



# Tracking Tax Reform: Capital Gains from Certain Partnership Profits Interests Subject to Extended Holding Period for Favorable Tax Treatment under the Tax Cuts and Jobs Act

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Under the “Tax Cuts and Jobs Act”, the recently enacted federal tax reform legislation (the “Act”), a new limitation applies to profits interest awards. Under the Act, income from “applicable partnership interests” will not receive favorable long-term capital gains treatment unless an extended three-year holding period is satisfied. The Act defines an “applicable partnership interest” as including a profits interest granted in connection with performance of certain investment services, which is widely recognized as being intended to include “carried interest” compensation arrangements, which are common among private equity funds, hedge funds and similar investment partnerships.

In general, equity awards received as compensation for services, which would include partnership profits interests, are subject to personal income tax based on the fair market value of such equity at the time of grant or when any applicable vesting restrictions lapse, as the case may be.<sup>1</sup> Existing federal tax law permits holders of partnership profits interests to be allocated income from the partnership in the same manner as any other partner. The character of the income allocated to such partner (i.e., ordinary, short-term capital gain or long-term capital gain) will depend on the nature of the income derived from the partnership’s operations or investments.

The IRS previously provided guidance with respect to the receipt of partnership profits interests and the potential recognition of income tax from such grant. Revenue Procedure 93-27 permits the recipient of a partnership profits interest to assign a zero value to the profits interest award on the date of grant, provided certain conditions are met.<sup>2</sup> If the requirements of Revenue Procedure 93-27 are satisfied, any income allocated from the partnership will be the same for the service recipient as any other partner.<sup>3</sup>

The Act changes existing law with respect to recipients of profits interests granted in exchange for investment services. Investment services include raising capital and investing in, disposing of, identifying or developing investment assets such as securities, commodities, or real estate assets.<sup>4</sup>

<sup>1</sup> Code Section 83. If the award is subject to vesting, then income is recognized at the time of vesting as opposed to the time of grant. Similarly, if the recipient’s right to transfer the awarded equity is restricted, then income is recognized at the time the equity becomes transferable as opposed to the time of grant.

<sup>2</sup> The conditions under Revenue Procedure 93-27 are: (1) The profits interest does not relate to a substantially certain and predictable stream of income from partnership assets; (2) the partner does not dispose of the profits interest within two years of receipt, and (3) the profits interest is not granted by a publicly traded partnership.

<sup>3</sup> In general, capital gains from property held by a taxpayer for one year or longer is taxed at the long-term capital gains rate (maximum of 20% in 2018), as opposed to the short-term capital gains rate (maximum of 37% in 2018).

<sup>4</sup> Internal Revenue Code Section 1061 as added by the Act.

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For such taxpayers, long-term capital gains attributable to their profits interests are determined under general capital gains calculation rules, substituting the extended three-year holding period for the generally applicable one-year holding period.<sup>5</sup> This change will be effective for any sales of profits interests or allocations of income on or after January 1, 2018, and it applies to newly-granted profits interests and existing profits interests alike. The extended three-year holding period applies regardless of whether an individual reported income when the profits interest was granted or made a Code Section 83(b) election.

Further, the Act has been interpreted to impose a three-year extended holding period on the underlying assets held by the partnership with respect to income recognized by holders of such profits interests. Although this is possibly an unintended consequence of the Act which could be clarified in future regulations or other guidance, taxpayers should be mindful of separately tracking holding periods for partnership assets with respect to holders of profits interests until such guidance is issued.

There are several other open questions regarding application of the new rules, including whether capital gains subject to the extended holding period are treated differently for purposes of offsetting capital losses and whether profits interest awards to management of portfolio companies could be subject to the extended holding period. Guidance from the Treasury Department is expected to provide further clarification on application of the new rules under the Act.

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<sup>5</sup> Long-term capital gains treatment generally applies if a taxpayer holds an asset for longer than one year or, for applicable partnership interests under the Act, longer than the extended three-year holding period.



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