SEC's effort to improve and simplify the investment offering structure. The SEC wanted to expand investment opportunities while retaining sufficient investor protections and promote capital formation.

Amendments to the accredited investor definition:

- qualify with credentials, designations, or professional certifications
- included 'knowledgeable employees' with investments in a private fund
- LLCs with \$5m in assets
- state-registered investment advisers, exempt reporting advisers and rural business investment companies (RBICs) entities that may qualify
- added Indian tribes, governmental bodies, funds and entities organised under the laws of foreign countries, with 'investments' of \$5m, and not formed for the specific purpose of investing in the securities offered
- 'family offices' with at least \$5m in AuM
- introduced 'spousal equivalent' so they may pool their finances.

The amendments expand the definition of 'qualified institutional buyer' in Rule 144A to include LLCs and RBICs if they meet the \$100m in securities owned and invested threshold in the definition. Investment managers should update the subscription agreements to reflect the expanded accredited investor definition on the effective date. Please reach out to your legal counsel for amending the subscription documents.