

IRS tightens rules for carried interest

The new Tax Cuts and Jobs Act (TCJA) makes it tougher for certain taxpayers to cash in on a tax break for “carried interests,” but left the door slightly open.

Alert: The IRS wants to lock things down. In a new Notice, the agency limits a special exception in the new law that was carved out for the benefit of C corporations. (*IRS Notice 2018-8, 3/1/18*)

However, some tax pros argue that the IRS is overstepping its bounds.

Here's the whole story: Under prior law, private hedge fund managers could benefit from favorable capital gain rules on carried interest (i.e., the portion of a fund's returns paid to managers instead of management fees). Payouts consisting of a share of the fund's long-term capital gains were taxed at the preferential long-term capital gain rates

Thus, if a taxpayer was compensated via carried interest, he or she could benefit from the 20% maximum federal income rate on long-term gains instead of paying the 39.6% prior-law maximum rate that applied to ordinary income. The top ordinary income rate in 2018 is 37%.

Previously, President Trump pledged to eliminate the tax break for carried interest. Eventually, a compromise was worked out in the TCJA, whereby the preferential capital gains rates for carried interest are only available for gains from assets held for more than three years (as opposed to the usual more-than-one-year holding period requirement).

Key exception: The longer holding period requirement wasn't extended to corporations. It's widely believed that this exception was intended only to benefit C corporations—not all corporations—but that's not the way the law was written. So taxpayers may try to avoid the crackdown by funneling carried interest through S corporations.

Now the IRS is nipping this strategy in the bud. In the new ruling, it states that the exception isn't available to S corporations. Also, the IRS announced it will issue new regulations on this point.

But the issue is still open to interpretation. Some tax experts are questioning whether the IRS can close this apparent loophole.

Tip: A technical corrections act may ultimately resolve matters.