

Profits interest grants and the new three-year holding period

The 2017 Tax Cut and Jobs Act changed the federal income tax consequences of and compliance requirements for receiving, holding and disposing of certain profits interests from companies treated as partnerships for tax purposes.¹ A profits interest represents a right to share in the future profits of a partnership. To understand the basics of a profits interest, please see [Profits interest grants – basics](#).

Generally, before the new tax law took effect, if you had held on to your partnership interest for more than one year and then sold it, you would have had long-term capital gain.² After the new tax law took effect, the required holding period for certain types of profits interests in partnerships, known as "applicable profits interests," has been increased to three years to qualify for long-term capital gains rates. This change was intended to limit the ability of fund managers to claim long-term capital gains on their carried interests. However, as drafted, this new rule potentially affects a much broader population than expected.

Applicable partnership interests

Beginning after December 31, 2017, the holding period for applicable partnership interests (APIs) must be greater than three years to qualify for long-term capital gains rates. Most carried interests likely fall within this definition. Gain on an API sold before the greater-than-three-year period is treated as short-term capital gains. This rule applies no matter when the interests were granted (ie, it applies to interests granted pre-2018).

An interest is an API if it is transferred to a partner (or to a related³ person) in connection with professional investing or money-managing services. More specifically, a profits interest is an API if the partnership's purpose is to raise or return capital by investing in or disposing of:

1. Securities such as corporate stock, a note/bond/debenture, currency, a partnership interest in a widely held or publicly traded partnership or trust
2. Commodities
3. Cash or cash equivalents
4. Options or derivative contracts or
5. Rental or investment real estate.

Consequently, any partnership that invests in any of the above assets and grants a profits interest to a service provider (eg, a fund manager) runs the risk of having its profits interest classified as an API. However, the new holding period rules do not apply if the API recipient is a corporation other than an S corporation. As a result, the tax treatment for sales of profits interests by investors in the same partnership can vary depending on the type of investor owning the interest.

Additional concerns

In addition to potential short-term gain characterization of a sale of a profits interest, gains from the sale of a partnership's underlying investments may also become subject to the new three-year holding period requirements. This ambiguity as to

whether the three-year holding period is imposed on the partnership interest itself or on the partnership's underlying assets creates compliance issues such as keeping track of when each asset was purchased by the partnership and who held a profits interest at the time of purchase. The Treasury has not yet issued any clarifying regulations.

For additional information or questions concerning the information covered in this article or the new holding period for APIs, please contact any of the authors or your usual DLA Piper Tax consultant.

¹Throughout this article, all references to "partnerships" include limited liability companies that are classified as partnerships for federal income tax purposes and references to "partners" include members in limited liability companies treated as partnerships for federal income tax purposes.

²Under current law, long-term capital gain is taxed at a lower rate than short-term capital gain in the hands of a non-corporate taxpayer. For non-corporate taxpayers, long-term capital gain is taxed at a 20% rate, and short-term capital gain is taxed at the same rate as ordinary income, the highest rate of which is 37%.

³The term "related person" refers to the following: 1) spouses, 2) children, 3) grandchildren, and 4) parents. It should be noted that siblings are not considered related for purposes of the new holding period rules.

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