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Carried Away: The Proposed Carried Interest Regs

by Monte A. Jackel

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In this three-part article, Jackel examines the recently proposed carried interest regulations under section 1061, which address a broad range of subjects that are integral in interpreting and applying the new law comprehensively. In this first installment, he analyzes the proposed definitions and operational rules.

Although Jackel was involved in developing these proposed regulations while working at the IRS Office of Chief Counsel in 2019, all views expressed herein are his own and do not represent the views of any other person, firm, or organization.

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I. Background and Review of Statute

This article explores the details of recently proposed regulations under section 1061 (REG-107213-18),[1] and it examines the issues presented by those regulations.

Section 1061 was enacted as part of the Tax Cuts and Jobs Act.[2] The statute contains six subsections and seven paragraphs, discussed below.

Unlike prior legislative proposals on carried interest,[3] section 1061 does not recharacterize capital gain into ordinary income[4] or impute ordinary income to the taxpayer.[5] Rather, it extends the long-term capital gain holding period from over one year to over three years; thus, the

[1] An unofficial copy of the regulations was released to the public on July 31. The regulation was filed with the Office of the Federal Register August 6 and was published in the *Federal Register* August 14. The proposed rules were reviewed twice by the Office of Management and Budget's Office of Information and Regulatory Affairs, which is an unusual practice given that the proposed rules had not yet been reviewed by the public and comments thus had not been submitted thereon. *See* Eric Yauch, "Fund Managers Get Some Answers in Complex Carried Interest Rules," *Tax Notes Federal*, Aug. 10, 2020, p. 1071; and Yauch, "Carried Interest Rules Back at OIRA for Second Review," *Tax Notes Federal*, June 8, 2020, p. 1763.

[2] For a recent list of questions on the application of the new statute, see American Bar Association Section of Taxation, "Recommendations for the 2020-2021 Department of the Treasury and Internal Revenue Service Priority Guidance Plan"(July 22, 2020).

[3] Lee A. Sheppard, "Warren Takes on Private Equity," *Tax Notes Federal*, Aug. 19, 2019, p. 1177; Sheppard, "Dissecting Wyden's Profits Interest Bill," *Tax Notes Federal*, Aug. 12, 2019, p. 981; Sheppard, "Private Investment Funds and the TCJA," *Tax Notes*, June 4, 2018, p. 1397; Yauch, "Carried Interest Workarounds Pop Up Amid Uncertainty Over Rules," *Tax Notes*, May 6, 2019, p. 894; Yauch, "ABA Tax Section Asks Reg Writers for Answers on Carried Interest," *Tax Notes*, Apr. 1, 2019, p. 124; Yauch, "Carried Interest Related-Party Language Needs Clarity," *Tax Notes*, Nov. 5, 2018, p. 756; Kurt R. Magette, "Carried Interest in a Tax Partnership: Reflection, Reaction, and Regs," *Tax Notes*, Apr. 23, 2018, p. 491; and Blake D. Rubin, Andrea M. Whiteway, and Maximilian Pakaluk, "Real Estate Owners: Don't Get Carried Away by New Carried Interest Rule," *Tax Notes*, Apr. 2, 2018, p. 45.

[4] This is sometimes known as the "Levin approach," based on several prior legislative proposals by then-Rep. Sander M. Levin and others over a period of several years, represented by proposed but never enacted section 710. *See*, *e.g.*, the Carried Interest Fairness Act of 2015, H.R. 2889 and S. 1686.

[5] This is sometimes known as the "Camp approach," based on a proposal in early 2014 by then-Rep. Dave Camp, as part of proposed tax reform legislation that was never enacted (the Tax Reform Act of 2014, H.R. 1). The proposal would have imputed income to the carried interest holder as if the capital providers had made a loan to the service provider holding the carried interest.

relevant asset[6] must be held for more than three years to obtain long-term capital gain treatment.

A. In General

Section 1061(a) sets forth the general operative rule of the statute. It provides that if one or more applicable partnership interests (APIs) are held by a taxpayer at any time during the tax year, the excess of the long-term capital gain "with respect to such interests" for the tax year over the amount that would be long-term capital gain if the asset was held for more than three years (in lieu of the regular over-one-year rule under section 1222(3) and (4)) is treated as short-term capital gain.

The statute does not specify what "with respect to" the API means. Before being confirmed by the proposed regulations, it was generally assumed that the term encompasses either a sale by the partnership of a specified asset, the sale of all or a portion of the API by the taxpayer, or the redemption of all or a portion of the taxpayer's API by the partnership. The term was also broad enough to include a partner's sale of a partnership specified asset that is distributed to the partner by the partnership and then sold by the distributee partner when its holding period is three years or less.

Property whose treatment does not expressly depend on its holding period did not appear subject to this rule. For example, on the face of the statute, neither section 1231 gain nor section 1256 gain is subject to the new rule.

Further, it was also not clear how the special categories of capital gain income under section 1(h) were to be treated under section 1061(a). Section 1(h)(1) is a computation provision and applies if a taxpayer has a "net capital gain." That term is defined at section 1222(11) as the excess of net long-term capital gain over net short-term capital loss. Section 1061(a) recharacterizes long-term capital gain as short-term capital gain; therefore, its application must come before the application of section 1(h).

A related point is that if section 1231 and 1256 gains are excluded from recharacterization under section 1061(a), those gains must be included in the section 1(h)(1) computation. That leaves open the treatment of:

- 28 percent rate gain under section 1(h)(4);
- collectibles gain under section 1(h)(5);
- unrecaptured section 1250 gain under section 1(h)(6); and
- section 1202 gain under section 1(h)(7).

Section 1(h)(5)(A) references a capital asset held for more than one year, so it appears that this gain should be treated in the same manner as section 1231 gain — that is, not subject to section 1061. Unrecaptured section 1250 gain that is not section 1231 gain appears to be subject to recharacterization under section 1061(a) because there is no reference to a specified holding period in that statute, and unrecaptured section 1250 gain that is also section 1231 gain does not appear to be subject to section 1061(a) for that same reason. Because section 1202 gain relates to an asset held for over five years, that provision does not appear to be affected by section 1061(a).[7]

Section 1061 and its legislative history are silent on any potential suspension of the three-year holding period rule, such as under section 1092 for straddles and under section 1233 for short sales. Section 1092 defines a straddle as offsetting positions on personal property, and personal property is then defined to include only actively traded personal property. This would appear to exclude most carried interest from those rules. And section 1233 applies only to short sales and the holding of substantially identical property. Thus, its application to partnership interests that are APIs also appears limited.

The statute is also silent on the use of financial instruments in an attempt to replicate the performance of an actual partnership interest to avoid section 1061 (such as a derivative partnership interest). These issues are addressed in the proposed regulations, as discussed later.

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[6] As discussed later, the relevant asset could be either the partnership interest, a partnership asset, or a distributed partnership asset.

[7] The preamble to the proposed regulations states: "API Gains and Losses do not include long-term capital gain determined under sections 1231 and 1256, qualified dividends described in section 1(h)(11)(B), and any other capital gain that is characterized as long-term or short-term without regard to the holding period rules in section 1222, such as capital gain characterized under the identified mixed straddle rules described in section 1092(b)." Section 1(h) is not discussed.

B. Special Rule

Section 1061(b) sets forth a curious special rule. It provides that to the extent provided by the IRS, section 1061(a) will not apply to any asset not held for portfolio investment on behalf of third-party investors. Based on the statute and its legislative history, it is unclear what this provision means.

C. Applicable Partnership Interest

The definition of an applicable partnership interest or API is critical to the operation of the statute. Any gain "with respect to" an API is subject to recharacterization as short-term capital gain. The general definition of API means any interest in a partnership that, directly or indirectly, is transferred to (or is held by) the taxpayer in connection with the performance of substantial services by the taxpayer[8] or any other related person in any applicable trade or business (ATB).

Neither the statute nor the pertinent legislative commentary otherwise addresses what the term "substantial" means in this context. Presumably, however, a taxpayer would not be granted a profits interest for insubstantial services. Similarly, the term "taxpayer" is not defined. For example, does it mean only the person subject to tax, or does it also include entities involved in the ATB? Is it both, or some other meaning?

The term "related person" is not defined for purposes of any provision other than section 1061(d).[9] Presumably, the statutory reference to ATB under section 1061(c)(2) is meant to incorporate the standards under section 162.[10]

A "specified asset" under section 1061(c)(3) means securities (generally under section 475(c)(2)), commodities (generally under section 475(e)(2)), cash or cash equivalents, options or derivative contracts on any of the foregoing, and an interest in a partnership to the extent of the partnership's proportionate interest in any of the foregoing.[11]

The statute, at section 1061(c)(4), expressly provides for two exceptions to what is an API: (1) any interest in a partnership directly or indirectly "held by a corporation," and (2) any capital interest in the partnership that gives the taxpayer a right to share in partnership capital commensurate with the amount of capital contributed (determined at the time of receipt of that partnership interest) or with the value of that interest subject to tax under section 83 upon the receipt or vesting of the interest. The IRS's position, set out in Notice 2018-18, 2018-12 IRB 443, is that an S corporation is not a corporation for this purpose.[12] The notice provides no rationale for that position.

D. Transfer of API to Related Person

Section 1061(d)(1) is literally worded as an income acceleration provision. However, some have viewed this language as merely a recharacterization provision, such as section 751(a). Section 1061(d)(1) provides that if a taxpayer transfers an API directly or indirectly to a person related to the taxpayer, the taxpayer "shall include in gross income as short term capital gain" any excess of (1) so much of the taxpayer's long-term capital gain on that interest for the tax year attributable to the sale or exchange of any asset held for not over three years as is allocable to that interest, over (2) any amount treated as short-term capital gain under section 1061(a) on the transfer of that interest.

A related person, solely for purposes of section 1061(d), is either (1) a person who is a member of the taxpayer's family under section 318(a)(1), or (2) a person who performed a service

[8] For a discussion of this and other issues under section 1061, see ABA tax section, "Comments on the Treatment of Applicable Partnership Interests Under Section 1061" (Mar. 22, 2019).

[9] The blue book references section 267(b) or 707(b) for this purpose. Joint Committee on Taxation, "General Explanation of Public Law 115-97," JCS-1-18, at 197 (Dec. 2018) (blue book).

[10] *See* discussion below.

[11] This would preclude a partnership interest from otherwise being a security if not either widely held or publicly traded or to the extent the partnership does not hold specified assets. *See generally* Monte A. Jackel, "Partnership Interest as a Security," *Tax Notes Federal*, July 27, 2020, p. 669.

[12] On this issue, see Bruce Lemons and Richard Blau, "Are S Corporations 'Corporations' Under the Carried Interest Rules?" *Tax Notes Federal*, Sept. 2, 2019, p. 1567. On the definition of corporation generally, see Benjamin M. Willis, "Corporations Are Carried Away From the Carried Interest Rules," Tax Analysts blog, Oct. 18, 2019 (discussing a circuit court case dealing with whether nonprofits are corporations under section 6621); and Yauch, "Federal Circuit Says Nonprofits Are Corporations in Interest Case," *Tax Notes Federal*, Oct. 21, 2019, p. 513 (same).

within either the current calendar year or the preceding three calendar years in any ATB in which or for which the taxpayer performed a service.

E. Reporting and Regulations

Reporting is required as the IRS determines to be necessary to carry out the purposes of section 1061 under section 1061(e). And regulations or other guidance are to be issued as is necessary to carry out the purposes of section 1061, as set forth in section 1061(f).

II. The Proposed Regulations

The proposed regulations are complex because of their many definitions and interrelated provisions. The key provisions are discussed below.

A. Definitions, Operational Rules

1. In general.

The definitions in prop. reg. section 1.1061-1, combined with the operational rules in prop. reg. section 1.1061-2 (1) identify the taxpayer to which section 1061 applies, (2) identify when an interest is an API, (3) determine what constitutes an ATB, and (4) determine who is a related party. The proposed regulations also define terms for identifying interests when an API is held through one or more passthrough entities.[13]

Section 1061(a) refers to a taxpayer in terms of the person who calculates the amount of net long-term capital gain that is recharacterized as net short-term capital gain under the statute. These calculations then enter into the computation of net capital gain under section 1(h)(1). The proposed regulations refer to the amount in section 1061(a) as the "recharacterization amount."

Section 1061(c) also refers to a taxpayer as the person who is transferred or holds the API in connection with the taxpayer's or a related person's substantial services. As stated earlier, an API is defined under the statute as any interest in a partnership that directly or indirectly is transferred to (or held by) the taxpayer in connection with the performance of substantial services by the taxpayer, or by any other related person, in an ATB.

In determining whether an interest is an API, the proposed regulations expand the statute to provide that solely for purposes of section 1061, an interest in a partnership also includes any financial instrument or contract whose value is determined in whole or in part by reference to the partnership (including the amount of partnership distributions, the value of partnership assets, or the results of partnership operations).[14]

That provision mirrors reg. section 1.7704-1(a)(2)(i)(B), which defines a partnership interest for purposes of section 7704(b) as "any financial instrument or contract the value of which is determined in whole or in part by reference to the partnership (including the amount of partnership distributions, the value of partnership assets, or the results of partnership operations)."

2. Taxpayer, owner taxpayer, and passthrough taxpayer.

Comments submitted before the issuance of the proposed regulations described three potential approaches to the definition of the term "taxpayer": the aggregate approach, the partial entity approach, and the full entity approach.[15]

Under the aggregate approach, both the existence of the API and the recharacterization amount are determined solely at the ultimate owner level. If the recharacterization amount is calculated at the ultimate owner level, gains and losses from multiple APIs held by the taxpayer can be combined and netted with each other. Under the full entity approach, the recharacterization amount and the existence of an API are both determined at the entity level, and the recharacterization amount would be calculated for each entity and then netted and combined at the ultimate owner level. Finally, under the partial entity approach, the existence of

[13] A passthrough entity is defined to mean a partnership, an S corporation, or passive foreign investment company. The term is most frequently used in the proposed regulations for tiered partnerships, but other structures are also included within the meaning of the term.

[14] The preamble states: "These proposed regulations also provide that solely for purposes of section 1061, an interest in a partnership includes any financial instrument or contract, the value of which is determined, in whole or in part, by reference to the partnership (including the amount of partnership distributions, the value of partnership assets, or the results of partnership operations)."

[15] *See* ABA tax section, *supra* note 8.

an API is initially determined at the entity level, but the recharacterization amount is determined at the ultimate owner level.

The proposed regulations adopt the partial entity approach.[16] To apply that approach under 1061, the proposed regulations provide two definitions of a taxpayer: owner taxpayer and passthrough taxpayer. Those definitions shape the scope of the term "taxpayer" for purposes of computing the recharacterization amount and determining whether a partnership interest is an API.

An owner taxpayer is the person subject to tax on the net gain "with respect to" the API, and the recharacterization amount is determined solely by that owner taxpayer. For this purpose, taxpayers include S corporations and qualified electing funds under sections 1293 and 1295, but no other C corporations.

The ability to treat qualified electing funds as subject to section 1061 when those entities are clearly C corporations is subject to substantial doubt. The issues surrounding treating an S corporation as not being a corporation for purposes of section 1061 are also doubtful as a technical matter. Those issues will be discussed in the second part of this article.

The term "taxpayer" is defined to include individuals and simple and complex trusts and estates. If an owner taxpayer holds one or more APIs indirectly (through one or more passthrough entities), amounts subject to section 1061 flow through those entities and are then netted at the owner taxpayer level to determine the recharacterization amount.

A passthrough taxpayer, as described earlier, is an entity that generally does not pay tax itself. An owner taxpayer and a passthrough taxpayer each are treated as a taxpayer — both separately and as an aggregate along with related parties and agents or delegates of them — in determining whether an API exists under the proposed regulations. This expansive approach can include portions of an ATB conducted in separate chains of tiered partnerships.

In determining whether the elements of an API are present, the proposed regulations provide that a passthrough taxpayer can be (1) the service provider, (2) a person related to the service provider, (3) engaged in an ATB, or (4) the recipient of an interest in connection with the performance of substantial services in an ATB. If a passthrough taxpayer is treated as the recipient (or holder) of a partnership interest, directly or indirectly, in determining the existence of an API, the ultimate owners of the passthrough taxpayer are treated as owner taxpayers in calculating the recharacterization amount.

3. Profits interests.

Rev. Proc. 93-27, 1993-2 C.B. 343, defines a profits interest and provides a safe harbor under which the IRS will not treat the receipt of a profits interest as a taxable event for the partner or the partnership if specified requirements are met.[17] The preamble to the proposed regulations provides that section 1061 applies to all partnership interests that meet the definition of an API, regardless of whether the receipt of the interest is treated as a taxable event under Rev. Proc. 93-27. The preamble also warns that taxpayers should not equate an interest that meets the definition of an API with an interest whose receipt would not be treated as a taxable event under Rev. Proc. 93-27.

For example, the preamble provides that Rev. Proc. 93-27 applies to a person who receives a profits interest for the provision of services to or for the benefit of a partnership in a partner capacity or in anticipation of being a partner, whereas section 1061 applies to partnership interests transferred or held in connection with the performance of substantial services in an ATB. Moreover, the preamble states that a financial instrument or contract may be treated as an API under section 1061, but that the same financial instrument or contract is not an interest in a partnership for purposes of Rev. Proc. 93-27 unless it is otherwise a partnership interest for federal tax purposes.

[16] Compare and contrast the treatment of tiered partnerships in the context of the recently finalized section 163(j) regulations. *See* T.D. 9905 and REG-107911-18 for the entity treatment of partnerships in that case, and prop. reg. section 1.163(j)-6(j)(3) in particular.

[17] *See also* Rev. Proc. 2001-43, 2001-2 C.B. 191.

4. API holder, indirect API, passthrough interest.

The proposed regulations include the term "API holder" to refer to any person who holds an interest in a particular API. An API holder can include either or both of a passthrough taxpayer or an owner taxpayer. The proposed regulations define an indirect API as an API that is held through one or more passthrough entities, and they define a passthrough interest as an interest in a passthrough entity that represents, in whole or in part, an API.

5. API gains and losses.

i. Realized and unrealized gain.

API gains and losses are net long-term capital gains and losses on an API. The proposed regulations provide that API gains and losses include long-term capital gain or loss from a deemed or actual disposition of the API (including gain recognized under sections 731(a) and 752(b)) and the holder's distributive share of the partnership's net long-term capital gain or loss under sections 702 and 704 "with respect to" the API. The proposed regulations also treat long-term capital gain or loss on the disposition of a capital asset distributed from a partnership "with respect to" an API (distributed API property) as API gain or loss if the asset has been held for more than one year but not more than three years when the distributee partner disposes of the distributed property.[18]

Notably, API gains and losses are defined to include both realized and unrealized capital gains and losses. Unrealized API gains and losses include capital gains and losses allocated to the API holder for the API that increase or decrease the API holder's section 704(b) capital account and that were not recognized under the code when they were included in determining the API holder's capital account balance. The proposed regulations state that unrealized capital gains and losses that are allocated to the API holder under a capital account revaluation under the section 704(b) regulations are API gains and losses when they are recognized for tax purposes.

Regarding the maintenance of capital accounts, the preamble states:

> In the case of a partnership that maintains capital accounts under reg. section 1.704-1(b)(2)(iv) . . . the allocation must be based on the capital account determined under reg. section 1.704-1(b)(2)(iv). In the case of a Passthrough Entity that is not a partnership (or a partnership that does not maintain capital accounts under reg. section 1.704-1(b)(2)(iv)), if the Passthrough Entity maintains and determines accounts for its owners in a manner similar to that provided under reg. section 1.704-1(b)(2)(iv), those accounts will be treated as capital accounts under the proposed regulations. . . . To qualify to be treated as a capital account for this purpose, each owner's account must be increased by the money and the net fair market value of property contributed to the Passthrough Entity and income and gain allocated to the owner. Each owner's account must be decreased by any money and the net fair market value of property distributed to the owner and allocations of expenditures, loss, and deduction.

Some have argued that a revaluation of an API so that it is fully booked up will cleanse an otherwise tainted API and convert it into a capital interest for future allocations and that the proposed regulations support such an approach. However, the proposed regulations explicitly say that a capital interest never includes an API. As a result, a revaluation of an API, or multiple revaluations, should not transform the API into a capital interest. These capital account rules are intended to apply so that revaluation gains on an API create their own separate capital account, which remains an API. When you have a revaluation gain allocation on top of a prior revaluation gain allocation, each revaluation allocation needs to be bifurcated between the API component and the capital interest component on contributed capital. The capital interest component has its own capital account, which reflects one or more revaluations for actual capital

[18]For this purpose, the holding period of the asset in the partner's hands includes the partnership's holding period for the asset. It should be noted that the term "distributed API" property as used in the regulations could include property, such as section 1231 property, that is not subject to section 1061 if sold by the partnership. This should be clarified when the regulations are finalized.

contributed to the partnership.[19] Without interpreting the regulations in this manner, the return on the services component of the partnership interest will most likely be understated and the return on the contributed capital component will most likely be overstated. The pertinent part of the special analysis section of the preamble states it this way:

> There is uncertainty among taxpayers whether unrealized capital gains with respect to an API (unrealized API gains) can be converted to gains that would qualify for the capital interest exception [by a revaluation that fully books up the interest so that no book gain remains in the interest]. The proposed regulations clarify that unrealized API gains cannot [by this mechanism] be converted to gains that qualify for the capital interest exception.

ii. Tiered partnerships.

For tiered partnership entities, the preamble explains that under the principles of reg. section 1.704-3(a)(9), an upper-tier partnership must allocate the gains and losses allocated from a lower-tier partnership in a manner that reflects the API holder's share of API gains and losses in the lower-tier partnership.

What this really means is that to comply with the rules of the proposed regulations, it is necessary for both the upper- and lower-tier partnerships to revalue their assets under reg. section 1.704-1(b)(2)(iv)(f) and allocate those items in a manner that effectively treats the upper- and lower-tier partnerships as a single partnership under the section 704(b) capital account regulations.[20]

In the case of (1) a revaluation of partnership property directly or indirectly held by a partnership that is part of a tiered structure or (2) the contribution of an API to another partnership, API gains and losses are defined to include unrealized API gains and losses that would be allocated directly or indirectly to the API holder by the lower-tier partnerships as if a taxable disposition of the property of each of the lower-tier partnerships also occurred on the date of the revaluation. The preamble states that the taxpayer should look to the unrealized appreciation that would occur if a revaluation had occurred under reg. section 1.704-1(b)(2)(iv)(f), but solely for purposes of section 1061.[21]

According to the preamble, revaluations must be made through each relevant tier of passthrough entities:

> Although the proposed regulations do not require revaluations under section 1.704-1(b)(2)(iv)(f), solely to determine and identify Unrealized API Gains and Losses for purposes of section 1061 upon the occurrence of a revaluation or contribution, these regulations require that a revaluation under the principles of reg. section 1.704-1(b)(2)(iv)(f) be made through each relevant tier of partnerships. Thus, the proposed regulations require revaluations of all the properties held by all relevant partnerships in a tiered structure to determine the extent to which the partnership has Unrealized API Gains and Losses. If a partnership is required to revalue its assets for purposes of section 1061, such partnership is permitted to revalue its property for purposes of section 704 as though an event in reg. section 1.704-1(b)(2)(iv)(f)(5) had occurred.

The preamble explains that Treasury and the IRS believe that the proposed rules serve two purposes: (1) they ensure that capital gains and losses that would be API gains and losses are not converted to capital interest gains and losses through a revaluation or contribution; and (2) they ensure that a partnership's unrealized API gains and losses when recognized are properly allocated to the correct API holder in a tiered partnership structure. Treasury and the IRS have requested comments on "whether such section 1061 revaluations are necessary or whether there

[19] This treatment of what is a capital interest and what is an API is clearly indicated in the special analysis section of the preamble in discussing the economic analysis of the capital interest exception. *See* preamble to REG-107213-18, at Part I.C.3.c.

[20] This functions in a manner similar to the section 721(c) partnership tiered partnership rules. *See* reg. section 1.721(c)-1 et seq.

[21] *Id.*

is another mechanism that would ensure that API Gain or Loss is allocated to API Holders when there is a revaluation event in one or more of the tiers of entities." Comments are also requested on whether the section 704(b) regulations should be amended to specifically include section 1061 revaluations "or to address revaluations through tiers of partnerships for purposes of section 704 more generally."

iii. Carry waivers.

Unrealized API gains and losses do not lose their character despite being included in an API holder's capital account until they are recognized for tax purposes and included in income as API gains and losses, and they do not lose their character as they are allocated through the tiers in a tiered partnership structure.

Further, API gains and losses do not include any amounts that otherwise are treated as ordinary income under any code section, including sections 751 and 1245. The preamble states:

> The Treasury Department and the IRS are aware that taxpayers may seek to circumvent section 1061(a) by waiving their rights to gains generated from the disposition of a partnership's capital assets held for three years or less and substituting for these amounts gains generated from capital assets held for more than three years. Alternatively, taxpayers may waive their rights to API Gains and substitute gains that are not taken into account for purposes of determining the Recharacterization Amount. Some arrangements also may include the ability for an API Holder to periodically waive its right to an allocation of capital gains from all assets in favor of an allocation of capital gains from assets held for more than three years and/or a priority fill up allocation designed to replicate the economics of an arrangement in which the API Holder shares in all realized gains over the life of the fund. These arrangements are often referred to as carry waivers or carried interest waivers. Taxpayers should be aware that these and similar arrangements may not be respected and may be challenged under section 707(a)(2)(A), reg. sections 1.701-2 and 1.704-1(b)(2)(iii), and/or the substance over form or economic substance doctrines.

6. Related person.

As noted earlier, section 1061(c)(1) provides that an API includes an interest transferred to or held by a taxpayer in connection with the performance of substantial services by the taxpayer or a related person in an ATB; section 1061(d)(1) provides a rule for transfers of an API to specified related persons; and section 1061(d)(2) provides a definition of related person that applies solely to transfers subject to section 1061(d)(1). The proposed regulations refer to that person as a "section 1061(d) related person."

However, section 1061 does not include a definition of related person for the remainder of section 1061. Accordingly, in defining related person for that purpose, the proposed regulations use the general definition of a person or entity that is related under section 707(b) or 267(b).[22]

7. Once an API, always an API.

Section 1061 does not contain a provision that would cause an interest to cease to be an API, unless and until one of the exceptions to the definition of API applies. Therefore, according to the preamble, the proposed regulations clarify that once a partnership interest becomes an API, the partnership interest remains an API unless and until an exception applies, regardless of whether the taxpayer or a related person continues to provide services in an ATB:

> Therefore, even after a partner retires and provides no further services, if the retired partner continues to hold the partnership interest, it remains an API. Similarly, if the partner provides services, but the ATB Activity Test (as defined below) is not met in a later year, the partnership interest will continue to be an API. Further, an API remains an API if it is contributed to another Passthrough Entity or a trust. . . . [A]ny unrecognized API Gains and Losses included in a capital account upon

[22]JCS-1-18, *supra* note 9, at 201 n.1002.

> contribution of an API to a Passthrough Entity remain subject to section 1061 when they are recognized [for tax purposes] under the Code.

8. Substantial services.

The proposed regulations contain a presumption that if a taxpayer provides any services in an ATB and is transferred or holds an allocation of a partnership's profits in connection with the services that were provided to other than a disregarded entity,[23] those services are considered substantial. That presumption is appropriate, the preamble explains, "because the parties to the arrangement have economically equated the potential value of the interest granted with the value of the services performed."

Treasury and the IRS have requested comments on the presumption and on "the specifics of any arrangements in which insubstantial services could be performed in connection with the receipt of a profits interest such that the presumption could be overcome." They ask that those comments address how and why Rev. Proc. 93-27 and Rev. Proc. 2001-43, 2001-2 C.B. 191, would apply to partnership interests received in exchange for the insubstantial services.

The second segment of this article will finish its examination of definitions and operational rules and begin an analysis of significant issues and policy decisions reflected in the regulations. The final segment will complete that analysis and provide a conclusion. ■

[23] The preamble states: "Entities that are disregarded from their owners (collectively, disregarded entities) under the Code or regulations, including grantor trusts and qualified subchapter S subsidiaries, are disregarded for purposes of these regulations. Accordingly, if an API is held by or transferred to a disregarded entity, the API is treated as held by or transferred to the disregarded entity's owner."

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Carried Away: The Proposed Carried Interest Regs, Part 2

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In this second installment of a three-part article, Jackel continues his examination of the recently proposed carried interest regulations under section 1061, which address a broad range of subjects that are integral in interpreting and applying the new law comprehensively.

Although he was involved in developing these proposed regulations while working at the IRS Office of Chief Counsel in 2019, all views expressed here are his own and do not represent the views of any other person, firm, or organization.

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9. Applicable partnership interest, specified actions.

The proposed regulations provide that an ATB means any activity for which the ATB activity test regarding specified actions is met. The proposed regulations provide that the ATB activity test is met if specified actions are conducted at the level of activity required for an activity to constitute a trade or business under section 162.

Further, all specified actions conducted by related persons are combined for this purpose. The preamble states that if the specified actions, all taken together, rise to the level of activity required to find a trade or business under section 162, then each related person is determined to be engaged in the relevant ATB for this purpose. The proposed regulations provide that a relevant ATB is the ATB in which services were performed in connection with which the API was transferred.

The definition of specified assets in the proposed regulations generally tracks the statutory definition of specified assets in section 1061(c)(3). Both the statute and the proposed regulations provide that a specified asset generally includes a security as defined in section 475(c)(2). All corporate stock, regardless of the size of the corporation or whether the corporation is publicly traded, is a specified asset. Also, the proposed regulations provide that an interest in a partnership or a beneficial ownership interest in a trust is a specified asset if it is a security described in section 475(c)(2).

Options or derivative contracts regarding any of the foregoing specified assets are also specified assets. Partnership interests that are not securities are specified assets to the extent that the partnership holds specified assets. The preamble states:

> The Blue Book provides an example in which a hedge fund acquires an interest in a partnership that is neither publicly traded nor widely held and whose assets consist of stocks, bonds, positions that are clearly identified hedges with respect to securities, and commodities. The Blue Book provides that the partnership interest is a specified asset for purposes of the provision. . . . The proposed regulations incorporate this concept as illustrated by the Blue Book. Similar to the statute's treatment of options or derivative contracts of other Specified Assets as Specified Assets, the proposed regulations provide that, solely for purposes of section 1061, Specified Assets also include a derivative of a partnership interest to the extent not otherwise included in the definition of Specified Assets.

10. ATB activity test.

The proposed regulations provide that in the case of a partnership that directly holds specified assets, actions taken regarding or on account of these assets, as well as a percentage of the actions taken regarding the partnership interest as a whole, will be taken into account for purposes of the ATB activity test. The test takes into account the aggregate actions conducted regarding "raising or returning capital actions" and "investing or developing actions."[1] The test does not require that each such action individually meet the required activity level for the ATB activity test to be satisfied.

The preamble states that in some cases, once sufficient capital to engage in investing or developing actions has been raised, actions involving raising or returning capital may not be taken for a period. Also, at the beginning and the end of the activity, actions involving the raising or returning of capital may be significant and actions involving investing or developing capital may not be taken. Nonetheless, the preamble states that the ATB activity test looks at the actions taken as a whole:

> Accordingly, the proposed regulations provide that the ATB Activity Test is met if Investing or Developing Actions alone satisfy the ATB Activity Test in the current year or if Raising or Returning Capital Actions have been taken in prior years and it is anticipated that they will be taken in the future. Additionally, the test is satisfied if Raising or Returning Capital Actions during the year satisfy the ATB Activity Test and Investing or Developing Actions are anticipated but not yet taken.

11. When an API arises.

An API is stated to arise when an interest in a partnership is transferred or held in connection with substantial services in an ATB. The preamble states:

> An API arises when an interest in a partnership is transferred or held in connection with services in an ATB. The Treasury Department and the IRS are aware that interests in a partnership may be issued to a service provider in anticipation of the service provider providing services to an ATB, but because an ATB does not exist at the time of the transfer, the interest is not an API. The Treasury Department and the IRS have concluded that once the service provider is providing services in an ATB, the interest becomes an API. Once the interest becomes an API, its status as an API does not depend on whether the ATB continues to meet the ATB Activity Test.

12. Exceptions.

Section 1061 includes four exceptions to its application. Also, the proposed regulations provide for an additional exception:

- First, the statutory definition of an API excepts an interest held by a person who is employed by another entity that is conducting a trade or business (other than

[1] "Investing or developing actions" is defined as actions involving either investing in (or disposing of) specified assets (or identifying specified assets for such investing or disposition) or developing specified assets. "Raising or returning capital actions" is defined as actions involving raising or returning capital but doesn't include investing or developing actions.

an ATB) and provides services only to that other entity (non-ATB employee).

- Second, section 1061(c)(4)(A) provides that an API does not include any interest in a partnership directly or indirectly held by a corporation (corporate exception).
- Third, section 1061(c)(4)(B) provides that an API does not include any capital interest in the partnership (capital interest exception).
- Fourth, section 1061(b) provides that to the extent provided by the IRS, section 1061 will not apply to income or gain attributable to any asset not held for portfolio investment on behalf of third-party investors (not-for-portfolio-investment exception).
- Finally, prop. reg. section 1.1061-3 introduces a fifth exception that applies to an unrelated purchaser who is a non-service provider.

i. Held by a corporation.

Section 1061(c)(4)(A) provides that an API does not include a partnership interest directly or indirectly held by a corporation. The proposed regulations provide that partnership interests held by S corporations are treated as APIs if the interest otherwise meets the API definition.[2] The preamble states:

> Section 1061(c)(4)(A) provides that the term API does not include a partnership interest directly or indirectly held by a corporation. On March 19, 2018, the Treasury Department and the IRS issued Notice 2018-18, notifying taxpayers that the Treasury Department and the IRS intended to issue regulations providing that the term corporation as used in section 1061(c)(4)(A) does not include an S corporation. . . . The notice informed taxpayers that the regulations under section 1061 would provide that this rule is effective for taxable years beginning after December 31, 2017 to prevent taxpayers from avoiding the application of section 1061 through the use of an S corporation. The Blue Book also provides that the term corporation for purposes of section 1061(c)(4)(A) does not include an S corporation. . . . Accordingly, these proposed regulations provide that partnership interests held by S corporations are treated as APIs if the interest otherwise meets the API definition.

The proposed regulations also treat qualified electing funds (QEFs) under sections 1293 and 1295 as ineligible for the corporate exception even though a QEF is clearly a C corporation under the code. The preamble states as its rationale for this position:

> The Treasury Department and the IRS also have concluded that a partnership interest held by a PFIC with respect to which a taxpayer has a QEF election in effect is treated as an API if the interest meets the API definition. Under section 1291, generally, a U.S. person who owns stock of a PFIC is subject to an interest charge regime in which interest is charged with respect to certain PFIC distributions and dispositions of PFIC shares. However, the shareholder can avoid the interest charge regime by making an election under section 1295 to treat the PFIC as a QEF. If this election is made, then the holder of the stock generally is not subject to the interest charge regime and instead includes in income each taxable year its pro rata share of the ordinary income and long-term capital gain of the QEF. The Treasury Department and the IRS are concerned that, absent this rule, taxpayers may use PFICs with respect to which they have made QEF elections to avoid the application of section 1061. Such taxpayers would have the benefit of passthrough tax treatment without the application of section 1061. The Treasury Department and the IRS believe it is inappropriate for a PFIC with respect to which the shareholder has elected to receive passthrough treatment to be treated as a corporation for purposes of section 1061. Therefore, the proposed regulations clarify that a PFIC with respect to which the shareholder has a QEF election in

[2] *See* Bruce Lemons and Richard Blau, "Are S Corporations 'Corporations' Under the Carried Interest Rules?" *Tax Notes Federal*, Sept. 2, 2019, p. 1567.

> effect is not treated as corporation for purposes of section 1061(c)(4)(A). As a result, a partnership interest held by a PFIC with respect to which the shareholder has a QEF election in effect will be treated as an API if the interest otherwise meets the API definition.

Finally, on the question of the authority of the IRS to exclude S corporations and QEFs, the preamble states:

> Section 1061(f) provides that the Secretary has authority to issue regulations as are necessary or appropriate to carry out the purposes of section 1061. Both the Conference Report and the Blue Book further direct the Treasury Department and the IRS to issue regulations to address the prevention of abuse of the purposes of the provision. The Treasury Department and the IRS have concluded that the grant of regulatory authority in section 1061 is sufficient for the government to issue regulations providing that the exception in section 1061(c)(4)(A) does not include S corporations and PFICs with respect to which shareholders have QEF elections in effect.

ii. Capital interests.

The proposed regulations state that they clarify how the capital interest exception applies to capital gains and losses allocated to an API holder regarding its capital investment in a passthrough entity. The proposed regulations further state that they clarify that an interest holder's capital investment in a passthrough entity is not limited to the interest holder's initial capital investment. The interest holder's capital investment is stated to include all of the interest holder's contributions and gains that have been recognized but not distributed by the partnership. The proposed regulations also set forth how to determine the amount of gain or loss recognized on the disposition of a passthrough interest that is allocable to the capital interest.

These amounts are defined under the proposed regulations as capital interest gains and losses. Specifically, the proposed regulations provide that capital interest gains and losses are (1) capital interest allocations,[3] (2) passthrough interest capital allocations,[4] and (3) capital interest disposition amounts.[5]

The proposed regulations provide that allocations based on the partners' capital account balances that have the same terms; the same priority; the same type and level of risk; the same rate of return; the same rights to cash or property distributions during partnership operations and on liquidation, will be treated as made in the same manner. The proposed regulations also provide that an allocation to an API holder will not fail to be treated as a capital interest allocation solely because it is subordinated to an allocation to unrelated non-service partners, or because it is not reduced by the cost of services provided by the API holder.[6]

In the case of a partnership, for an allocation to qualify as a capital interest allocation or a passthrough interest capital allocation, all partners must either have capital accounts determined and maintained under reg. section 1.704-1(b)(2)(iv) and the allocation must be based on that capital account, or, as stated earlier, the partners must have accounts similar in principle and practice to such a capital account. It is not necessary to liquidate based on capital account balances for this exception to apply, thus

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[3]"Capital interest allocations" are defined as allocations of long-term capital gain or loss made under the partnership agreement to an API holder and to unrelated non-service partners based on their respective capital account balances that meet the requirements set forth in the proposed regulations.

[4]"Passthrough interest capital allocations" are defined as allocations made by passthrough entities that hold an API interest in a lower-tier passthrough entity. Passthrough interest capital allocations can be either passthrough capital allocations or passthrough interest direct investment allocations. In turn, passthrough capital allocations are capital interest allocations made directly or indirectly to the passthrough entity by a lower-tier entity and that are allocated by the passthrough entity among its owners in accordance with the proposed regulations; and passthrough interest direct investment allocations are allocations of solely long-term capital gain and loss derived from assets (other than an API) directly held by the passthrough entity and otherwise in accordance with the proposed regulations.

[5]"Capital interest disposition amounts" are defined as the amount of long-term capital gain and loss recognized on the sale or disposition of all or a portion of a passthrough interest (an interest in a passthrough entity (a partnership, S corporation, or passive foreign investment company) that represents in whole or part an API) that may be treated as capital interest gain or loss (gains and losses that are capital interest allocations, passthrough interest capital allocations, and capital interest disposition amounts) under the proposed regulations.

[6]The argument that a revaluation on top of a prior revaluation converts an API into a capital interest on future allocations was addressed in the prior segment.

preserving the viability of targeted allocations and waterfall distributions by private equity and other funds.

The preamble provides that, generally, passthrough interest capital allocations must be based on each owner's share of the passthrough entity's capital account in the partnership making the capital interest allocations to the passthrough entity. In turn, passthrough interest direct investment allocations generally must be based on each owner's share of the capital investment made by the passthrough entity.

The proposed regulations provide that, generally, this amount is equal to the capital account of the owner reduced by that owner's share of a capital account held directly or indirectly by the passthrough entity in a lower-tier partnership entity. The proposed regulations further state, however, that if a passthrough entity allocates all passthrough interest capital allocations for the tax year in the aggregate regardless of whether they are capital interest allocations or passthrough interest direct investment allocations, the passthrough entity may allocate those allocations based on each owner's capital account in the passthrough entity regardless of whether some or all of an owner's capital contribution is included in the capital account of a lower-tier entity.

The proposed regulations provide that a capital account does not include the contribution of the proceeds of any loan or other advance made or guaranteed, directly or indirectly, by any other partner or by the partnership (or any person related to any such other partner or the partnership). This provision was apparently added to address situations where a loan was made in form but not in substance, but the preamble does not so state. The repayments on the loan, however, are included in capital accounts as those amounts are paid (unless the repayments are funded with a similar loan from the partners or the partnership). The proposed regulations do not address how the benchmark for the interest to meet the capital interest exception is affected, if at all, by this exclusion for partner loans; that is, whether the exclusion for the loan is taken into account in determining whether the API holder's return on capital is commensurate with the return on interests held by a significant number of non-service partners.

The proposed regulations provide that capital interest allocations and passthrough interest capital allocations never include any amounts that are treated as API gains and losses that are allocated to the passthrough entity by a lower-tier partnership entity. Those allocations also exclude partnership transition amounts (discussed below).

The proposed regulations state that capital interest allocations can be made only by a partnership that has both API holders and unrelated non-service partners. For this purpose, those unrelated partners do not (and did not) provide services to the relevant ATB and are not (and were not) related to an API holder in the partnership or related to any person who provides services to the relevant ATB.

Capital interest allocations are allocations of long-term capital gain and loss made under the partnership agreement to the API holder and unrelated non-service partners based on their respective capital account balances if (1) the allocations are made to unrelated non-service partners with a "significant"[7] aggregate capital account balance; (2) the allocations are made in the same manner to the API holder and the unrelated non-service partners; (3) the terms of the allocations to the API holder and the unrelated non-service partners are identified both in the partnership agreement and on the partnership's books and records; and (4) the allocations are clearly separate and apart from allocations made regarding the API.

Passthrough interest capital allocations are long-term capital gain and loss allocations made by a passthrough entity that holds an API. The proposed regulations provide for two types of passthrough interest capital allocations: passthrough capital allocations and passthrough interest direct investment allocations.

Passthrough interest capital allocations are capital interest allocations made directly or indirectly to the passthrough entity from a lower-

[7]The proposed regulations provide that allocations made to unrelated non-service partners with an aggregate capital account balance of 5 percent or more of the aggregate capital account balance at the time the allocation is made by the partnership are significant.

tier partnership entity regarding its capital account balance in the lower-tier partnership entity. These allocations must be made by the passthrough entity to each of its owners in the same manner based on each owner's share of the capital account in the lower-tier partnership entity making the capital interest allocation to the passthrough entity.

If a passthrough entity receives distributed API property from a lower tier entity and the property is no longer distributed API property because it has been held for over three years in the aggregate, the property is included in the passthrough entity's direct investment at that time.

The proposed regulation preamble provides that, generally, allocations must be made in the same manner to each of the owners of the passthrough entity based on each owner's relative investment in the assets held by the passthrough entity. The preamble further provides that an allocation will not fail to qualify to be a passthrough interest direct investment allocation if the passthrough entity is a partnership and allocations made to one or more unrelated non-service partners have more beneficial terms than allocations to the API holders if the allocations to the API holders are made in the same manner. The proposed regulation preamble states:

> For example, if an Unrelated Non-Service Partner receives a priority allocation and distribution of 10 percent of net long-term capital gain and loss and the other partners, including the API holders, share the remaining 90 percent of the net long-term capital gain from the Passthrough Entity's direct investments, allocations to the API holders are Passthrough Interest Direct Investment Allocations. Further, allocations made in the same manner to some API holders by a partnership will not fail to qualify to be treated as a Passthrough Interest Direct Investment Allocation as to those partners despite allocations being made to one or more service providers (or related parties) that are treated as APIs issued by the Passthrough Entity. For example, if (1) all of the partners of the Passthrough Entity are API holders and one partner manages the Passthrough Entity's direct investments and receives a 20 percent interest in the net long-term capital gains from those investments that is treated as an API as to that partner and (2) the other API holders share the remaining 80 percent of gain from those investments based on their relative investments in the Passthrough Entity, then (3) the allocation of the 80 percent of net long-term capital gain is a Passthrough Interest Direct Investment Allocation to those partners.[8]

Instead of separately accounting for passthrough capital allocations and passthrough interest direct investment allocations, the proposed regulations provide that owners of the passthrough entity may prefer to allocate items of capital interest gain or loss without regard to whether these items arose from direct investment by the passthrough entity or from an investment in a lower-tier passthrough entity. Therefore, the proposed regulations permit an upper-tier passthrough entity to allocate its passthrough capital allocations and passthrough interest direct investment allocations in the same manner to all of its partners using the partners' capital accounts in such passthrough entity unreduced by amounts that are included in a capital account of the lower-tier entity.

The preamble requests comments on other allocation arrangements that appropriately could be treated as capital interest gains and losses under the regulations without inappropriately expanding the capital interest exception. These comments, it is stated, should take into account the statutory requirement that the API holder's right regarding its capital interest be commensurate with other partners' rights regarding contributed capital.

The proposed regulations also provide rules for determining when gains and losses recognized on the disposition of a passthrough interest composed of both an API and a capital interest are excluded from section 1061 because they are treated as capital interest gains and losses.

[8] The latter quoted language is apparently directed to family offices and residual profits allocations after providing for a separate carried interest.

The preamble states that nothing in section 1061 or the proposed regulations overrides existing law regarding the determination of gain recognized on the disposition of all or a portion of a passthrough interest:

> In particular, in the case of a disposition of a portion of a Passthrough Interest, Revenue Ruling 84-53 (1984-1 C.B. 159) applies and basis must be equitably apportioned between the portion of the interest disposed of and the portion retained. These proposed regulations contain amendments to reg. section 1.1223-3 for determining a divided holding period when a partnership interest includes an API and/or a profits interest. . . . A commenter requested guidance on whether a capital interest can be disposed of separately from an API for purposes of section 1061(a). The disposition of a capital interest will be treated as such under section 1061 and the gain or loss on the disposition is treated as Capital Interest Gain or Loss if the interest being disposed of is clearly identified as a capital interest. However, nothing in section 1061 or these proposed regulations changes the established partnership principle that a partner has a unitary basis in its partnership interest. *See* Revenue Ruling 84-53. As noted above, the basis must be equitably apportioned to the transferred portion under the principles described in Rev. Rul. 84-53 and the holding period of the interest would be determined under the rules of reg. section 1.1223-3. Thus, a partner may dispose of solely a capital interest or an API, but in either case, the partner's basis and holding period (including a split holding period) is apportioned between the interest retained and the interest transferred.

B. Computational Rules

1. Not held for portfolio investment.

As noted earlier, section 1061(b) provides that, to the extent provided by the IRS, section 1061(a) will not apply to income or gain attributable to any asset not held for portfolio investment on behalf of third-party investors. Proposed regulations are reserved regarding the application of section 1061(b).

A third-party investor is defined in section 1061(c)(5) as a person who holds an interest in the partnership and who does not provide substantial services for such partnership or in any applicable trade or business. The preamble states:

> Comments have suggested that the exception is intended to apply to family offices, i.e., portfolio investments made on behalf of the service providers and persons related to the service providers. The Treasury Department and the IRS generally agree with these comments and believe that the section 1061(b) exception effectively is implemented in the proposed regulations with the exception to section 1061 for Passthrough Interest Direct Investment Allocations. The Treasury Department and the IRS request comments on the application of this provision and whether the proposed regulations' exclusion for Passthrough Interest Direct Investment Allocations properly implements the exception.

2. Unrelated purchasers.

The proposed regulations add an exception not provided for in the statute for unrelated taxpayers who purchase an API. The proposed regulations provide that an interest in a partnership that would be treated as an API but is purchased by an unrelated buyer for the fair market value of the interest is not an API if (1) the buyer does not currently and has never provided services in the relevant ATB (or to the passthrough entity in which the interest is held, if different), (2) does not contemplate providing services in the future, and (3) is not related to a person who provides services currently or has provided services in the past. The preamble states:

> However, it should be noted that this exception does not apply to an unrelated non-service provider who becomes a partner by making a contribution to a Passthrough Entity that holds an API and in exchange receives an API. In this case, allocations to the Unrelated Non-service

Partner with respect to the API are API Gains and Losses and retain their character as API Gains and Losses.

This exception to the exception is not explained in the preamble but is apparently directed to the case in which an investor makes a contribution in form to an upper-tier partnership, which then distributes an interest in the lower-tier API to that new upper-tier partner. This is most likely in substance a sale and purchase of the API to the new investor by the upper-tier partnership and so could be a taxable purchase at FMV and fit within the exception. Apparently, the bona fides of such a transaction was not viewed as comparable to an unrelated non-service provider partner who pays FMV in a straightforward taxable purchase and would otherwise be buying into a tax problem.[9]

A purchaser who meets the unrelated purchaser test at the upper-tier should also be treated as acquiring any indirect APIs, that is, an API in a lower-tier partnership that is held by the upper-tier partnership when the upper-tier partnership interest was purchased by the unrelated purchaser, but that is not explicitly stated. That is the theory of the regulations, and it should apply here. It could use a clarification though. This interpretation is supported by (1) the rule at prop. reg. section 1.1061-3(d)(3), which references tiers of partnerships in testing for services provided; (2) the look-through rule at reg. section 1.1061-4(b)(9), which applies to the disposition of an indirectly held API; (3) the related party rule at reg. section 1.1061-5(c)(1)(B) , which also deals with taxpayer dispositions of an indirect API to a related party; and (4) the definition of an owner taxpayer, which is what the purchaser of upper-tier would be but for this exception, that includes both directly held APIs and indirectly held APIs. Otherwise, the exception at reg. section1.1061-3(d) wouldn't make sense.

3. Capital interest disposition amount.

The proposed regulations provide that the amount of long-term capital gain or loss recognized on a disposition that is treated as a capital interest disposition amount is determined in a multistep process. First, amounts that are treated as ordinary income under section 751(a) or (b) as a result of the disposition are excluded from all steps of the calculation. The computation then proceeds as follows.

- First, determine the amount of gain or loss that would be allocated to the passthrough interest (or the portion of the passthrough interest sold) if all of the assets of the passthrough entity were sold for their FMV in a fully taxable transaction (deemed liquidation) immediately before the disposition.
- Second, determine the amount of gain or loss from the deemed liquidation that is allocable to the passthrough interest as a result of capital interest allocations, passthrough interest capital allocations, and API holder transition allocations.[10]
- If gain is recognized under the code on the disposition of an interest, and the capital interest allocations, passthrough interest capital allocations, and API holder transition amounts would result in the allocation of a loss, the proposed regulations then provide that all of the gain recognized on the disposition will be treated as API gain. Similarly, if loss is recognized on the disposition of an interest, and the capital interest allocations, passthrough interest capital allocations, and API holder transition amounts would result in an allocation of a gain, the proposed regulations provide that all of the loss recognized on the disposition will be treated as an API Loss.
- If gain is recognized under the code on the disposition of the interest and capital interest allocations, passthrough interest capital allocations, and API holder transition amounts would result in allocations of both capital gain and API gain, the API holder must determine the portion of the gain that is attributable to the

[9] If, however, in the example the cash is distributed to another partner, it could in substance be a disguised sale of a partnership interest that is then eligible for the exception.

[10] If a transferor recognizes capital gain under section 751(b), any amount that constitutes API gain or loss is added to any API gain or loss that results from the disposition of the interest.

capital interest and the portion of the gain that is attributable to the API.

The proposed regulations provide that the taxpayer must divide the capital gain that would be allocated to the interest regarding (1) capital interest allocations, (2) passthrough interest capital allocations, and (3) API holder transition amounts on a deemed liquidation of the partnership by the total amount of gain (or loss) that would be allocated to the interest on the deemed liquidation. This amount is then multiplied by the total amount of gain (or loss) recognized on the sale to determine the amount of the gain (or loss) that is treated as a capital interest disposition amount. To the extent that the gain (or loss) is not allocable to the capital interest, the regulations provide that it is API gain or loss.

The preamble issues a warning about attempts to circumvent these rules:

> The Treasury Department and the IRS are aware that some taxpayers have taken the position that a recapitalization or division is a capital contribution under section 1061(c)(4)(B) that would allow taxpayers to recharacterize what would be API Gains under these proposed regulations as Capital Interest Gains. Although a recapitalization or a division may be treated as a section 721 contribution, these transactions would not have the effect of recharacterizing API Gains and Losses as Capital Interest Gains and Losses under these proposed regulations. The section 1061 statutory language does not support this position and the Treasury Department and the IRS do not believe it to be a reasonable interpretation of the statute.

4. Recharacterization amount.

Under the proposed regulations, the recharacterization amount is the amount by which the owner taxpayer's one-year gain amount exceeds the three-year gain amount. The owner taxpayer's one-year gain amount has two components: (1) the owner taxpayer's combined net API one-year distributive share amount from all APIs held during the tax year, and (2) the owner taxpayer's API one-year disposition amount. The owner taxpayer's three-year gain amount also has two components: (1) its combined net API three-year distributive share amount from all APIs held during the tax year, and (2) its API three-year disposition amount.

Each passthrough entity must calculate an API one-year distributive share amount to each API holder that directly holds an interest in the passthrough entity for the tax year. Under the proposed regulations, all long-term capital gain and loss allocated to the API holder by the passthrough entity are API gains and losses to the API holder unless an exception applies.

If the passthrough entity is a partnership, the passthrough entity determines its API one-year distributive share amount in a series of steps:

- Step 1. The partnership determines the long-term capital gains and losses that are allocated to the API holder under the partnership agreement under sections 702 and 704. This amount includes long-term capital gains and losses from the taxable disposition of distributed API property by the partnership that was distributed to it from a lower-tier partnership entity.
- Step 2. The partnership then reduces this amount by amounts that are not taken into account under the proposed regulations for calculating the recharacterization amount.

For this purpose, section 1231 amounts, section 1256 amounts, and related excluded amounts are excluded from the calculation of the recharacterization amount. They are not included in the API one-year distributive share amount.

The same is true for the API holder transition amount and for long-term gain or loss from the disposition of property that was once distributed API property but that has ceased to be distributed API property because it was disposed of when the asset had a holding period that was over three years.

- Step 3. Finally, the partnership reduces the amount determined under the second step above by any amounts that are treated as capital interest gains and losses. The resulting amount is the API holder's one-year distributive share amount, and the partnership must report this amount to the API holder.

This amount must also be calculated by an S corporation that holds an API for each direct API holder in the S corporation. In this case, the S corporation must report to each API holder its pro rata share of the API gains and losses allocated to the S corporation regarding its API. Such amounts also must be calculated and reported by PFICs for which a taxpayer has a QEF election in effect.

Under the proposed regulations, the API three-year distributive share amount is equal to (1) the API holder's one-year distributive share amount, (2) less amounts that are not treated as long-term capital gain and loss if such amount was computed by applying section 1222(3) and (4), substituting three years for one year in those paragraphs of section 1222. This amount must be calculated by the passthrough entity and reported to the API holder.

The API one-year disposition amount includes the long-term capital gains and losses that the owner taxpayer recognizes from the direct taxable disposition of an API, including gain under sections 731(a) and 752(b) that has been held for over one year. The API one-year disposition amount also includes long-term capital gain or loss recognized on distributed API property by the owner taxpayer, and long-term capital gains that the taxpayer must include because of the application of the look-through rule test, described below.

The API three-year disposition amount includes only the long-term capital gain or loss from the direct taxable disposition of an API held by the owner taxpayer for over three years. To the extent that a deemed exchange under section 751(b) and its regulations results in long-term capital gain regarding the API, it is included in the one-year disposition amount and, if appropriate, those amounts may be included in the three-year disposition amount.

In determining the one-year gain amount and the three-year gain amount, all amounts are netted at the owner taxpayer level. If an owner taxpayer holds more than one API, the owner taxpayer combines and nets its API distributive share amounts from each API that it held during the tax year to determine its combined net API one-year distributive share amount and net API three-year distributive share amount. If the one-year gain amount is zero or less than zero, section 1061 does not apply because there is no gain to recharacterize.

5. Transition amounts.

As described earlier, section 1061(c)(4) provides an exception regarding some capital interests. Before the enactment of section 1061, taxpayers would generally have had no reason to have tracked which portion of the unrealized appreciation on its property was attributable to capital interests in the partnership. Therefore, the preamble states, partnerships may not have information readily available to enable them to comply with the proposed regulations regarding property that the partnership held for over three years as of the effective date of section 1061.

As a response to this concern, the proposed regulations provide a transition rule for property that was held by the partnership for over three years as of the effective date of section 1061. A partnership that was in existence as of January 1, 2018, may elect to treat all long-term capital gains and losses from the disposition of all assets, whether or not they would be API gains or losses or capital interest gains or losses in prior periods, that were held by the partnership for over three years as of January 1, 2018, as partnership transition amounts. Such amounts that are allocated to the API holder during the tax year (API holder transition amounts) are not taken into account for purposes of determining the recharacterization amount. Rather, they are treated as long-term capital gains.

The API holder transition amount in any year is the amount of the partnership transition amount for the year that is included in the amount of long-term capital gains and losses allocated to the API holder under sections 702 and 704 regarding its interest in the partnership under the current partnership agreement.

However, the amount allocated to the API holder in any tax year cannot exceed the amount of the partnership transition amount that would have been allocated to the API holder regarding its partnership interest under the partnership agreement for the 2017 tax year to the extent it was amended on or before March 15, 2018.[11]

[11] This is the latest date under section 761(c) that a partnership agreement can be amended and be effective for the preceding tax year.

6. Installment sales.

The proposed regulations provide that the owner taxpayer's one-year gain amount and three-year gain amount include gains from installment sales regardless of whether the installment sale occurred before the effective date of section 1061. The proposed regulations also make clear that the holding period of the asset on the date of its disposition is used for purposes of applying section 1061.

7. Distributed property.

Generally, the distribution of property regarding an API does not accelerate the recognition of gain under section 1061.[12] However, if distributed API property is disposed of by the distributee-partner when the holding period is three years or less (inclusive of the partnership's holding period), gain or loss regarding the disposition is API gain or loss.

Distributed API property, according to the regulation preamble, retains its character as it is passed from one tier of partnerships to the next. However, at the time that distributed API property is held for over three years, it loses its character or taint and is no longer treated as distributed API property. If distributed API property is distributed from one passthrough entity to another and the upper-tier partnership entity disposes of the property, the long-term capital gain or loss is included in the upper-tier entity's long-term capital gain or loss as API gain or loss. If the property is distributed to an owner taxpayer and the owner taxpayer disposes of the property, it is included in the owner taxpayer's API one-year disposition gain.

The preamble states that this rule is necessary to prevent the avoidance of section 1061 because, absent such a rule, section 1061 could be avoided by the partnership's distribution of an asset to the API holder before the sale of the asset in situations in which the asset has been held by the partnership for three years or less.[13]

8. Holding periods.

The preamble states that comments submitted before the proposed regulations were issued considered different approaches to the holding period rules. These approaches included using: (1) the holding period of the owner of the asset sold (whether the asset disposed of is the API itself or is an underlying capital asset held by the partnership); (2) the owner taxpayer's holding period in its partnership interest; (3) the partnership's holding period in its assets; or (4) the lesser of the holding period of the partnership in its assets or the owner taxpayer's holding period in the partnership interest.

The proposed regulations adopt the approach that the holding period of the owner of the asset sold controls, whether it is the partnership (of a partnership asset) or the partner (regarding the partnership interest). To this end, the proposed regulations provide that if a partnership disposes of an asset, it is the partnership's holding period in the asset that controls. This includes the disposition of an API by the partnership.

This result, it is stated, is consistent with the application of section 702(b) and Rev. Rul. 68-79, 1968-1 C.B. 310, which held that when a partnership sells a capital asset held by the partnership for over six months (the then-required holding period for long-term capital gains), a new partner takes into account his distributive share of gain from the sale as long-term capital gain, notwithstanding that the partner has not held its interest in the partnership long enough to qualify for long-term capital gain treatment if the partnership interest itself had been sold.

Under the proposed regulations, the sale of a partnership interest generally follows an entity approach as opposed to an aggregate approach. Following this approach, the proposed regulations provide that except to the extent that the look-through rule test applies, the holding period that an API holder has in an API is the applicable holding period upon the disposition of an API.

The proposed regulations also propose to amend reg. section 1.1223-3 to clarify how to calculate the holding period of an API when the API is a portion of the partnership interest and the partnership interest has a divided holding period

[12] A possible exception would be for a distribution of property to a related party partner under section 1061(d) although the proposed regulations only refer to transfers of APIs to related parties.

[13] The proposed regulations should have expressly excluded from the tainted distributed property any property that if sold by the partnership, wouldn't be subject to recharacterization, as seen with section 1231 or 1256 gains.

under reg. section 1.1223-3. This clarification applies to the calculation of all profits interests and all APIs.

Reg. section 1.1223-3(a) provides that a partnership has a divided holding period if (1) portions of the interest are acquired at different times, or (2) the partner acquired portions of the partnership interest in exchange for property transferred at the same time but resulting in different holding periods. The general rule in final reg. section 1.1223-3(b)(1) is that the portion of the interest to which the holding period relates is determined by reference to a fraction, (1) the numerator of which is the FMV of the portion of the partnership interest received in the transaction to which the holding period relates, and (2) the denominator of which is the FMV of the entire partnership interest determined immediately after the acquisition transaction.

In the case of the portion of a partnership interest that is composed in part by one or more APIs or profits interests, the proposed regulations change the timing of this determination as to that portion to the date of disposition of the asset (as compared to the date of acquisition of the asset) of all or a part of the interest. This eliminates a zero answer for the profits interest because the FMV is deemed to be zero on the date of grant.

Therefore, in the case of a partnership interest that has a divided holding period and the partnership interest includes one or more profits interests, the relative FMVs of portions of the interest composed of a profits interest and that have different holding periods are determined at the time of the interest's disposition (or partial disposition). The holding period of the portion of the interest that is not a profits interest continues to be determined under final reg. section 1.1223-3(b)(1) as of the date of acquisition. The preamble provides that no inference is intended regarding the valuation of a profits interest that fails to meet the safe harbor under Rev. Proc. 93-27, 1993-2 C.B. 343 (as clarified in Rev. Proc. 2001-43, 2001-2 C.B. 191).

9. No separate rule for suspension of holding period.

As noted earlier, the statute does not contain any express rule relating to the suspension of the three-year holding period. The proposed regulations also do not include a rule that the holding period for an asset or an API does not include any period for which an offsetting position has been entered into regarding that asset or the API. This means that rules that already exist in the code, such as sections 1092 and 1233, are all that exists to suspend the holding period where economically appropriate. It is not expected that those rules will have any meaningful impact here because partnership interests are not ordinarily actively traded, as is required by section 1092, nor subject to a short sale.

10. Look-through rule.

The proposed regulations do not, as a general rule, look through a partnership to its assets on the sale of a partnership interest. Rather, the general rule is that the entity approach applies.

However, out of concern that some taxpayers may try to circumvent section 1061 by (1) forming a partnership that conducts minimal activity, (2) having that partnership acquire assets that could be subject to section 1061 later, and (3) then disposing of the API after three years but before the partnership has held substantially all of its assets for over three years, the proposed regulations include a limited look-through rule that is applied to the sale of an API that has been held for over three years at the time of the disposition. The rule applies if substantially all of the partnership's assets by value are capital assets held for three years or less by the partnership. "Substantially all" is defined as 80 percent or more of the gross FMV (inclusive of debt) of the assets held by the partnership at the time of the API disposition. Additional coordinating rules apply to tiered partnerships to effectively implement this look-through rule.[14]

If the rule applies, the proposed regulations provide that a percentage of the gain or loss on the disposition of the API is included in the API one-year disposition amount. The percentage is, generally, the total gain that would be attributable to assets held for not over three years if a hypothetical sale of all of the partnership's assets occurred immediately before the disposition.

[14] For example, the rule will apply if an upper-tier partnership holds a lower-tier partnership interest for over three years but the lower-tier partnership's assets have been held for three years or less.

Again, coordinating rules apply to tiered partnerships. The remaining gain or loss is not subject to the look-through rule.

The third segment of this article analyzes the key points of the section 1061 regulations. ■

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Carried Away: The Proposed Carried Interest Regs, Part 3

by Monte A. Jackel

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Carried Away: The Proposed Carried Interest Regs, Part 3

by Monte A. Jackel

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Monte A. Jackel is a tax practitioner who formerly worked for the Big Four and national law firms. He most recently served as special counsel to the IRS chief counsel. He lives in Silver Spring, Maryland.

Jackel, in this final installment of a three-part article, continues his detailed examination of the recently proposed carried interest regulations under section 1061 and analyzes issues raised by the regulations.

Although Jackel was involved in developing these proposed regulations while working at the IRS Office of Chief Counsel in 2019, all views expressed here are his own and do not represent the views of any other person, firm, or organization.

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The first two segments of this article examined the details of the recently proposed regulations under section 1061 (REG-107213-18).[1] This final installment continues the discussion of the proposed operational rules and concludes with an analysis of the issues presented by the regulations.

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[1] *See* Monte A. Jackel, "Carried Away: The Proposed Carried Interest Regs," *Tax Notes Federal*, Aug. 17, 2020, p. 1237; and Jackel, "Carried Away: The Proposed Carried Interest Regs, Part 2," *Tax Notes Federal*, Aug. 24, 2020, p. 1459.

II. The Proposed Regulations (continued)

C. Related-Party Transfers

Under section 1061(d), if a taxpayer transfers[2] an applicable partnership interest (API) to a related person, the taxpayer includes in gross income the excess of the net built-in long-term capital gain in assets attributable to the transferred interest over the amount included in gross income under section 1061(a) on the transfer. The scope of section 1061(d)(1) is broader than the tax result that would occur if the partnership had actually sold all its property, because both the statute and the proposed regulations do not exclude section 1231 gains and other excluded gains (such as under section 1256) from the gain computation under subsection (d).

Ever since its enactment, there has been confusion as to precisely what this provision was intended to address. The proposed regulations interpret section 1061(d) to require that gain be accelerated on the transfer of an API to a "section 1061(d) related person" (or to recharacterize gain that is recognized on disposition), regardless of whether the transfer is a taxable transaction for federal income tax purposes or whether gain is realized or recognized under the code on the transfer.

However, the proposed regulations provide that gain will not be accelerated under section 1061(d)(1) if (1) the API is transferred to a partnership in a transaction governed by section 721(a), and (2) the partnership agreement of the transferee partnership requires that income from the transferred API that could be recharacterized under section 1061(a) or accelerated under section 1061(d) continue to be allocated to the transferor partner after the transfer. For this purpose, the term "transfer" is defined to include contributions, distributions, sales, and gifts. The preamble asks for comments on other transfers that could be excepted from this rule.

The proposed regulations use the term "person" as it is generally used under section 7701(a)(1). Section 7701(a)(1) defines person to include an individual, trust, estate, partnership, association, company, or corporation. Under that definition, a management company, for example, could qualify as a related person under section 1061(d)(2) because it would have performed a service in the same ATB in which the taxpayer performed a service in the three years preceding the transfer.

Section 1061(d)(1)(A) recharacterizes as short-term capital gain so much of the taxpayer's long-term capital gain on that interest for the tax year attributable to the sale or exchange of any asset held for not over three years as is allocable to that interest.

The proposed regulations determine long-term capital gain on the transferred API by requiring the transferor to determine how much long-term capital gain from assets held three years or less would be allocated to the transferred API if, immediately before the transfer, the partnership that issued the API had sold all its assets for fair market value in a hypothetical sale. If the result is negative, the result is deemed to be zero and section 1061(d) does not apply.[3]

If the owner taxpayer transfers the interest in a transaction in which gain would not be recognized currently but for the application of section 1061(d), the gain that the owner taxpayer recognizes under section 1061(d) but would not recognize currently without the application of section 1061(d) increases (before the application of section 1015(d), if applicable) the tax basis of the transferred interest. If an owner taxpayer transfers only a portion of an API, section 1061(d) applies only to the portion transferred.

If this rule is retained in the final regulations, the term "transfer" should be further defined to address potential cases involving indirect transfers of an API, such as the admission of new partners into the partnership or the withdrawal of partners from the partnership. It should also be clarified whether the transfer of a distributed asset held or deemed held by the partnership for three years or less is subject to section 1061(d),[4] or

[2] The statute references a transfer "directly or indirectly" to a related person. The term "indirectly" is not defined. For example, does the term transfer "indirectly" to a related person include a transfer to a non-grantor trust where section 318(a)(1) persons are trust beneficiaries? That seems like an overbroad result and should be clarified.

[3] This is similar to the manner in which ordinary income is determined under reg. section 1.751-1(a)(2).

[4] It seems like it should because a taxable sale by that partner would be subject to section 1061.

whether a forfeiture of an API is also a transfer for this purpose.[5] If the term includes such an expansive reading, section 1061(d) would then appear to be extremely overbroad.[6]

D. Securities Aggregation

The proposed regulations include a proposed amendment to reg. section 1.704-3(e)(3). Reg. section 1.704-3(e)(3)(i) provides that in making reverse section 704(c) allocations, a securities partnership may aggregate gains and losses from financial assets using any reasonable approach that is consistent with the purpose of section 704(c). Under the proposed regulations, an approach will not be considered reasonable if it fails to take into account the application of section 1061.

The proposed regulations provide that if the partnership aggregates gains and losses for capital assets held for over one year, for the partial netting approach in reg. section 1.704-3(e)(3)(iv) and the full netting approach in reg. section 1.704-3(e)(3)(v) to be considered reasonable, the partnership must establish separate accounts to take into account each API holder's share of book API gains and losses and book capital interest gains and losses and to determine each API holder's share of tax API gains and losses and tax capital interest gains and losses.

Adopting this approach would seem to add more complexity to an already complex regulation. Given the rapid turnover of assets by a typical hedge fund, is this rule really necessary? Probably yes, given that the managers of these funds may very well exit from the partnership far short of the three-year holding period.

E. Information Reporting

The proposed regulations provide that the owner taxpayer must report any information the IRS may require in forms, instructions, and other published guidance to demonstrate the taxpayer's compliance with section 1061. Under the proposed regulations, the passthrough entity in which the owner taxpayer holds its interest is required to provide information that generally is needed by API holders to comply with section 1061 and the proposed regulations.

In some cases, the owner taxpayer may need more information from the passthrough entity to comply with section 1061 because, for example, the owner taxpayer disposed of an interest in the passthrough entity during the tax year. The proposed regulations provide that if, to comply with section 1061 the owner taxpayer needs additional information from a passthrough entity in which it holds an interest, the owner taxpayer must timely request that information from the passthrough entity so as to timely meet its own filing obligations (taking into account extensions).

If an owner taxpayer fails to obtain the required information by the due date (including extensions) of its income tax return, (1) all long-term capital gain or loss recognized by the owner taxpayer on its interest in the passthrough entity is included in the one-year gain amount, and (2) no capital gain is included in the three-year gain amount unless (3) the owner taxpayer is able to independently establish and verify the three-year gain amount with accurate and complete information.

Accordingly, the proposed regulations provide that if an owner taxpayer does not have information regarding the amount of its one-year API distributive share of long-term capital gain, all long-term capital gain is included in the one-year gain amount. If the owner taxpayer does not have information to determine the three-year distributive share amount, it must treat that amount as zero. If the owner taxpayer lacks sufficient information to determine amounts that are excepted because they are treated as capital interest gains and losses or API holder transition amounts, then consistent with reg. section 1.6001-

[5]It could be because it is a transfer and the partnership issuer is most likely a related party for this purpose.

[6]Transfers of an API to grantor trusts when the owners of the trust are related parties under section 1061(d) should be treated as subject to section 1061(d) in accordance with Rev. Rul. 85-13, 1985-1 C.B. 184. Contrast that with a transfer by a grantor of an API to a grantor trust wholly owned by the grantor, which should not be treated as a transfer for this purpose. The proposed regulations contain their own parallel rule, but that is not needed given Rev. Rul. 85-13. *See* Jackel, "Grantor Trust Ownership: What Does It Mean?" *Tax Notes Federal*, Apr. 13, 2020, p. 269. It is not clear whether death would be a disposition or a transfer for this purpose, including but not limited to transfers at death of APIs where liabilities exceed tax basis. *See* Jackel, "Death as a Disposition Redux," *Tax Notes Federal*, Oct. 7, 2019, p. 101) (arguing that death is a disposition where liabilities exceed tax basis at death). A clarification should be added in the final regulations similar to the Opportunity Zone regulations at least in cases where liabilities do not exceed basis at death (which should be reserved and comments requested). *See* reg. section 1.1400Z2(b)-1(c)(5)(i), (ii).

1(a) and (e), the taxpayer must treat all amounts as API gains and losses.

A passthrough entity that has an API holder is required to provide the API holder specified information for the tax year to enable the API holder to comply with the regulations under section 1061.This information includes the API one-year distributive share amount, the API three-year distributive share amount, the amount of capital interest gains and losses, and API holder transition amounts that are allocated to the API holder during the tax year.

If the API holder timely requests information from the passthrough entity in order to comply with section 1061 and the proposed regulations, the passthrough entity must timely provide the requested information to the API holder.

A passthrough entity that holds an interest in a lower-tier partnership entity may need information from the lower-tier entity to meet its reporting obligations under the proposed regulations. In this case, the passthrough entity must timely request information from any lower-tier partnership entities in which it owns an interest. The lower-tier partnership entity must timely respond by furnishing the required information.

The proposed regulations were, frankly, drafted with the understanding that "those in the know" in the private equity industry would know what to do to acquire the necessary information. In fact, it is very likely that this information is already tracked and known. Nevertheless, given the burdensome nature of these information-gathering requirements that could apply to small business taxpayers, some loosening up of these requirements for either "small partnerships" or "small partners" would appear to be more than justified. The preamble to the proposed regulations asks for comments on this issue.

F. Effective Dates

The proposed regulations generally provide that the final regulations will apply to tax years of owner taxpayers and passthrough entities beginning on or after the date the final regulations are published in the *Federal Register*. However, except for the rules in the proposed regulations regarding partnership transition amounts and API holder transition amounts, owner taxpayers and passthrough entities may rely on the proposed regulations for tax years beginning before the date final regulations are published in the *Federal Register* if they follow the proposed regulations in their entirety and in a consistent manner.

In contrast, taxpayers may rely on the rules in the proposed regulations regarding partnership transition amounts and API holder transition amounts for tax years beginning in 2020 and subsequent tax years beginning before the date final regulations are published in the *Federal Register*. Moreover, they may do so without consistently following all of the rules provided in prop. reg. section 1.1061-1 through -6 if the partnership treats capital gains and losses from the identified assets as partnership transition amounts and API holder transition amounts for the year in which the election is made and all subsequent tax years beginning before the date final regulations are published in the *Federal Register*. This approach makes eminent sense given that preexisting partnerships can and will be drawn into these rules — in some cases, years after the partnership started operations.

As indicated in section 4 of Notice 2018-18, 2018-12 IRB 443, prop. reg. section 1.1061-3(b)(2)(i), which provides that the term "corporation" does not include an S corporation, is proposed to apply to tax years beginning after December 31, 2017. Further, prop. reg. section 1.1061-3(b)(2)(ii), which provides that the term "corporation" does not include a passive foreign investment company for which the shareholder has a qualified electing fund (QEF) election under section 1295 in effect, is proposed to apply for tax years beginning after the date of publication of the proposed regulations in the *Federal Register* (August 14). If these rules are retained in the final regulations, the effective dates seem fair given the apparent abuse potential of allowing some passthrough entities to claim exempt status as a corporation.

For an API in a partnership with a fiscal year ending after December 31, 2017, section 706 determines the capital gains and losses the owner taxpayer includes in income for an API after December 31, 2017. Under section 706, the taxable income of a partner for a tax year includes amounts required by sections 702 and 707(c) for a partnership (based on the income, gain, loss, deduction, or credit of a partnership) for any tax year ending within or with the partner's tax year.

Thus, the preamble states that if a calendar-year owner taxpayer has an API in a fiscal-year partnership that has a year-end after December 31, 2017, section 1061 applies to the owner taxpayer's distributive share of long-term capital gain or loss on the API in calendar year 2018, regardless of whether the partnership disposed of the property giving rise to the gains and losses in the period before January 1, 2018.[7]

G. Smaller Partnerships

The preamble to the proposed regulations requests comments on whether a simplified method for determining and calculating the API gain or loss should be provided for smaller partnerships, and if so, the criteria that should be used to determine which partnerships should be eligible to use the simplified method. The preamble states that these comments should include comments on and suggestions for a simplified method.

III. Analysis

The key points, as I see them, regarding the section 1061 proposed regulations are as follows.

A. No Suspension of Holding Periods

There is no separate rule in the proposed regulations addressing suspension of the holding period of an API to obtain a more-than-three-year holding period without undertaking additional risk — that is, the hedging of the API. There is an express rule for Opportunity Zone interests,[8] and there should have been a specific rule here.

The proposed regulations provide that the relevant holding period for either an asset or an API is determined under sections 735 and 1223. The proposed regulations do not even cite section 1092 or 1233 or similar provisions of law. Those latter provisions would likely be of little use anyway because section 1092 requires actively traded personal property and section 1233 requires a short sale. Why is there not such a rule? Is it too late to provide one?

B. S Corporations and QEFs

On its face, section 1061 excludes a partnership interest held by a "corporation." Notice 2018-18 and the legislative history at time of enactment offer no reason why S corporations should or should not qualify for the exception.[9] Further, QEFs are PFICs that make an election under section 1295 to be treated as a passthrough entity for ordinary income and capital gain under section 1293.

An S corporation is clearly a corporation, a QEF is clearly a C corporation, and partnership interests held by them should be excluded from section 1061. This appears to be another illustration of the IRS Office of Chief Counsel writing regulations when it doesn't like the statutory result, regardless of what the words of Congress actually say. No one is arguing that it would be good tax policy to allow S corporations and QEFs to escape section 1061, but on the other hand, who is the legislator here — Congress or the IRS?[10]

C. Book-Ups and Tiered Partnerships

Revaluations through tiers of partnerships are generally elective. In addition to the generally elective nature of revaluations, there are technical problems with making a revaluation at the level of a lower-tier partnership for a revaluation event occurring at the upper-tier partnership level.[11]

There is limited aggregate treatment for tiered partnership revaluations under reg. section 1.704-3(a)(9).[12] The taxation regime under the proposed

[7] Reg. section 1.706-1(a)(1).

[8] Reg. section 1.1400Z2(a)-1(b).

[9] Bruce Lemons and Richard Blau, "Are S Corporations 'Corporations' Under the Carried Interest Rules?" *Tax Notes Federal*, Sept. 2, 2019, p. 1567; and Jackel, "S Corporations and Carried Interests," *Tax Notes Federal*, Nov. 11, 2019, p. 987.

[10] *Gitlitz v. Commissioner*, 531 U.S. 206, 220 (2001), establishes the principle of law that the plain text of a statute controls even if it leads to an inappropriate result. It is up to Congress to fix those cases as it did in this case.

[11] *See* Gary Huffman and Barksdale Hortenstine, "Tiers in Your Eyes: Peeling Back the Layers on Tiered Partnerships," 86 *Taxes* 179 (2008); and Jackel, "Complexity and Confusion: Cross-Border Partnership Regs Finalized," *Tax Notes Federal*, Feb. 10, 2020, p. 931.

[12] For a comprehensive analysis of reverse section 704(c) allocations through tiers of partnerships, see Robert Burke, "Revaluations in Upper-Tier Partnerships — An Alternative Approach," *Tax Notes*, Apr. 15, 2019, p. 359.

section 1061 regulations depends on revaluations being done — and being done accurately — throughout tiers of partnerships. However, not infrequently, the information necessary for a revaluation may be unavailable, at least for non-controlled partnerships.

It will be interesting to see the public comments on this issue. Of particular note is the request for comments on whether an exception should be provided for smaller partnerships, allowing them to be excluded in whole or in part from the complex tiered revaluation rules of the proposed section 1061 regulations.

D. Partial Aggregate Taxpayer Approach

The proposed regulations adopt a so-called partial aggregate approach in defining the term "taxpayer" for purposes of section 1061. In testing for who has the gross income inclusion, the owner taxpayer is treated as the taxpayer. This is an aggregate approach. But in determining whether an ATB exists, the term includes not only owner taxpayers but also passthrough entities. This is an entity approach. Further, one trade or business can be contained in multiple separate tax entities, and one separate tax entity can have multiple trades or businesses.

This aggregate-entity conundrum for tiered partnerships will need to be resolved before finalization of the proposed regulations.

E. Capital Interest Allocations

The proposed regulations implement the capital interest exception under section 1061(c)(4)(B) by requiring that the API holder share in profits and losses "in the same manner" regarding its capital account as of the receipt of the API. The proposed regulations sensibly and logically expand this treatment to apply continuously to a partner's capital account even though the words of the statute are quite clear that only capital contributed "at the time of receipt of such partnership interest," meaning capital contributions only, is taken into account. The words used by the Congress, although clearly in error, are being disregarded. Do the ends justify the means in this case?

Further, as discussed in a prior segment of this article, some argue that a so-called revaluation upon a revaluation converts an API into a capital interest to the extent of future book and related tax allocations. They argue that the proposed regulations' use of comparative capital accounts and not comparative capital contributions causes a conversion of the API into a capital interest.

The proposed regulations were not intended to work in this manner, but a clarification is clearly warranted under the circumstances. For example, it should be clarified that a separate capital account or its equivalent should be separately maintained for both the API and the capital interest, and that the appropriate portions of future gains and losses should be allocated to each account. Determining the effective date of such a clarification will depend on whether the IRS views this argument as based on a good-faith reading of the proposed regulations or just an abuse. Time will tell on that one.

The proposed regulations require that the comparative baseline to test "in the same manner" for capital interest allocations be the same as that of a significant number of non-service providers for their capital. Requiring exact matching of allocations and distributions "in the same manner" may cause burdens and frustrate ordinary course business arrangements.

Further, not all partnerships maintain capital accounts in compliance with the section 704(b) regulations, and those taxpayers may be unfamiliar with these concepts.

F. Sections 1(h), 1231, and 1256

Section 1061(a) recharacterizes gain and loss on assets held for three years or less as short-term capital gain. The statute accomplishes this by requiring that section 1222(3) and (4) (defining long-term capital gain and loss, respectively) be read as if it referenced assets held for over three years rather than over one year.

This raises the question of section 1061's potential effect on other code provisions that contain a holding period reference or a reference to the ultimate tax treatment as long or short term without regard to section 1222. Some statutory provisions, such as sections 1231 and 1256, either have their own separate holding period in applying the statute (as does section 1231) or do not have a holding period requirement and just mandate the tax treatment (as does section 1256).

This results in a haphazard inclusion or exclusion of items from section 1061.

Similarly, the proposed regulations do not address how net capital gain is computed or the order of steps in doing so under section 1(h)(1). That statute imposes tax on "net capital gain." That term is defined in section 1222(11) as the excess of net long-term capital gain (defined in section 1222(7) as the excess of long-term capital gain over long-term capital loss) over net short-term capital loss (defined in section 1222(6) as the excess of short-term capital losses over short-term capital gains, as defined in section 1222(1) and (2)). Because section 1061(a) recharacterizes what would have been long-term capital gain into short-term capital gain, it is apparent that section 1061(a) must be applied somewhere in the process before the application of section 1(h).

Complicating this analysis and not addressed in the proposed regulations, reg. section 1.1(h)-1 contains a look-through rule when a partnership interest is sold in order to determine what portion of the gain on sale will be treated as collectibles gain or section 1250 capital gain, which have different rates of tax under section 1(h). And importantly, although section 1231 or 1256 gains are excluded from section 1061, a sale of a partnership interest holding such assets is not excluded, and all the gain is subject to section 1061(a) unless section 751(a) applies.

The proposed regulations make a distinction between cases in which other code provisions tie directly into the treatment under section 1222 and cases in which the other code provision either has its own separate holding period or merely prescribes the tax treatment as long or short term. The legislative history is utterly devoid of any guidance on this issue. The approach taken in the proposed regulations is reasonable, but a technical correction from Congress would be welcome here.

G. With Respect to an API

Section 1061(a) references gains and losses "with respect to an API." As noted earlier, there is no definition of the term "with respect to."

The proposed regulations take the position that "with respect to an API" means either (1) sales of APIs, (2) sales of capital assets held by partnerships whose interests are APIs, or (3) the redemption of an API interest by a partnership from a partner. The proposed regulations also treat as an asset "with respect to an API" a capital asset distributed by a partnership to a partner with a holding period of three years or less in the hands of the partner immediately before the sale of the asset.

For all but the last rule, this approach is reasonable and is consistent with prior legislative proposals.[13] The last rule, which treats as a per se tainted asset the distribution to a partner of three-year-or-less property, is an attempt to enable the IRS to avoid the issue of whether the distribution was "with respect to" the holding of the API or just a separate distribution of an asset that is no longer part of the partnership scheme.

The question here is no different from the question that exists generally when a partnership distributes an asset that is promptly sold by the partner: Is that sale a partner sale or a partnership sale? Avoidance of providing a resolution of this difficult issue in the proposed regulations can be supported on the basis of good tax policy, but one can expect the rule to be challenged in court on the appropriate set of facts.

H. Once an API, Always an API

Under the proposed regulations, a partnership interest that at any time was an API is treated as an API forever, regardless of whether it would meet the relevant statutory tests at that later point in time unless an exception under section 1061(c) or the proposed regulations applies.

Although this proposed rule is not explicitly stated in the statute, it is implicit in the statutory scheme. Without such a rule, it would be relatively easy to cleanse an API of its taint with some simple related-party nonrecognition transfers, such as under section 721. I suspect that this rule, if finalized in its present form, will be challenged but ultimately will be upheld in court.

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[13] The 2014 tax reform proposal by then-Rep. Dave Camp (the Tax Reform Act of 2014, H.R. 1) also used the term "with respect to" in describing the legislative proposal. The accompanying legislative material clearly references either an asset sale by the partnership, the sale of a partnership interest, or the redemption of a partnership interest. Were the rule otherwise, form could make a huge difference in tax treatment, and this should be avoided if possible.

I. Tiered Partnership Allocations

Closely connected to the required revaluation of all partnerships in a tier of partnerships to accurately track API book gains and losses is the requirement to know the nature of the allocation received from the next-lower-tier partnership entity in the structure.

Even though a partnership in a tier of partnerships is treated as a taxpayer in testing for the existence of an ATB, the same partnership is essentially treated as an aggregate in testing for allocations of API gains and losses from one partnership to the immediate upper-tier partnership. This is the case even though, if tested separately, API gains and losses could conceivably be blocked through the insertion of a new partnership in the structure.

This proposed rule is necessary to preserve the integrity of the proposed regulations; otherwise, the statute could be easily avoided for the reasons stated earlier. Nevertheless, tracking through a tier of partnerships may not be feasible in all cases, particularly for non-controlled partnerships, and comments will surely address these compliance and privacy issues, specifically including the addition of an exception for smaller partnerships.

J. Derivative Partnership Interests

The proposed regulations treat a derivative of a partnership interest as a partnership interest in applying section 1061(a) but not for any other purpose under the code or regulations. Because payments made before termination of a swap are almost always ordinary income,[14] it may not make economic or tax sense to use that financial instrument in lieu of a partnership interest in an arguable attempt to avoid section 1061. This raises the question whether such a derivative rule is really needed to appropriately administer section 1061 without injecting unnecessary complexity into the tax system.

K. Related-Party Transfers

The proposed regulations treat section 1061(d) as an income acceleration provision that will require an inclusion in gross income of gain that has not yet been either realized or recognized as gross income on a transfer of all or part of an API to a related party. Treasury and the IRS rejected commentators' recommendation that either application of the statute be deferred until Congress acts to clarify the provision or the statute be interpreted to apply only as a recharacterization-type provision, such as section 751(a).

Although it is not believed that the statute can be read as other than an income acceleration provision, it cannot be denied that the statute is written in a confusing manner. Neither the legislative history nor the blue book clearly explain the meaning of section 1061(d). Expect pushback on this issue, particularly given the unclear breath of the term "transfer" in section 1061(d)(1) ("If a taxpayer transfers any applicable partnership interest, directly or indirectly. . .").[15]

L. Real Estate Rental or Investment

Real estate held for rental or investment is a specified asset, but that property may not constitute a section 162 trade or business.[16] Additional guidance may be needed in this area to make the statute more administrable on this issue.[17] If property held for rental or investment is listed as a specified asset, which it is, what sense does it make for section 1231 gain to be excluded from section 1061?

M. Proliferation of Interrelated Definitions

The proposed regulations are difficult to read and comprehend in some places because of the many interrelated new terms and definitions. This

[14] *See, e.g.*, reg. section 1.446-3, concerning notional principal contracts.

[15] For example, as noted earlier, does the admission of a new partner cause a transfer by the preexisting partners, as constructively occurs when there is a book revaluation?

[16] Witness the controversy surrounding the term "trade or business" in the context of rental real estate under section 199A, another Tax Cuts and Jobs Act statute. *See, e.g.*, Joseph DiSciullo, "ABA Tax Section Suggests Changes to Rental Real Estate Safe Harbor," *Tax Notes Federal*, July 15, 2019, p. 383.

[17] As noted in T.D. 9905 (final regulations under section 163(j)), a trade or business as defined for purposes of section 469(c)(7)(C) (the passive activity rule for real estate professionals) expressly includes "any interest in rental real estate, including any interest . . . that gives rise to deductions under section 212." Section 1061 does not define "real property held for rental or investment," so it is unclear whether the activity must qualify under section 162 or whether section 212 is sufficient.

complexity is largely caused by the standard use of tiered partnership structures in private equity-type investments, which are the main congressional target of section 1061.

As a result, the IRS asks for comments on providing a so-called smaller partnership exception to the application of these complex rules, as noted earlier. Providing such an exception is critically important to the integrity of the entire section 1061 regulatory regime.

N. Securities Aggregation

The proposed regulations contain a special rule for partnerships that aggregate tax gains and losses for reverse section 704(c) purposes. This is because if section 1061 would otherwise apply, there would be no method to apply the section 1061 proposed regulations to aggregated securities.[18] Is this rule really necessary, given the rapid turnover of assets by the fund? Or, given the proclivity for manager withdrawal before the three-year holding period expires, is the rule needed to plug a gap in securities aggregation under section 704(c)?

O. Information Reporting

The proposed regulations impose significant reporting burdens on partnerships and their partners, with adverse tax consequences resulting if timely compliance has not occurred. The reporting rules were apparently drafted based on the assumption that in most private equity funds — again, the principal congressional target of the statute — there will be a limited number of individuals who are in control of the business, and "they know everything."

Even assuming that this assumption is valid, the reporting requirements are extensive, and smaller partnerships and non-controlled partnerships may have difficulty complying without significant cost and expense. This is a further argument in favor of exempting small partnerships from these rules.

[18]Reg. section 1.704-3(e)(3) (special aggregation rule for securities partnerships).

P. 'Substantial' Services

The proposed regulations contain a presumption that all services rendered for an API are substantial. Is this a valid assumption? Meaning, will a profits interest granted in the ordinary course of business be issued for services that are not "substantial," whatever quantitative or qualitative definition is given to that term? I would expect many comments on this issue.

Q. Significant Interest

In testing for whether allocations and returns on non-service provider capital accounts are taken into account under the exception for capital interests, those allocations serve as a baseline allocation only if the non-service providers hold a 5 percent or greater interest in the partnership.

Although a specific number or percentage of non-service holders must comprise the tested group (otherwise, the statute could be easily avoided), the pertinent question is whether 5 percent is too large or too small.[19]

Further, the treatment of profits interests in a family office scenario in which is a priority carried interest should be clarified given that management fee priority in those cases is clearly within the scope of the capital interest exception in the proposed regulations.

R. Distributed API Property

The proposed regulations treat the distribution of a capital asset in connection with an API interest holder as subject to section 1061(a) if the interest has not been held for over three years at the time of sale by the partner (counting the tacking of holding periods when appropriate).

[19]The preamble also curiously states: "Allocations made in the same manner to some API Holders by a partnership will not fail to qualify to be treated as a Passthrough Interest Direct Investment Allocation as to those partners despite allocations being made to one or more service providers (or related parties) that are treated as APIs issued by the Passthrough Entity. For example, if (1) all of the partners of the Passthrough Entity are API Holders and one partner manages the Passthrough Entity's direct investments and receives a 20 percent interest in the net long-term capital gains from those investments that is treated as an API as to that partner and (2) the other API Holders share the remaining 80 percent of gain from those investments based on their relative investments in the Passthrough Entity, then (3) the allocation of the 80 percent of net long-term capital gain is a Passthrough Interest Direct Investment Allocation to those partners." As noted in a prior segment of this article, this provision was apparently directed to so-called family offices.

Although not explicitly stated in the statute, section 1061(a) references "with respect to an API."

As noted earlier, the question thus becomes whether this language is sufficiently broad to be covered by the statute even though distributed property is not mentioned in either the statute, the legislative history, or the blue book. And, as noted in an earlier segment of this article, distributed property for this purpose should exclude property that, if sold by the partnership, would be excluded from section 1061, such as section 1231 and 1256 gains.

Given the vagueness of the statute and the policy objectives that would be served by including these distributions, it is likely that their inclusion, if challenged, would be treated as a valid exercise of regulatory authority. However, I would expect a judicial challenge to the rule if finalized in its present form.

S. Carry Waivers

The preamble to the proposed regulations warns that — based on subchapter K antiabuse provisions — allocations of gain that has a more-than-three-year holding period, or allocations of gain that has a holding period equal to or less than three years, or related waiver transactions, may not avoid the application of section 1061. These antiabuse provisions include the substantial economic effect rule under reg. section 1.704-1(b)(2)(iii); the partnership antiabuse rule under reg. section 1.701-2; as well as the common law antiabuse doctrines, such as the sham transaction, economic substance, step transaction, lack of entrepreneurial risk, and substance-over-form rules or other common law doctrines.

Ultimately, the key issue is whether there is sufficient entrepreneurial risk and economic substance to sustain the allocations or waiver.[20] Given the brevity of the foregoing statement in the preamble, is more definitive guidance warranted under the circumstances? I think it is, but I wouldn't expect that guidance any time soon given that proposed regulations under section 707(a)(2)(A) have been outstanding since 2015 and that the substantial economic effect test under the section 704(b) regulations has been left intentionally vague for many years now on the question of how much risk of loss is enough to sustain a special allocation. Overly aggressive carry waiver cases are surely to be on the list of issues to be examined in a partnership audit of section 1061 and its application to a particular partnership. For example, is a 1 percent chance of risk of loss sufficient to support the waiver? Ten percent? One-third? Time will tell.

T. Partnership Look-Through Rule

The proposed regulations provide that if a partnership interest held for over three years has substantially all of its assets held for three years or less, an aggregate approach is applied to determine what portion of the partnership interest has been held for over three years and which portion has been held for three years or less in the case of a disposition of all or a portion of that interest. Additional rules apply if there is a tiered partnership structure.

Although there is regulatory authority under section 1061(f) to issue regulations or other guidance "as is necessary or appropriate to carry out the purposes of this section," if a partnership is a bona tax partnership under relevant *Moline*-type authority,[21] is it appropriate for the IRS to apply aggregate principles in this limited case? That issue is far from clear.[22]

U. Single ATB

In determining whether an ATB exists, activities conducted in multiple entities — either in the same chain of entities or in a brother-sister related chain — are taken into account. This can greatly complicate the analysis. Perhaps some simplifying safe harbors are in order.

V. Maintenance of Capital Accounts

For an API holder to benefit from the capital interest exception, the proposed regulations generally require that it have a properly maintained capital account under the section

[20] *See, e.g.*, the proposed fee waiver regulations under prop. reg. section 1.707-2. REG-115452-14 (issued in 2015; still proposed).

[21] *Moline Properties v. Commissioner*, 319 U.S. 436 (1943).

[22] Jackel, "Practitioner Summarizes Partnership Aggregate-Entity Authorities" (July 25, 2017).

704(b) regulations or a similarly maintained account,[23] even though the partnership is not required to liquidate based on those capital accounts. This leaves out of the scope of the capital interest exception partnerships that do not necessarily properly maintain capital or similar type accounts because liquidation proceeds are distributed based on a liquidation priority waterfall rather than remaining capital accounts.[24]

There are many bona fide partnerships in the marketplace that have what are known as "targeted allocations" with waterfall distributions. What of those business arrangements? If these partnerships do not have partners who properly maintain capital or similar accounts when those capital accounts lack economic significance in the business arrangement, is it fair to exclude those arrangements from the capital interest exception? What about the partnerships that use generally accepted accounting principles?

W. Capital Interest Loans

In computing returns on capital, the proposed regulations exclude from a partner's capital account any capital that is funded through a loan or loans from another partner, the partnership, or a related party to a partner or the partnership. Repayments of loans result in capital account credit, but only if the repayments are not funded through another prohibited loan. As stated in an earlier segment of this article, this exclusion was apparently included to avoid a case-by-case determination whether a loan in form was in fact a loan in substance.

How difficult will the tracing regime be here to connect the loan proceeds with the capital contribution?[25] The proposed regulations are silent on that issue. And what of loans that are basically fully secured by partnership assets? There is silence on that issue as well. Clarification is in order here. And, as noted earlier, what effect, if any, will the exclusion of such a loan have on the benchmark comparison between the return on capital of a service provider and a significant number of non-service providers? This should be clarified as well.

X. Recapitalizations and Divisions

The preamble to the proposed regulation warns of arrangements whereby partnership recapitalizations or divisions may have been used to try to circumvent the API rules by creating a separately disposable partnership interest attributable solely to capital and not to services. The preamble cautions that those arrangements will not be effective either under subchapter K antiabuse principles or the common law antiabuse doctrines. Is this necessarily true?

The language concerning recapitalizations and divisions does not expressly appear in the text of the regulations, and neither term is defined in the proposed regulations. Although the term "division" is presumably referencing a partnership division under section 708(b)(2) because the concept is an attempted separation of the API from the capital component of the partnership interest, it would be preferable if this were clarified.

Regarding recapitalizations, unlike in subchapter C, the term "recapitalization" is not a term of art in subchapter K, although it is often used in practice. For example, does the term solely mean a reclassification of one type of partnership interest into another class or kind of interest, such as the conversion of a single partnership interest into a services interest and a capital interest in accordance with an amendment of the partnership agreement, or is the term broader in meaning? Could the term include any attempt to convert an API into a capital interest, such as the distribution of money by a partnership to an API holder when, for whatever reason (such as a section 752 debt allocation), gain is not recognized by the partner under section 731 and then, after a period of time, the cash is recontributed to the partnership by the distributee or by a related-party affiliate as a putative separate capital contribution?

It would seem that in cases like this, the standard regulatory and case law antiabuse doctrines, such as reg. section 1.701-2 or the common law economic substance, substance-

[23] Reg. section 1.704-1(b)(2)(ii), (b)(2)(iii), (b)(2)(iv), and (b)(4).

[24] Some partnership agreements attempt to "true-up" the capital accounts to what will be distributed, and some do not. Should the capital interest exception hinge on such treatment?

[25] This is most recently illustrated by prop. reg. section 1.163-14 and -15 in the recently proposed section 163(j) regulations.

over-form, step transaction, sham, lack of entrepreneurial risk, or lack of business purpose doctrines would apply, and if the transaction passed muster under those rules, that would presumably end the matter favorably on the taxpayer's behalf.

The preamble does state, however, that a partner may separately dispose of a capital interest in a partnership or an API, but it also states that the unified basis principle of Rev. Rul. 84-53, 1984-1 C.B. 159, continues to apply so that the tax basis and holding periods will be apportioned to both the interest retained and the interest disposed of. Thus, the ability to isolate specified tax attributes into a particular interest and then dispose of that interest is not accepted by the proposed regulations.

Y. Transition Amounts

The proposed regulations exempt from section 1061 properly identified gains and losses from assets held by a taxpayer for over three years as of January 1, 2018, and governed by a partnership agreement executed or amended no later than the due date (without extensions) for filing the return for the 2018 tax year under section 761(c). The theory behind this exception is that taxpayers would not be tracking gains and losses attributable to capital and to services before that time. How easy or difficult will it be to identify those assets and gains and losses to qualify for this exception?

Z. Rev. Rul. 68-79, Look-Through

Finally, the proposed regulations adopt the approach whereby, with one exception, the holding period of the relevant asset or interest disposed of is tested in applying section 1061(a). Thus, (1) gain on the sale or exchange of a partnership interest is based on the holding period of the partnership interest; (2) gain on a sale or exchange of a capital asset by the partnership is based on the holding period of the partnership for that asset; and (3) the holding period of the partnership interest is again relevant on the redemption of a partnership interest. The sole exception is when the look-through rule is applied upon the disposition of all or a portion of either a directly or indirectly held API.

This rule is logical because it is most consistent with partnership tax principles. However, the authority for the look-through exception is subject to some doubt, and if that rule is held invalid, the taxing regime of the proposed regulations will be easily manipulated.

IV. Conclusion

The proposed regulations are very complex, with many intersecting definitions and rules. This detailed and complex regime was arguably necessary to conform to the standard mode of business operations of private equity and similar funds, and also to prevent abuse and to ensure that the appropriate transactions are subject to the correct amount of tax.

If that was the goal, it was mostly accomplished. But with how much burden and at what cost? The burdens of compliance with the proposed regulations will be high, and depending on which taxpayers are excepted from these detailed rules based on being a smaller partnership, the regulations could turn out to be either a success or a failure. Time will tell. ■