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Report No. 1442
October 5, 2020

The Honorable David J. Kautter
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The Honorable Charles P. Rettig
Commissioner
Internal Revenue Service
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The Honorable Michael J. Desmond
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Internal Revenue Service
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Re: *Report No. 1442 – Report on Proposed Regulations under Section 1061*

Dear Messrs. Kautter, Rettig, and Desmond:

I am pleased to submit our Report No. 1442 commenting on the recently issued proposed regulations under Section 1061 of the Code.

We commend the Internal Revenue Serivce and the Department of the Treasury for their thoughtful guidance in the proposed regulations. Our comments are directed at ensuring that Section 1061 operates in a manner consistent with its intended scope, is administrable and provides consistent results for economically equivalent investments and arrangements.Issues addressed in our report include the capital interest, corporate, and self-investment exceptions to API treatment, exclusion of Section 1231 gains, and transfers subject to Section 1061(d), as well as rules relating to holding periods and reporting requirements.

We appreciate your consideration of our report. If you have any questions or comments, please feel free to contact us and we will be glad to

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Respectfully submitted,

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Report No. 1442

New York State Bar Association

Tax Section

Report on Proposed Regulations Under Section 1061

October 5, 2020

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I. Introduction

This Report[1] comments on the proposed regulations (the "Proposed Regulations")[2] issued by the Department of the Treasury and the Internal Revenue Service (the "IRS" and, together with the Department of the Treasury, "Treasury") under Section 1061.[3] Section 1061 was enacted as part of the so-called Tax Cuts and Jobs Act of 2017 (the "TCJA")[4] to recharacterize certain gains from partnership profits interests held in connection with the performance of investment services.[5] The Proposed Regulations address the mechanics of calculating the amount of such recharacterized gains, the scope of various exceptions to recharacterization, rules regarding transfers

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[1] The principal author of this Report is David W. Mayo, with substantial drafting assistance from Noah H. Marks and significant contributions from Phillip Gall, Orla J. O'Connor and Matthew Busta. Helpful comments were received from Lee E. Allison, Noah Beck, Kimberly S. Blanchard, Andrew H. Braiterman, Jonathan S. Brenner, James R. Brown, Simcha B. David, Pamela L. Endreny, Jason R. Factor, Marcy G. Geller, Kathleen Saunders Gregor, Udi Grofman, Philip S. Gross, Martin T. Hamilton, Rafael Kariyev, Patrick N. Karsnitz, Stephen B. Land, Andrew W. Needham, Amanda H. Nussbaum, Yaron Z. Reich, Jason Sacks, Michael L. Schler, David H. Schnabel, Mark Schwed, David I. Shapiro, Eric B. Sloan, Jonathan Talansky, Conrad van Loggerenberg, Lindsey L. Wiersma and Libin Zhang. This Report reflects solely the views of the Tax Section of the New York State Bar Association ("NYSBA") and not those of the NYSBA Executive Committee or the House of Delegates.

[2] Guidance Under Section 1061, REG-107213-18, 85 Fed. Reg. 49754 (August 14, 2020). For clarity, this Report uses "Prop. Reg." to cite provisions of the Proposed Regulations and "Preamble" to refer to and cite the explanatory material published preceding the text of the Proposed Regulations in the Federal Register.

[3] Unless otherwise indicated, all "Section" (and §) references are to the Internal Revenue Code of 1986 (the "Code"), as amended, or the Treasury Regulations promulgated thereunder. Defined terms not defined in this Report have the meaning given in the Proposed Regulations.

[4] The TCJA is formally known as "An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018," Pub. L. No. 115-97, 131 Stat. 2054 (2017).

[5] *See* H.R. Rep. No. 115-466 at 416 (2017) (Conf. Rep.) (hereinafter "Conference Report"); Report of the Committee on Ways and Means on H.R. 1, H.R. Rep. No. 115-409 at 277 (2017) (hereinafter "House Report") ("The Committee is concerned about Federal tax issues arising from the use of carried interests in asset management businesses. . . . The arrangement requires the performance of services by individuals whose professional skill as fund managers generates capital income for investors in the fund. . . . Long-term capital gain allocated to individual partners may represent compensation for their services as fund managers.").

between certain related persons and the reporting obligations imposed on investment partnerships to enable taxpayer compliance with Section 1061.

The balance of this Report focuses on certain aspects of the Proposed Regulations and is divided into three parts. Part II contains a summary of our recommendations and requests for guidance. Part III provides background, describes Section 1061, and presents a general summary of the Proposed Regulations. Part IV contains a detailed discussion of our recommendations and requests.

II. Summary of Principal Recommendations[6]

A. The Capital Interest Exception

- Our overarching comment is that the Capital Interest Exception is too rigid and excludes many common, non-abusive commercial arrangements typical of investment funds which we believe come within the scope of rights that are "commensurate" with the amount of capital contributed or income recognized under Section 83 within the statute.
- We recommend that Treasury clarify the scope of "cost of services provided," specify that a general partner's capital interest not being subject to incentive payments or allocations, or management fees, does not disqualify it from the Capital Interest Exception, and provide guidance on other common differences between service providers' capital interests and investor limited partners' interests.

[6] Certain capitalized terms in this Part II are defined in Parts III and IV.

- We recommend that Treasury replace the rigid requirement that allocations and distributions follow overall capital accounts with a requirement that rights to allocations and distributions be commensurate with the rights of non-service partners based on capital contributed and accommodate deal-by-deal allocations and distributions.
- We recommend that Treasury resolve explicitly whether subsequent gains on crystallized incentive allocations (and certain post-distribution appreciation of Distributed API Property) are subject to Section 1061 or come within the Capital Interest Exception.
- We recommend that Treasury eliminate the exclusion of interests obtained with loan proceeds from qualifying for the Capital Interest Exception and instead rely on general income tax principles in Sections 83 and 7872 to determine whether a loan-financed arrangement qualifies.
- We recommend that Treasury provide that the Capital Interest Exception can apply to service-provider investments made through a co-invest vehicle.
- We recommend that Treasury carefully consider the implications of Example 5 in Proposed Regulations Section 1.1061-3(c)(7)(v), which appears to have the potential to produce anomalous results in the calculation of inside gain and outside gain when a service provider

sells a portion of its partnership interest and could have ramifications that are far broader than Section 1061.

B. The Corporate Exception

- We agree that Treasury has the authority to exclude S Corporations and Passive Foreign Investment Corporations for which shareholders have made Qualifying Electing Fund elections from the Corporate Exception.

C. The Self-Investment Exception (Section 1061(b))

- Our overarching comment is that the Passthrough Interest Direct Investment Allocations rule is insufficient to accommodate the arrangements we believe should come within Section 1061(b).
- We recommend that Treasury provide guidance, including safe harbors, under which family members who provide investment management services in typical family office arrangements are exempted from Section 1061(a) under Section 1061(b).
- We believe that Section 1061(b) should also accommodate arm's-length investments in service companies using different commercial approaches, including direct purchases of interests, indirect contributions to service companies and disguised sales.
- We also recommend that Treasury revise the bona fide unrelated purchaser exception to encompass all Passthrough Entities and to clarify its operation in tiered structures.

D. Exclusion of Section 1231 Gains

- We strongly believe that Section 1231 gains should be subject to Section 1061(a) as a policy matter, and are not convinced that Treasury's reading excluding them is the best reading of Section 1061.

E. Transfers Subject to Section 1061(d)

- We recommend that Treasury consider whether its reading of Section 1061(d) as an acceleration provision and not merely a recharacterization provision, which creates many traps for the unwary, is appropriate and aligns with Section 1061(d)'s language, function and origins.
- We recommend that Treasury provide guidance on how to apply Section 1061(d) to transfers by Passthrough Entities, transfers of Distributed API Property, and in tiered structures.
- We recommend that Treasury clarify whether amounts treated as capital gains based on provisions other than Sections 1222(3) and (4) are subject to Section 1061(d).
- We recommend that Treasury revise the definition of "transfer" to prevent typical commercial structuring in the upper tiers of investment funds from being subject to Section 1061(d).
- We recommend that Treasury explicitly include transfers at death and the attendant tax basis step-up alongside gifts as being subject to Section 1061(d).
- We recommend that Treasury clarify that Section 1061(d) is limited to vested portions of and the gain inherent in transferred APIs.

- We recommend that Treasury explicitly coordinate the tax basis adjustment in Section 1061(d) with Section 743.

F. Holding Periods

- We recommend that the gains from dispositions of property that was, but no longer is, Distributed API Property distributed to an Owner Taxpayer be included in the API Three Year Disposition Amount, as it is included in the API Three Year Distributive Share Amount.
- We recommend that Treasury revise the definition of Distributed API Property to accommodate in-kind distributions that are commensurate with capital contributed and accordingly come within the Capital Interest Exception.
- We recommend that due to the significant administrative burden it imposes, Treasury limit the scope of the Lookthrough Rule. We also recommend that the lookthrough rule in the Capital Interest Disposition Amount calculation be revised correspondingly.
- We recommend that the Lookthrough Rule approach the calculations from the lower-tier entities up, aligning with the approach to tiered structures elsewhere in the Proposed Regulations and allowing the rule to appropriately accommodate lower-tier gains from assets whose sale proceeds are treated as capital gains without regard to Sections 1222(3) and (4).

G. Reporting Requirements

- We recommend that Treasury revise the definitions and corresponding reporting of the API One Year Distributive Amount and API Three

Year Distributive Amount to allow complete Owner Taxpayer level netting.

- We recommend that Treasury revise the information reporting requirements to accommodate tiered structures realistically and to remove the punitive consequences for failing to receive necessary information where the Owner Taxpayer does not control the reporting entities and timely requests such information.
- We recommend that Treasury provide guidance on how to substantiate unreported amounts.

H. <u>Additional Recommendations</u>

- We recommend that Treasury provide guidance on how the presumption that services are substantial operates and provide examples of de minimis services that will not trigger Section 1061.
- We recommend that Treasury revise the ATB Activity Test to provide that ownership structures that use C corporations do not necessarily constitute applicable trades or businesses.
- We recommend that Treasury clarify the purpose of the Partnership Transition Amounts, provide examples of where they believe it will assist taxpayers with their compliance burdens and consider providing a mechanism to revoke the election.
- We recommend that Treasury eliminate the mandatory Section 1061 revaluation rules.
- We recommend that Treasury clarify that the Unrealized API Gains and Losses taint persists when a lower-tier partnership distributes an

interest to an upper-tier partnership in respect of such upper-tier partnership's API as an incentive payment.

- We recommend that Treasury formally define who is a "taxpayer" and the meaning of the term "person" for different pieces of Section 1061 in the final regulations.

III. Background

A. Taxation of Profits Interests Prior to the TCJA

Under current law, the receipt of a partnership profits interest generally is not a taxable event. In 1993,[7] the IRS issued Revenue Procedure 93-27,[8] which announced a safe harbor under which the IRS would not treat the receipt of a partnership profits interest in exchange for the provision of services to or for the benefit of the partnership and performed by a partner or in anticipation of becoming a partner as a taxable event to the recipient or to the partnership.[9] Revenue Procedure 93-27 defined "profits interest" as a partnership interest that is not a "capital interest" and defined "capital interest" as "an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value and then the proceeds were distributed in a complete

[7] The history of controversy predating Revenue Procedure 93-27 is discussed in McKee, Nelson & Whitmire, *Federal Taxation of Partnerships & Partners* § 5.02[1] (4th ed. 2007 & Supp. 2020-3).

[8] 1993-24 I.R.B. 63.

[9] Coming within the safe harbor requires that (1) the services must be to or for the benefit of the partnership, (2) the person providing the services must do so in a partner capacity or in anticipation of being a partner in such partnership, (3) the profits interest not be related to "a substantially certain and predictable stream of income," (4) the partner not dispose of the profits interest within two years of receipt and (5) the partnership not be a publicly traded partnership as defined in Section 7704(b). *Id.* §§ 4.01 & 4.02.

liquidation of the partnership."[10] The determination of whether an interest is a capital interest or a profits interest is generally made at the time of the receipt of such interest.

The IRS extended and clarified the safe harbor in Revenue Procedure 2001-43,[11] specifically by describing conditions under which the grant of a "substantially nonvested" partnership profits interest, and its vesting, will not be treated as a taxable event to the recipient or the partnership.[12] If those conditions are met, the service provider recipient will be treated as receiving the interest on the date of its grant, which is significant for the purpose of evaluating liquidation value.

Many fund managers receive significant economics in the form of a share of the profits generated by the fund (referred to as "carried interest" or "carry"[13]) through partnership profits interests structured to fit within the safe harbor described above. Accordingly, such professionals avoid immediate tax upon the grant (and, as relevant, the vesting) of their carried interest. Furthermore, as partners in the investment fund partnership,[14] the items of income and gain that make up the allocations of carry retain

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[10] *Id.* §§ 2.01 & 2.02. The Proposed Regulations, if adopted, would codify this definition into Treasury Regulations Section 1.1223-3(b)(5)(ii).

[11] 2001-34 I.R.B. 191.

[12] "Substantially nonvested" is defined by reference to Treas. Reg. § 1.83-3(b), *id.* § 3, which in turn defines substantially nonvested as (1) being subject to "a substantial risk of forfeiture" and (2) being "nontransferable," Treas. Reg. § 1.83-3(b); *see also id.* §§ (c) & (d) (defining both terms, respectively).

[13] This term is often traced to the compensation paid to Phoenician sea captains for their trading expeditions. *See, e.g.*, John Cassidy, *Mastering the Machine*, The New Yorker, July 25, 2011 at 56, 59; Maxwell Gawley, *Closing the Carried Interest Loophole and the Impacts on Venture Capital*, 68 DePaul L. Rev. 671, 674 (2019) ("The term 'carried interest' can be traced back hundreds of years to merchants in the Mediterranean who would carry cargo belonging to others and earn 20% of the profits on the cargo for their services.").

[14] As discussed below, typically such managers will indirectly hold partnership profits interests through tax-transparent upper-tier entities that themselves are the partners in the investment fund partnership.

their character including, to the extent applicable, long-term capital gain or qualified dividend income.

B. Section 1061

The TCJA added Section 1061 to the Code to provide that "the lower rates that apply to long-term capital gain from sales or exchanges of capital assets of partnerships should not be available to holders of [partnership interests received in exchange for services] unless an extended holding period requirement has been met."[15] At a high level, Section 1061 extends the holding period required to receive preferential long-term capital gains tax treatment, specified in Sections 1222(3) and (4) as more than one year, to more than three years for capital gains allocated to certain partnership profits interests received in exchange for the provision of investment management services.

1. Applicability and Mechanics

Section 1061 applies to a specific category of partnership interests referred to in the statute as "applicable partnership interests" ("APIs"). An API is an interest in a partnership that is directly or indirectly transferred to or held by a taxpayer in connection with the performance of substantial services by the taxpayer, or a related person, in an "applicable trade or business" ("ATB").[16] An ATB is "any activity conducted on a regular, continuous, and substantial basis" through one or more entities that consists, at least in part, of (1) raising or returning capital and (2) investing in, disposing of,

[15] House Report, *supra* note 5, at 277 ("The Committee believes that providing a three-year holding period requirement on certain capital gains for holders of applicable partnership interests strikes the right balance for economic growth and fairness without stifling investment.").

[16] Section 1061(c)(1).

identifying for investment or disposition, or developing "specified assets," which includes securities.[17]

If a taxpayer holds one or more APIs at any time during a tax year, Section 1061 treats as short-term capital gain the amount that the taxpayer's net long-term capital gain with respect to such APIs exceeds the amount of net long-term capital gain that the taxpayer would have had if the holding period in Sections 1222(3) and (4) were "3 years" instead of "1 year" (such amount, the "Recharacterization Amount"). This recharacterization applies regardless of and notwithstanding Section 83 and any Section 83(b) election made by the taxpayer.[18]

2. *Exceptions*

Section 1061 specifies three exceptions to the definition of API and authorizes Treasury to carve out a fourth exception to Section 1061(a) through regulations.

First, Section 1061(c)(4)(A) provides that API does not include "any interest in a partnership directly or indirectly held by a corporation" (the "Corporate Exception"). Before the release of the Proposed Regulations, the IRS issued Notice 2018-18,[19] which announced that forthcoming regulations would provide that the term "corporation" does not include an S Corporation.[20] As discussed below, the Proposed Regulations contain

[17] Section 1061(c)(2). Specified assets are defined as securities, commodities, real estate held for rental or investment, cash or cash equivalents, options or derivative contracts with respect to such items, and an interest in a lower-tier partnership to the extent of the partnership's proportionate interest in such items. Section 1061(c)(3).

[18] Section 1061(a).

[19] Guidance Under Section 1061, Partnership Interests Held in Connection with Performance of Services, 2018-12 I.R.B. 443 (Mar. 19, 2018).

[20] *Id.* § 3.

that clarification and confirm the IRS's intention for such rule to apply to all tax years beginning after December 31, 2017.[21]

Second, Section 1061(c)(4)(B) provides that API does not include "any capital interest in the partnership which provides the taxpayer with a right to share in partnership capital commensurate with . . . the amount of capital contributed (determined at the time of receipt of such interest)" or commensurate with the value of such interest subject to tax under Section 83 upon its receipt or vesting (the "Capital Interest Exception").

Third, Section 1061(c)(1) excludes from the definition of API an interest (1) held by a person employed by another entity who (2) provides services only to such other entity, so long as (3) such other entity conducts a trade or business that is not an ATB.

Fourth, to the extent provided by Treasury, Section 1061(a) does not apply to income or gain attributable to any asset that is not held for portfolio investment on behalf of third-party investors (the "Self-Investment Exception").[22] A third-party investor is defined as a person that holds an interest in the partnership that is not property held in connection with an ATB and that is not and has not been actively engaged in, or related to a person actively engaged in, providing substantial services in an ATB for the partnership or any ATB.[23]

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[21] Prop. Reg. § 1.1061-3(b)(2)(i). As a practical matter, because Section 1061 only applies to tax years beginning after December 31, 2017, this effective date results in S Corporations never having been treated as corporations for the purposes of the Corporate Exception. TCJA, *supra* note 4, § 13309(c).

[22] Section 1061(b).

[23] Section 1061(c)(5).

3. Transfer of an API to a Related Person

Section 1061(d) appears to apply to a taxpayer who transfers an API, directly or indirectly, to a related person (defined as a member of the taxpayer's family or a current or past colleague (including, in certain instances, a supervisor or an employer)[24]). Such a taxpayer "shall include in gross income (as short term capital gain) . . . the taxpayer's long-term capital gains with respect to such interest for such taxable year attributable to the sale or exchange of any asset held for not more than 3 years as is allocable to such interest."[25] To avoid double counting,[26] such amount is reduced by "any amount treated as short term capital gain" under Section 1061(a) "with respect to the transfer of such interest."[27] Section 1061(d) does not specify the types of transfers to which it applies (e.g., taxable versus non-taxable), how to determine attribution, the mechanics of the "sale or exchange" determination (e.g., deemed sale or only actual sales), or which assets are relevant (e.g., the ultimate underlying assets versus partnership interests).[28]

4. Regulatory Authority

Section 1061(e) directs Treasury to require reporting as is necessary to carry out the purposes of Section 1061. In addition, Section 1061(f) includes a general grant of

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[24] Family is defined by reference to Section 318(a)(1). Section 1061(d)(2)(A). Colleague encompasses anyone who performed a service in the current calendar year or the preceding three calendar years in any ATB for which the taxpayer also performed a service. Section 1061(d)(2)(B).

[25] Section 1061(d)(1)(A).

[26] *See* House Report, *supra* note 5, at 280; Conference Report, *supra* note 5, at 422; Staff of Joint Comm. on Taxation, 115th Cong., 2d Sess., JCS-1-18, General Explanation of Public Law No. 115-97 203 (2018) (hereinafter "Bluebook").

[27] Section 1061(d)(1).

[28] Numerous commentators have highlighted Section 1061(d)'s somewhat inscrutable language. *See, e.g.*, Walter D. Schwidetzky, *Carried Interests Under the TCJA: Progress or Regress?*, 160 Tax Notes 1673, 1678–79 (Sept. 17, 2018) (characterizing Section 1061(d) as "perplexing"); *see also infra* Section IV.E.2.(a).

authority directing Treasury to issue regulations or other guidance as is necessary or appropriate to carry out such purposes.

C. Overview and Structure of the Proposed Regulations

The Proposed Regulations are divided into six sections. Proposed Regulations Section 1.1061-1(a) provides relevant definitions. Proposed Regulations Section 1.1061-2(a) provides rules and examples for determining when an interest in a partnership is an API and tracking unrealized gains and losses allocated to API holders, while Proposed Regulations Section 1.1061-2(b) provides rules, definitions and examples for determining whether a partnership is engaged in an ATB. Proposed Regulations Section 1.1061-3 provides rules for applying the exceptions to the definition of API – the Corporate Exception (Proposed Regulations Section 1.1061-3(b)), the Capital Interest Exception (Proposed Regulations Section 1.1061-3(c), including examples in Proposed Regulations Section 1.1061-3(c)(7)), an exception for APIs purchased by unrelated third parties (Proposed Regulations Section 1.1061-3(d)) (the "Third-Party Purchaser Exception"),[29] and the exception for employees of non-ATB businesses (Proposed Regulations Section 1.1061-3(a)). Proposed Regulations Sections 1.1061-4(a) and (b)(1)–(5) provide rules and definitions for applying Section 1061(a) to calculate the Recharacterization Amount (examples are provided in Proposed Regulations Section 1.1061-4(c)(1)). Proposed Regulations Sections 1.1061-4(b)(6) & (7) provide amounts excluded from the Recharacterization Amount, and Proposed Regulations Sections

[29] *See* Preamble at 49771–72 ("By clarifying the treatment of an API that is sold at arm's length, the proposed regulations reduce uncertainty and compliance burdens for taxpayers entering into these transactions. The Treasury Department and the IRS have determined this exception is consistent with the purpose of section 1061, which applies to service providers and persons related to service providers and is not meant to apply to bona fide purchasers of a partnership interest who do not provide services.").

1.1061-4(b)(8) & (9) specify, respectively, the relevant holding periods and a special rule (the "Lookthrough Rule") where, despite sufficient holding periods, some long-term capital gain is included in the Recharacterization Amount (examples of such rule are provided in Proposed Regulations Sections 1.1061-4(c)(2)(i)–(iv)). Finally, Proposed Regulations Section 1.1061-5 provides rules for applying Section 1061(d) (examples are provided in Proposed Regulations Section 1.1061-5(f)) and Proposed Regulations Section 1.1061-6 specifies reporting obligations for Owner Taxpayers (Proposed Regulations Section 1.1061-6(a)) and entities (Proposed Regulations Section 1.1061-6(b)).[30]

IV. Detailed Discussion of Proposed Regulations and Recommendations

A. The Capital Interest Exception

1. *Proposed Regulatory Framework*

Section 1061(c)(4)(B) provides for the Capital Interest Exception to the definition of API. Proposed Regulations Sections 1.1061-3(c)(3)(i), (3)(ii)(A) and (4) provide that for a partnership interest to qualify for the Capital Interest Exception, allocations to such interest must be made in the same manner to API Holders and Unrelated Non-Service Partners, such Unrelated Non-Service Partners must in the aggregate have a significant capital account balance (defined as 5% or more of the total capital account balances of the relevant partnership) at the time the allocations are made, and allocations to API Holders must be based on such holders' relative capital account balances.[31] For these

[30] The Proposed Regulations also provide for (1) a new Section 1.704-3(e)(3)(vii) that requires securities partnerships using the special aggregation rules in making reverse Section 704(c) allocations to account for Section 1061 and (2) a new Section 1.1223-3(b)(5)(ii) that codifies the definitions of profits interest and capital interest from Revenue Procedure 93-27.

[31] Proposed Regulations Section 1.1061-3(c)(3)(i) states that "in general, allocations will be considered to be made in the same manner if, under the partnership agreement, the allocations are based on the relative capital accounts of the partners," indicating that in some situations allocations not so made may still be considered to be "in the same manner." (emphasis added). Proposed Regulations Section 1.1061-3(c)(3)(ii)(A), however, states that "Capital Interest Allocations . . . must be based on an API

purposes, Proposed Regulations Section 1.1061-3(c)(3)(ii)(A) requires that, if a partnership maintains capital accounts in accordance with Section 704 and Treasury Regulations Section 1.704-1(b)(2)(iv), those balances be used for these purposes, and if such capital accounts are not so maintained, accounts maintained with principles similar to those provided in such Sections must be used. Proposed Regulations Section 1.1061-3(c)(3)(ii)(C) excludes from "capital account" for the purposes of the Section 1061 regulations the contribution of amounts to the partnership that are directly or indirectly attributable to any loan or other advance made or guaranteed, directly or indirectly, by any other partner or the partnership (or a Related Person of either).

Proposed Regulations Section 1.1061-3(c)(3)(i) specifies that allocations are "made in the same manner" if, in addition to being made based on relative capital accounts, the "terms, priority, type and level of risk, rate of return, and rights to cash or property distributions during the partnership's operations and on liquidation are the same." However, allocations to API Holders will not fail to be made "in the same manner" because they are not reduced by the "cost of services provided" by the API Holder or a Related Person to the partnership.[32]

The Preamble to the Proposed Regulations indicates that allocations to API Holders will also not fail to be made "in the same manner" if such allocations have less

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Holder's relative capital account balance in a Passthrough Entity," therefore making the capital account-based allocations mandatory for API Holders to come within the Capital Interest Exception. (emphasis added). We recommend that Treasury tweak the language of these provisions to ensure that they align and avoid ambiguity.

[32] Proposed Regulations Section 1.1061-3(c)(3) also provides that an allocation will not fail to be "in the same manner" *solely* because the allocation is subordinated to allocations made to Unrelated Non-Service Partners. Consistent with our overarching comments on revising the Capital Interest Exception rules to accommodate flexibility, *see infra* Section IV.A.2.(c), we recommend removing the "solely" from Proposed Regulations Section 1.1061-3(c)(3).

beneficial terms than the terms of allocations to some or all of the Unrelated Non-Service Partners.[33] Furthermore, if allocations to some API Holders are not proportionate to their relative capital accounts, allocations to other API Holders, if based on the relative capital accounts of such other API Holders, would still qualify as made "in the same manner."

Finally, the Preamble responds to the position taken by some taxpayers in the wake of Section 1061 that a recapitalization or division can be used to convert an API into an interest within the Capital Interest Exception under Section 1061(c)(4)(B). The Treasury rejects such position, describing it as unsupported by the statutory language and as an unreasonable interpretation.[34]

2. *Background and Comments*

(a) Introduction

We appreciate Treasury's efforts to provide guidance on the scope of and requirements for coming within the Capital Interest Exception. However, as drafted, Proposed Regulations Section 1.1061-3(c) significantly narrows the exception by requiring that allocations comply with various rigid rules. Most notably, as discussed below, the absolute requirement that allocations strictly follow capital accounts will preclude many common investment fund arrangements that we believe the Capital Interest Exception was intended to encompass from qualifying for it. Furthermore,

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[33] The Preamble, in discussing the requirements for allocations to qualify as Passthrough Interest Direct Investment Allocations, states this principle, which may go beyond the similar principle articulated in the general "in the same manner" provision and explanation regarding subordination. *Compare* Preamble at 49762 *with id.* at 49761 and Prop. Reg. § 1.1061-3(c)(3)(i). However, Proposed Regulations Section 1.1061-3(c)(5)(iii)(B) states that the requirements for qualifying as a Passthrough Interest Direct Investment Allocation are the same as the general requirements for qualifying as a Capital Interest Allocation. Accordingly, we recommend Treasury incorporate the additional examples into the discussion of "in the same manner" in Proposed Regulations Section 1.1061-3(c)(3)(i).

[34] Preamble at 49763.

attempting to comply with the requirements of the Proposed Regulations would in many instances lead to inefficient structures and unnecessarily circular funds flows. For the reasons discussed below, we recommend that Treasury revise these rules to accommodate many instances where an Owner Taxpayer has the right to share in partnership returns "commensurate with" its capital contribution to the partnership, as required by the statute, but would not come within the Proposed Regulations as drafted. Additional specific recommendations are discussed below.

Our recommendations proceed as follows. First, to contextualize our recommendations, we present a brief summary of what we understand are the common structures and economic terms of typical private equity funds and hedge funds. Second, based on that description, we present specific recommendations for revisions.

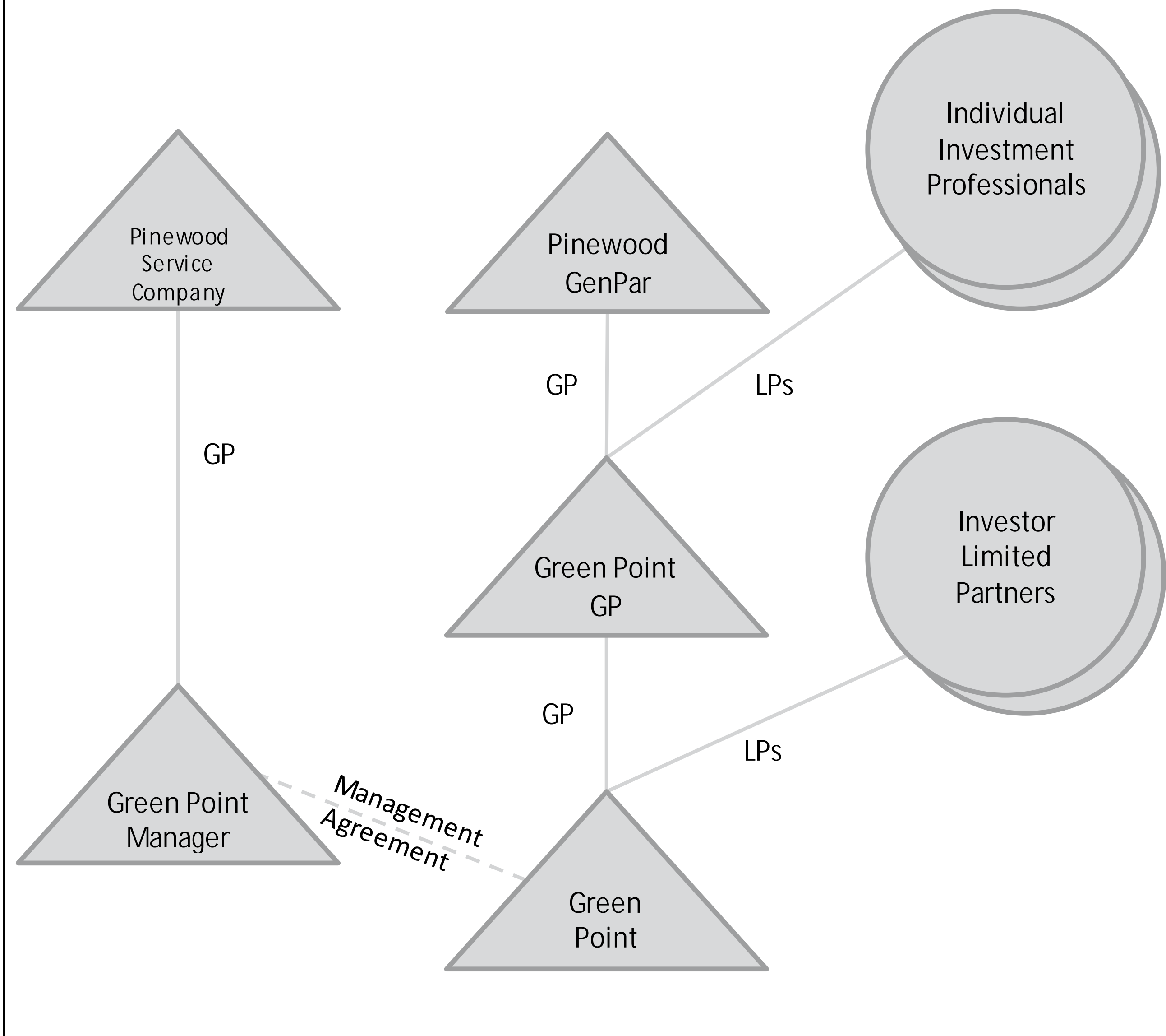
(b) Typical Private Equity Fund and Hedge Fund Operations

At a high level, the Proposed Regulations reflect the basic economic arrangement of a private equity fund: investor limited partners are admitted to a fund vehicle, which is controlled by a general partner who is entitled to an allocation of, commonly, 20% of the profits earned by the fund's investments.[35] The following discussion seeks to present a more detailed and complete description of the structure, operation and economic arrangement between investment professionals and investors in private equity funds and hedge funds.

Typical Private Equity Fund Structure and Economics. Figure 1 depicts a simplified structure for an established private equity fund manager, Pinewood, raising a new fund, Green Point:

[35] *See, e.g.*, Prop. Reg. § 1.1061-3(c)(7)(i) Example 1.

Figure 1



The Individual Investment Professionals are typically employed by the Pinewood Service Company if they are not also partners in that entity.

Mechanics. Investors invest by becoming limited partners in Green Point, the fund partnership, which is controlled by Green Point GP, an entity associated with Pinewood, but specifically formed to be the general partner of Green Point. Green Point GP, in turn, is controlled by Pinewood GenPar, a Pinewood entity that Pinewood would

typically use to hold all of the controlling interests in each fund-specific general partner entity. Pinewood GenPar would be entitled to the portion of the carried interested allocated to senior investment professionals of Pinewood, and such investment professionals would receive carry as limited partners of Pinewood GenPar.

Green Point Manager, a separate entity also associated with Pinewood but formed specifically to be the investment manager of Green Point, enters into a management agreement with Green Point. Green Point GP delegates certain of its investment management authority to Green Point Manager and, in turn, Pinewood employees[36] manage the Green Point private equity fund through it. Pinewood GenPar, or the general partner of Pinewood GenPar, typically would serve as general partner of Pinewood Service Company. We note that some investment funds utilize a simplified structure where, for example, Green Point GP serves as Green Point's investment manager, removing the need for Pinewood to form and operate Green Point Manager.

Investor limited partners are admitted into Green Point upon the basis of committing to contribute a fixed-dollar amount to the partnership, but often no or only minimal contributions are made upon admission. Additionally, investor limited partners may be admitted at one or one of a few closing dates occurring over a limited period of time, after which no additional investors will be allowed to join the fund.

Green Point Manager executes an investment strategy to invest in, for example, unregistered stock of privately held companies ("portfolio companies"). When Green Point Manager has selected an investment, Green Point GP will issue a capital call to

[36] While the senior investment managers could be principals of or partners in Pinewood's main fund entity (depending on its form), many investment managers will be Pinewood's employees.

Green Point partners, requiring each of them to make a capital contribution, typically pro rata based on their respective capital commitments or the unfunded portion thereof, to fund the investment. Once investors contribute capital, they are not able to withdraw the capital. Instead, investors achieve liquidity in stages, as Green Point disposes of its investments and distributes the proceeds from such dispositions to its partners according to the distribution waterfall discussed below.

Green Point will have a term specified in its limited partnership agreement, typically ten years. That time is split into an investment period, during which Green Point calls capital and makes investments, and a harvest period, during which additional capital is not called (with some narrow exceptions for expenses and follow-on investments) and the investment managers are actively managing the investments in portfolio companies and ultimately disposing of the investments either in a private sale or an IPO.

Based on typical market practice, Green Point's investor limited partners will expect Pinewood or its principals to commit investment capital alongside them (the "GP Capital Commitment"), as a means to ensure that Pinewood's incentives and risks and the investor limited partners' risks are aligned. Pinewood will likely use one of four different arrangements to make its GP Capital Commitment: (1) Pinewood could form a separate entity ("Pinewood (Green Point) LP") which would be admitted to Green Point as an investor limited partner, (2) Green Point GP could make the commitment directly,[37] (3) Pinewood could form a separate partnership ("Pinewood (Green Point Parallel) LP") which would invest alongside Green Point proportionately, but not be admitted as a partner of Green Point and (4) Pinewood personnel could invest in Green Point directly

[37] The GP Capital Commitment may be, and often is, made through a combination of these arrangements.

as investor limited partners. If Pinewood utilizes structure (2) and Green Point GP makes the commitment directly, Green Point's governing documents will often delineate between Green Point GP's entitlement to carried interest and its entitlement to returns on its GP Capital Commitment, the latter of which will generally be included with and generally subject to the same terms as investor limited partners' contributed capital, with some notable exceptions described below.

The typical GP Capital Commitment is between 1% and 3% of total capital commitments.[38] Pinewood itself may provide some of the GP Capital Commitment, but will typically give its employees the opportunity to invest in (or alongside) Green Point, which will be counted toward the GP Capital Commitment. Pinewood will often facilitate such employee investments by loaning the contribution to the employees either in a nonrecourse or recourse manner, with the loan expected to be repaid through returns from Green Point, or by arranging for third-party financing. In addition, Pinewood will often incentivize such employee investments by offering them the ability to invest on a fee-free and carry-free basis and, in each case, such arrangements may be subject to vesting.

In exchange for investment management services, Green Point Manager is paid (usually quarterly) a fee (the "<u>Management Fee</u>") in the amount of a certain percentage, calculated annually, of either the capital committed to Green Point (during the investment period) or the capital invested by Green Point (after the investment period). Such percentage is often set at 1.5 to 2%, but certain investors may receive discounts based on the size of their capital commitment or other factors. Investor limited partners will be

[38] *See* MJ Hudson, *Private Equity Fund Terms Research* 43 (5th ed. 2019–2020) (reporting that 61% of funds surveyed made commitments in this range).

subject to periodic obligations to contribute capital to Green Point to fund its Management Fee obligations.

Distributions. As proceeds of investments are received by the fund, they typically will be initially apportioned to the partners pro rata based on the capital contributed to make the investment that generated the proceeds. Funds use this procedure to accommodate the possibility of defaults on capital contributions by limited partners or limited partners who are excused from an investment due to tax, regulatory or other reasons, and to take into account different management fee rates and other specially-allocable amounts. Note that this apportionment typically is not done based on overall capital contributions or capital account balances. The amount apportioned to each investor limited partner will then be split between Green Point GP and investor limited partners based on a distribution waterfall. Green Point will either employ a "return-all-capital" waterfall or a "deal-by-deal" waterfall, but the high-level steps in each are the same: (1) return of capital contributions; (2) preferred return (typically 8%, compounded annually from the time capital is contributed until the date of the distribution); (3) Green Point GP catch up; and (4) a split of the remaining proceeds between Green Point GP and investors (typically 20% and 80%, respectively). Furthermore, the mechanics of the Green Point GP catch up are typically set[39] to ensure that the overall split between Green Point GP and investors of the aggregate amount of income distributed in steps (2), (3) and

[39] Step (3), the Green Point GP catch up, splits income between Green Point GP and investors with Green Point GP receiving more than its percentage in step (4), and distributions are typically allocated in step (3) until the aggregate percentage split between Green Point GP and investors of all income distributed in steps (2) and (3) matches the percentage split of income distributed in step (4). Typically, such split would be either 100% Green Point GP/0% investors, 80% Green Point GP/20% investors, or 50% Green Point GP/50% investors. A lower Green Point GP percentage in step (3) is more investor friendly, because a lower percentage extends the time that income will be distributed in step (3) and increases the amount of income Green Point must make for Green Point GP to receive its full percentage of profits.

(4) – that is, Green Point's profits – matches the percentages in step (4) (assuming Green Point is sufficiently profitable).

Regarding the GP Capital Commitment, we would expect Pinewood to exempt allocations on its GP Capital Commitment from the distribution waterfall, whether initially funded by Pinewood or its employees. The rationale for this is that, because Pinewood is the ultimate recipient of both the investor return and of the carried interest, it is not necessary for Green Point GP to pay itself carry on its own investment, nor does Green Point GP need to receive a preferred return on its contributed capital before carry is paid, and typically this same rationale is extended to employee capital.

In a return-all-capital waterfall, after the initial apportionment, step (1) returns all capital contributed to the fund to date (for the investment generating the current return and all other investments, as well as expenses) and the preferred return in step (2) is calculated based on all contributed capital (aggregating the compounded preferred return accrued on each contribution of capital made by a given partner). In a deal-by-deal waterfall, proceeds from each investment are run through the waterfall separately: after the initial apportionment, in step (1) the amount of capital contributed to the investment disposed of, typically along with any other investments that have been sold at a loss or written off and not previously returned and allocable expenses, but not generally the capital or costs associated with other active investments, is returned, and in step (2) the amount of preferred return is accrued and compounded on the amount of capital contributed to the investments that are subject to a priority return in step (1).[40]

[40] We present an example of the mechanics of both types of waterfalls and comparative returns to investors in Appendix I.

Pinewood's internal allocations of both the carried interest paid to Green Point GP and of the returns on the GP Capital Commitment will vary over time, as the investment professionals involved in Green Point change. Such upper-tier arrangements in a way often echo the deal-by-deal waterfall by allocating funding obligations, carry and the returns on the GP Capital Commitment deal-by-deal, compensating investment professionals based on the returns from the deals on which each of them work and the manner in which they invest. In addition, Green Point GP and Pinewood may waive distributions of carry and instead reinvest such allocations into Green Point's investments.

Giveback Obligation. Regardless of whether Green Point uses a return-all-capital waterfall or a deal-by-deal waterfall, investors will typically insist on a giveback obligation imposed on the Green Point GP that is guaranteed by Pinewood and/or its employees to ensure that, on an aggregate basis over the life of the fund, Green Point GP does not receive more carry than the specified carry percentage in the last step of the waterfall, and to ensure that the investors achieve their preferred return. Green Point GP will, in turn, pass through this obligation by requiring the investment professionals and other Pinewood persons who receive portions of the carried interest to agree to such repayments (typically severally, not jointly) as a condition of receipt of such carry. Some funds will impose such giveback obligations at additional points prior to the fund's termination. However, the giveback obligation is typically net of taxes already paid (or deemed paid) by carry recipients on the prior distributions of such carry.

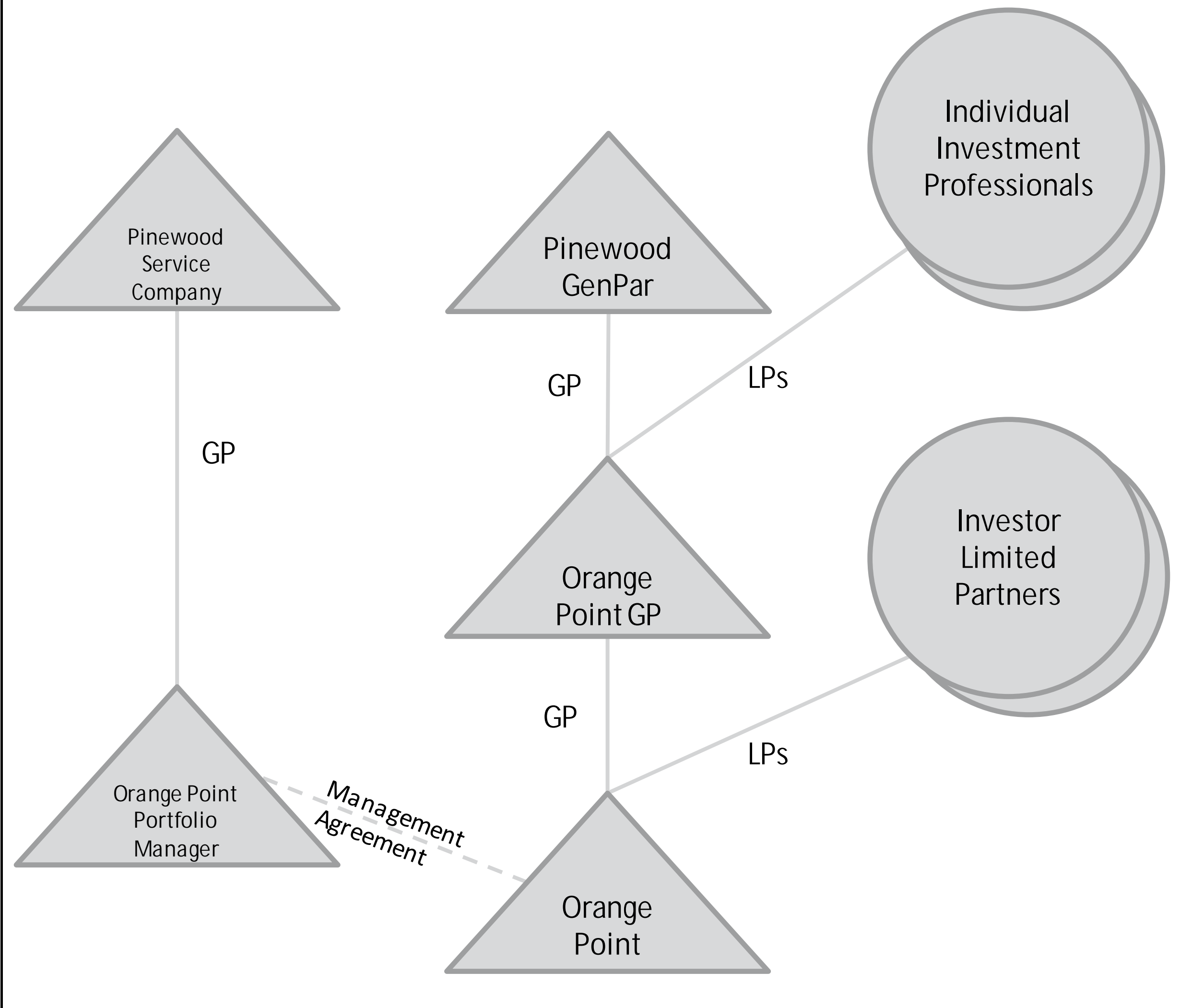
To accommodate the structures described above, typical fund partnerships use distribution-driven agreements that include targeted allocation provisions or loose

partners' interest in the partnership-based allocation provisions for capital accounts.[41] This diverges from the foundational assumption made by the Proposed Regulations in the Capital Interest Exception, that allocations can and do rigidly follow capital accounts.

Typical Hedge Fund Structure and Economics. Figure 2, below, presents the typical structure of a hedge fund called Orange Point, operated by Pinewood.

[41] *See, e.g.*, New York State Bar Association Tax Section, Report No. 1219, *Partnership Target Allocations* 3, 5, 7 (Sept. 23, 2010) ("In our experiences, investors and business people overwhelmingly prefer their partnership agreements to require liquidating distributions in accordance with the cash-driven distribution priorities of the agreement rather than in accordance with capital accounts. . . . [I]n many economic deals capital accounts will not in all possible scenarios match the amounts that the parties have agreed that they should receive. . . . In short, the 'target' allocation to each partner is the amount of income or loss necessary to establish a capital account balance equal to such partner's economic entitlements in a hypothetical liquidation."); William G. Cavanagh, *Targeted allocations or "Why I don't liquidate partnerships in accordance with capital accounts (much) anymore" and other real world partnership tax allocation matters*, Tax Forum No. 615, 4, 41 (Mar. 2, 2009) (unpublished manuscript) ("In fact, many sophisticated tax practitioners now use tax allocations that do not drive liquidations." . . . "The typical partnership agreement containing targeted allocation provisions provides for detailed cash distribution provisions and says simply that profits and losses are allocated so that each partner's capital account will be equal to (or as close as possible to) the cash he or she is supposed to receive under the cash distribution provisions if their partnership interest were liquidated at that time."); Andrew W. Needham, *Private Equity Funds*, B.N.A. Tax Mgmt. Portfolio 735-3rd § V.B (2015) ("Although the obligation to liquidate in accordance with capital accounts is a cornerstone of subchapter K, few if any funds do so. In most fund agreements, the profit and loss allocations produce capital accounts that track (rather than establish) the priority of distributions among the investors.").

Figure 2



The Individual Investment Professionals are typically employed by the Pinewood Service Company if they were not also partners in that entity.

Structure and Basic Mechanics. Structurally, Orange Point is similar to Green Point. Investors invest by becoming limited partners in Orange Point, the fund partnership, which is controlled by Orange Point GP, an entity associated with Pinewood, but specifically formed to be the general partner of Orange Point. Orange Point GP, in turn, is controlled by Pinewood GenPar, a Pinewood entity that Pinewood would

typically use to hold all of the controlling interests in each fund-specific general partner entity. Pinewood GenPar would be entitled to the portion of the incentive allocation allocated to senior investor professionals of Pinewood, and such investment professionals would receive investment allocations as limited partners of Pinewood GenPar.

Orange Point Portfolio Manager, a separate entity also associated with Pinewood but formed specifically to be the investment manager of Orange Point, enters into a management agreement with Orange Point. Orange Point GP delegates certain of its investment management authority to Orange Point Portfolio Manager and, in turn, Pinewood employees[42] manage the Orange Point hedge fund through it. Pinewood GenPar, or the general partner of Pinewood GenPar, typically would serve as the general partner of Pinewood Service Company. We note that some investment funds utilize a simplified structure where, for example, Orange Point GP serves as Orange Point's investment manager, removing the need for Pinewood to form and operate Orange Point Portfolio Manager.

However, the operation of a hedge fund differs significantly from a private equity fund. First, Orange Point Portfolio Manager's strategy typically is not to take control positions in portfolio companies. Further, the strategy typically will be more liquid than a private equity fund. As a result, Orange Point will typically have a shorter investment horizon than a private equity fund.

Second, investor limited partners typically fund their entire capital contribution in Orange Point at once upon being admitted to the fund. Third, Orange Point is not term-

[42] While the senior investment managers could be principals of or partners in Pinewood's main fund entity (depending on its form), many investment managers will be Pinewood's employees.

limited and instead has an indefinite term. Fourth, rather than being distributed, Orange Point's investment returns are reinvested in new investments perpetually and without limitation. As a result, investor limited partners achieve liquidity not through distributions of disposition proceeds but rather through full or partial redemptions of their interests in the hedge fund. Such redemptions, and admissions of additional investor limited partners, occur at the end of regular intervals, often quarterly (such intervals are referred to as "Accounting Periods"). During a hedge fund's life, each Accounting Period will typically close at the end of each month or each quarter (or on dates determined in Orange Point GP's discretion), and the next Accounting Period commences immediately following the preceding Accounting Period.

Based on typical market practice, Orange Point's investor limited partners will expect Pinewood or its principals and employees to invest capital alongside them (the "GP Capital Investment") as a way to ensure that Pinewood's incentives and risks and the investor limited partners' risks are aligned. The arrangements through which Pinewood can make such investment are the same as the options available in the private equity context discussed above. Although Pinewood itself will provide some of the GP Capital Investment, it will also typically give its employees the opportunity to invest. Pinewood will often facilitate such investments by loaning the contribution to the employees either in a nonrecourse or recourse manner, with the loan expected to be repaid through returns from Orange Point, or by arranging for third-party financing. In addition, Pinewood will often incentivize such employee investments by offering them the ability to invest on a fee-free and carry-free basis and, in each case, such arrangements may be subject to vesting.

In exchange for portfolio management services, Orange Point Portfolio Manager receives (usually quarterly or monthly) a Management Fee of 1 to 2% per annum of the Net Asset Value ("NAV") of Orange Point (with some investors receiving discounts). Regardless of how often the management fee is paid, it is typically accrued monthly. Because, as discussed below, the NAV is the fair market value of the invested capital less liabilities, not the cost of acquiring the underlying investments, the Management Fee will reflect portfolio gains and losses. In most circumstances, Pinewood will exempt its GP Capital Investment from having to pay Management Fees.

Economics and Allocations. Orange Point's economics revolve around its NAV, which is the amount by which the value of its assets exceed the amount of its liabilities, calculated in accordance with its operating agreement. Essentially, the NAV functions as a mark-to-market mechanism. The NAV is calculated as of the beginning of an Accounting Period and as of the end of an Accounting Period. The NAV at the end of an Accounting Period is calculated before giving effect to withdrawals.

Investors buy into Orange Point at the beginning of an Accounting Period based on the then-current NAV of Orange Point's investment portfolio. At the time they invest, Orange Point assigns each investor (including existing investors contributing new capital) a "capital account" in the amount of its investment. Each investor has a "partnership percentage" calculated at the beginning of each Accounting Period by dividing such investor's capital account for the Accounting Period by the aggregate capital accounts of all Orange Point partners, after taking into account withdrawals, distributions, Management Fee payments, and new investments. At the end of each Accounting Period, each capital account is adjusted by crediting or debiting it in proportion to its respective

partnership percentages by the overall amount of net gain or loss for such Accounting Period. Such overall net gain or loss is calculated by comparing the NAV at the end of the Accounting Period (including any Management Fees accrued or paid during such period)[43] to the NAV at the beginning of the Accounting Period. As a result of this mechanism, the investment returns of investors making capital contributions at a particular time will differ from the investment returns of investors making capital contributions at any other time.

Incentive Allocation. Orange Point GP is entitled to an "Incentive Allocation," which is a percentage, typically 20%, of Orange Point's annual increase in NAV above any loss recovery account balance (or "high-water mark"), discussed below, from each investor. Such Incentive Allocation is structured to be a partnership profits interest, and it is generally made annually. It is also made with respect to an investor upon such investor's full or partial withdrawal from Orange Point; otherwise, Orange Point GP would not receive its Incentive Allocations on any increase in NAV between the end of the prior year and the date of such investor's withdrawal.

As described above, investors may enter Orange Point at different times, and thus will have different beginning capital accounts, high-water marks and investment returns. In addition, because investors sometimes pay Management Fees at different rates, the adjustment for Management Fees must be done separately for each capital account, such that even investors that enter at the same time may have different capital account

[43] Management Fees that are accrued or paid during an Accounting Period are included in the end NAV to accurately reflect the fact that different investors bear such fees at different rates. If the end NAV were net of such fees, the resulting gains or losses allocated to investors pro rata based on their partnership percentages would allocate each investor a pro rata share of the aggregate Management Fee burden, rather than reflecting each investor's individual economic arrangement. Accordingly, once the pro rata portions of the overall net gain or loss are calculated, each investor's Management Fee payments during the Accounting Period are deducted to produce the amount added to, or subtracted from, its capital account.

balances. Accordingly, the Incentive Allocation must be calculated on a capital account by capital account basis.

When an Incentive Allocation is made, the amount of such allocation for each investor is subtracted from such investor's capital account and is added to Orange Point GP's capital account. Furthermore, Orange Point GP is never required to return such capital account allocation. Typically, Orange Point GP will not calculate or allocate an Incentive Allocation for its capital account.

As mentioned above, hedge funds typically provide a high-water mark loss recoupment mechanism. This mechanism tracks the net capital depreciation allocated to each investor in a "Loss Recovery Account." Each year, when Orange Point GP is authorized to receive an Incentive Allocation, an investor's Loss Recovery Account is increased by net decreases to their capital account (and is decreased by net capital appreciation) as compared to the prior year.[44] Each investor's Loss Recovery Account has a floor of zero. Typically, Orange Point GP will only be able to take an Incentive Allocation from an investor's capital account if such investor's Loss Recovery Account is at zero. This ensures that Orange Point GP only takes Incentive Allocations when the investor's capital account balance is higher than such investor's previous high-water mark.[45] (Because investors invest in Orange Point at different times, each investor has her own high-water mark.[46])

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[44] When the investor first invests, the comparative point is the investor's capital account balance at the time of her investment.

[45] The high-water mark is analogous to a taxpayer's basis in her assets. Just as a basis memorializes the amount of value on which a taxpayer has paid tax, the high-water mark memorializes the capital account balance for which an investor has already paid Incentive Allocation.

[46] An investor's capital account may have the same high-water mark as the capital accounts of investors that invested contemporaneously with it.

When an investor withdraws part of her investment, her Loss Recovery Account is reduced proportionately to the amount of the withdrawn investment. This ensures that such investor's Loss Recovery Account continues to accurately reflect net losses on the remaining invested capital.

Finally, Orange Point sometimes will have to meet some performance hurdle before Orange Point GP is authorized to take Incentive Allocations on any net capital appreciation. (This hurdle may be (1) a soft hurdle (where an Incentive Allocation is paid on the entire appreciation if the hurdle is met), (2) a hard hurdle (where an Incentive Allocation is paid only on appreciation above the hurdle), or (3) some other variant.) Performance hurdles in hedge funds are analogous to the preferred return in private equity funds – they ensures that investor limited partners receive some minimum amount of gain before Orange Point GP receives its share of fund profits.[47]

Side Pockets. Sometimes, Orange Point will choose to make investments in illiquid or hard-to-value assets, such as securities that are thinly traded, private companies, real estate or distressed debt. To preserve Orange Point's liquidity for investors, Orange Point Portfolio Manager may establish a segregated account called a "side pocket" to track the investment separately from the rest of Orange Point's liquid investment portfolio. Orange Point may also elect to shift an investment into a side pocket if the circumstances warrant isolating it and the investors in it from the rest of Orange Point's portfolio.

[47] We present an example of the Loss Recovery Account mechanism with both a soft hurdle and a hard hurdle in Appendix II.

When Orange Point makes a side-pocket investment (or moves an investment to a side pocket), its investors' regular capital accounts will be reduced and it will create parallel capital accounts to reflect the separate investment. An investor's side-pocket capital account balance will typically not include unrealized profits and losses from side pockets, but realized profits and losses will be included in the capital account balance calculation.

Orange Point GP will typically not take an Incentive Allocation on side-pocket assets until its gain is realized; side pockets are not marked-to-market at year end for Incentive Allocation purposes. Orange Point Portfolio Manager's Management Fee will include an amount based on a side-pocket investment, typically a percentage of the investment's "carrying value," which can be written down but cannot exceed the initial carrying value.[48]

Final Thoughts. We note that unlike Green Point, Orange Point GP will not be subject to any giveback obligation under which it would have to return Incentive Allocation taken on early gains such that Orange Point investors would recover later losses. Finally, as with Green Point, the structures described above mean that Orange Point's allocations will not follow its partners' tax capital accounts.

(c) Comments and Recommendations

Our overarching comment regarding the Proposed Regulations on the Capital Interest Exception is that they are too rigid and, accordingly, exclude many common

[48] In addition to side pockets, Orange Point may accommodate investors who for tax, regulatory or other reasons cannot participate in a particular investment. For example, FINRA Rule 5130 prohibits restricted persons and covered persons under FINRA Rule 5131 from investing in "new issues." *See* FINRA Rule § 5131, New Issue Allocations and Distributions, Fin. Industry Reg. Authority (2020). In such instances, Orange Point's portfolio managers will allocate appreciation and depreciation from such assets only to investors that are able to participate in such investments. In such instances, allocations will therefore not follow investors' overall capital accounts.

commercial arrangements typical of investment funds, such as the capital contributions made to or by Green Point GP and Orange Point GP discussed above, that we believe appropriately come within the Capital Interest Exception because the interests have the "right to share in partnership capital commensurate with the amount of capital contributed."[49] Our particular recommendations and comments below address six issues: exemptions from, among other things, carry; requiring allocations to be based on capital account balances; gains on crystallized Incentive Allocations; the use of loan proceeds to receive a capital interest; accommodating co-invest vehicles; and the implications of the Capital Interest Disposition Amount rules as applied in Example 5.

First, we appreciate that the Proposed Regulations provide that the Capital Interest Exception's "in the same manner" requirement is met even if fund managers do not deduct the "cost of the services" they provide from the capital they invest in their fund.[50] The scope of "cost of services provided" in the Proposed Regulations, however, is unclear. We recommend that Treasury clarify in the final regulations what is included as a cost of service, and specify that an investment that is not subject to the incentive payments or allocations of the general partner or to management fees meets the requirements of the Capital Interest Exception. This would reflect the commercial reality, discussed above, that fund managers do not charge management fees on the capital they and their affiliates invest, nor is such capital subject to carried interest or Incentive Allocations. Notably, however, an example illustrating the Capital Interest Exception in the Proposed Regulations includes the general partner's capital being subject to carried

[49] Section 1061(c)(4)(B).

[50] Prop. Reg. § 1.1061-3(c)(3)(i); *see* Preamble at 49761–62.

interest, suggesting that the carried interest may not be encompassed by the "cost of services" exception.[51]

We generally agree with Treasury's inclination that Section 1061(c)(4)(B)'s "commensurate with the amount of capital contributed" requirement excludes arrangements where investor limited partners and fund managers have substantive differences in the terms governing their investment returns. However, we believe that fund managers excusing their own investment capital from incentive payments or allocations is not such an arrangement.[52] Rather, it reflects the simple reality that there is substantial overlap between the investing fund managers and the service providers and that their efforts are on their own behalf with respect to their own investment in the fund. Furthermore, it avoids unnecessary, circular asset transfers. If (as often may be the case) each individual fund manager's portion of the overall GP Capital Commitment aligns with such individual fund manager's entitlement to incentive payments or allocations, and their capital interests were subject to incentive payments, the incentive portion of the returns on each fund manager's capital would be allocated to the fund entity entitled to such payments or allocations, which would turn around and allocate it back to the same fund managers. Accordingly, Treasury should confirm that it does not preclude fund managers' (or their principals' or employees') capital interests from qualifying for the Capital Interest Exception.

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[51] Prop. Reg. § 1.1061-3(c)(7)(i) Example 1.

[52] *See* Martin D. Ginsburg, Jack S. Levin and Donald E. Rocap, *Mergers, Acquisitions and Buyouts* § 1505.2 (2019) ("We do not think the exception should be unavailable merely because the fund income allocated to the investment professional with respect to its capital interest may not be reduced by certain charges (e.g., management fee expense and GP carried interest) that may reduce the income allocated to passive investors with respect to their capital interests." (emphasis added)).

Furthermore, we recommend that Treasury provide additional guidance regarding how other common differences between investor limited partner interests and general partner capital interests impact the Capital Interest Exception analysis. For example, typical investment funds will give the general partner additional rights, such as the right to tax distributions, allocations of expenses other than management fees, regulatory allocations such as minimum gain chargebacks, and withdrawal rights, each of which could affect the "in the same manner" analysis.

The Preamble, citing Section 1061(c)(4)(B)(i) and the Conference Report, states that "the exception for capital interests should apply only to the extent that a service provider's rights with respect to its contributed capital matches the rights of other non-service partners with respect to their shares of contributed capital."[53] We do not believe, however, the statute or the Conference Report endorses such a strict requirement of complete matching of rights. Rather, the Proposed Regulations' cost of services statement appropriately recognizes that the Capital Interest Exception should be grounded in the statutory term "commensurate,"[54] which indicates proportionality rather than identity. In other words, holders of Capital Interest Exception-qualifying interests must be entitled to returns aligning with the magnitude of their contribution and in line with other, non-service provider limited partners, but need not strictly stand in their shoes. We recommend that Treasury revise the final regulations accordingly.

Second, we believe that receiving returns "commensurate with the amount of capital contributed" does not require allocations and distributions to be made only based

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[53] Preamble at 49761 (citing Conference Report, *supra* note 5, at 420–21).

[54] Prop. Reg. § 1.1061-3(c)(3)(i).

on overall, aggregate capital accounts. As discussed above, in a typical private equity fund, each portfolio investment by the fund potentially is made using a different capital structure and, not infrequently, by a different group of investors. Accordingly, such a fund distributes returns on an investor-by-investor basis and, typically, on a deal-by-deal basis, in each case reflecting the particular amounts contributed by each investor to each investment, and allocates gain or loss on an investment to investors consistent with those distributions.[55] If, for example, investors are charged different rates of management fees or investors fail to provide capital for a particular investment, income and gain allocations will not be based on overall capital account balances. Allocations and distributions to investors, including the fund manager, are aggregated only at the end of the fund's life, to ensure that the overall returns on each investor's invested capital tracks the economic arrangement. Despite the fact that private equity funds do not make allocations based on capital accounts, fund managers (and their principals and employees) should generally be eligible for the Capital Interest Exception on their invested capital under the typical private equity arrangements described above, where gain on an investment is allocated commensurate with the capital contributed to make the investment.

Regarding hedge funds, as discussed above, the returns each investor receives in a typical hedge fund are determined based when each investor invests capital in and withdraws capital from the fund. The fund manager's contributed capital is no different; its returns will depend on when it is invested. Capital account allocations cannot be made

[55] *See also infra* note 142 and accompanying text (discussing another situation where distributions would not follow capital accounts).

based on relative capital account balances for all partners, because any given investor's returns are not related to any other investor's returns (except for potentially another investor that invests in and withdraws from the fund at the same time). Accordingly, for hedge funds the Capital Interest Exception should turn not on whether allocations align with capital account balances but rather whether allocations are made based on proportionate shares of the NAV on invested capital.

Accordingly, we recommend that Treasury revise the Capital Interest Exception to remove the capital account requirement and replace it with the requirement that distributions or allocations to the general partner or its affiliates and employees who provide capital be commensurate with the capital contributed relative to other, non-related capital, tracking the statutory language in Section 1061(c)(4)(B)(i). We recommend that Treasury explain that such requirement could be met (1) with distributions or allocations to a particular class of interests based on the capital contributed by such class and so long as the Unrelated Non-Service Partner requirement is met for such class; (2) with distributions or allocations made on a deal-by-deal basis proportionate to capital invested in the particular deal; and (3) with distributions or allocations proportionate to capital contributions or capital accounts, including, for example, NAV as used in a typical hedge fund (or another reasonable measure of overall fund economics). We believe that this proposal is flexible enough to accommodate the range of legitimate business arrangements while preventing abuse and adhering to the statute's "commensurate" requirement.

Third, we urge Treasury to resolve explicitly whether gains on crystallized Incentive Allocations in hedge funds are subject to Section 1061(a) or come within the Capital Interest Exception.

In a straightforward case, a Passthrough Entity allocates an item of realized long-term capital gain to an Owner Taxpayer with respect to such Owner Taxpayer's API, the Owner Taxpayer includes it in her Recharacterization Amount calculation for the taxable year, and the resulting amount is treated as short-term capital gain for such year.[56] Once so included, that amount is no longer included in the Section 1061(a) calculations. In other words, the Recharacterization Amount calculation restarts each taxable year and includes only allocations from that taxable year.[57] Furthermore, if the amount of such long-term capital gain is distributed to the Owner Taxpayer and she then returns it to the Passthrough Entity as a capital contribution, any gains on such contributed capital would qualify for the Capital Interest Exception; once included in a Recharacterization Amount calculation, the API taint dissipates.

Complexity arises, however, regarding the treatment of gains on Incentive Allocations in hedge funds. In the typical hedge fund structure discussed above, the Incentive Allocation is calculated annually (and upon an investor's withdrawal) on an investor-by-investor basis. The Incentive Allocation for each investor is debited against its capital account and credited to the general partner's capital account (such shift, its "crystallization"). Once its Incentive Allocation is crystallized, the general partner is not

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[56] *See* Prop. Reg. § 1.1061-4(a).

[57] *See, e.g.*, Prop. Reg. § 1.1061-4(a)(3)(i)(A) ("The API One Year Distributive Share Amount equals . . . [t]he API Holder's distributive share of net long-term capital gain from the partnership for the taxable year." (emphasis added)).

required to return such amount and may withdraw it from the fund. If not withdrawn, at the end of subsequent Accounting Periods, the general partner's partnership percentage, and corresponding allocations of the fund's net gain or loss, will be calculated including the crystallized Incentive Allocation.

The general partner is typically not subject to tax on the entire amount of the Incentive Allocation upon crystallization because the incentive is calculated on both realized and unrealized gains and losses. Furthermore, a withdrawal of the incentive would only be taxable if it were a distribution in excess of the general partner's basis in its interest in the fund,[58] which will depend on the amount of capital contributed by the general partner,[59] the amount of taxable income previously allocated to the general partner,[60] the amount of prior withdrawals by the general partner[61] and the amount of fund-level liabilities allocated to the general partner.[62]

We believe that there are several different possibilities for when subsequent returns on the amount included in the general partner's capital account as a result of crystallized Incentive Allocations cease to be subject to Section 1061(a). The harshest alternative is that all subsequent returns on the crystallized Incentive Allocation, including gains on new investments, would continue to be subject to Section 1061(a). In other words, the entire portion of the general partner's partnership interest represented by

[58] Section 731(a)(1).

[59] Section 722.

[60] Section 705(a)(1).

[61] Section 733.

[62] Section 752(a).

amounts resulting from crystallized Incentive Allocations would be treated as an API. On the other end of the spectrum, all gains attributable to future returns on amounts already crystallized could be excluded. In other words, if a crystallized Incentive Allocation includes unrealized gain with respect to an investment asset and the asset is later sold with a holding period not exceeding three years, the general partner's Recharacterization Amount calculation would include her share of gain up to her share of unrealized appreciation at the time of crystallization, applying Section 704(c) principles, but the general partner's share of subsequent appreciation would not be subject to Section 1061(a) (except, of course, to the extent that the subsequent appreciation is initially allocable to limited partners' capital accounts and reflected in subsequent years' Incentive Allocations).[63] A middle alternative is that while subsequent returns on previously-allocated realized amounts may be excluded, gains reflecting subsequent appreciation of investments reflected in previously-allocated unrealized amounts are not excluded and are subject to Section 1061(a) when realized.[64] We note that the Preamble states that recapitalizations and divisions are insufficient to constitute a capital contribution under Section 1061(c)(4)(B).[65] We do not believe that should apply in any of

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[63] For example, if a hedge fund holds an asset with $100 of unrealized appreciation, resulting in an Incentive Allocation of $20 to the general partner, and the hedge fund later sells the asset when it has a holding period not exceeding three years, realizing gain of $150, the crystallized $20 in gain would be subject to Section 1061(a) but the portion of the additional $50 gain allocated to the general partner's capital account (as increased by the previously allocated Incentive Allocation) would not be subject to Section 1061(a).

[64] In the example in the previous footnote, the general partner's entire share of the $150 gain on sale of the asset, including gain resulting from post-crystallization appreciation, would be subject to Section 1061(a).

[65] Preamble at 49763 ("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. . . . 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.").

these alternatives, where the general partner is not obligated to give back crystallized incentive and/or has paid tax on such amounts.

We do not believe the first, harsh possibility is appropriate or necessary. Requiring Owner Taxpayers to withdraw and reinvest to shelter subsequent gains from Section 1061(a) could well be detrimental to investor limited partners, and such circular flows of money are, as Treasury recognizes, inefficient and, frankly, unnecessary.[66]

Our Executive Committee is evenly divided as to whether the second or third alternative is more appropriate. Substantial support exists for the second alternative, that once Incentive Allocations are crystallized, subsequent gains (and losses) should be eligible to be excluded from Section 1061(a) (under the Capital Interest Exception). Notably, after crystallization, (1) the general partner is not required to return such crystallized incentive to the investors; (2) the general partner is typically permitted to withdraw the amount of crystallized incentive, after which the funds could be recontributed for an investment in the fund; and (3) the crystallized incentive earns a return commensurate with other, unrelated capital while it remains invested in the fund. Those facts result in previously-crystallized incentive amounts being equivalent to the general partner's capital and its continued investment being akin to the general partner making a capital contribution.

Similar substantial support also exists for the third alternative, that gains on the portion of the Incentive Allocation that is realized, on which the general partner has been subject to tax, should not be subject to Section 1061(a). However, until the unrealized

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[66] *See* Preamble at 49772 ("[P]artners with realized gains would be incentivized to engage in a series of inefficient transactions, first receiving a distribution reflecting those gains and then contributing the distributed amount back into the partnership in order to minimize tax.").

gains in the Incentive Allocation are realized, subsequent gains on such amounts should be subject to Section 1061(a).[67] First, the Proposed Regulations emphasize that once a partnership interest is an API, it remains an API until an exception applies to such interest (the "Once an API, Always an API Rule").[68] That rule only works if its corollary, that amounts are by default API Gains and Losses, unless and until they are subject to taxation, is also true. Otherwise, a general partner could divert gain from an API – undercutting a core piece of what makes it an API – away from Section 1061(a), realizing the upside of taint dissipation without being subject to the tax consequences. Second, by its terms, Section 1061(a)(1) applies to long-term capital gains "with respect to" such API; until gains are subject to tax, they, and the gains that accrue on them, continue to be "with respect to" an API.[69] Third, until amounts are taxed, such amounts are not actually the general partner's capital, and so such amounts remaining invested is not substantively the same as the general partner making a capital contribution (while the already-taxed amounts are substantively a deemed capital contribution) and the Capital Interest Exception does because there is no contributed capital to which returns must be

[67] Notably, prior legislative proposals regarding carried interest gave fund managers credit for taxable income allocated to their tax capital accounts but not for unrealized gains allocated to their book capital accounts. *See, e.g.*, H.R. 4213, 111th Cong. (as introduced in House of Representatives, Dec. 7, 2009) § 602(a) (proposed Section 710(e)(2)(D)).

[68] Prop. Reg. § 1.1061-2(a)(1)(i); *see id.* § 1.1061-2(a)(2)(i) Example 1; Section 1061(c)(1) (stating that API status is present "except as provided in this paragraph or paragraph (4)" and contemplating such status following transfers to related non-service providers); Preamble at 49755, 49758–59 ("[E]ven 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 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 or is held by an estate.").

[69] Proposed Regulations Section 1.704-3(e)(3)(vii)(A) supports this conclusion: "[I]f a partnership uses the partial or full netting approach, the partnership must establish appropriate accounts for the purpose of taking into account its book Unrealized API Gains and Losses and API Gains and Losses (as defined in § 1.1061-1(a)) separate from the book Capital Interest Gains and Losses (as defined in § 1.1061-1(a)) of an API Holder."

commensurate. And, finally, the Capital Interest Exception also applies to returns that are commensurate with "the value of such interest subject to tax under section 83 *upon the receipt or vesting of such interest*,"[70] indicating that it is not intended to apply to untaxed amounts.

If Treasury decides to adopt the third alternative, we recommend that it consider providing additional guidance on whether taxpayers have discretion to elect mark-to-market taxation of crystallized Incentive Allocation and, if such an election is provided, whether it must be consistent across time and across assets. Allowing inconsistent elections could be abused by taxpayers who would keep losses subject to Section 1061(a) to offset future gains but lock in existing gains to shelter subsequent returns from Section 1061(a).

Furthermore, under either approach, Passthrough Entities will need to implement sophisticated tracking mechanisms using Section 704(c) principles to delineate between Capital Interest Gains and Losses and API Gains and Losses.[71] Such mechanisms are complex and burdensome. We reiterate our comments in an earlier report that to the extent tracing is required through Subchapter K and its regulations, including the Proposed Regulations, it precludes aggregation as contemplated under Treasury Regulations Section 1.704-3(e).[72]

Distributed API Property presents a parallel situation to crystallized Incentive Allocations, in that the Proposed Regulations do not distinguish between pre-distribution

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[70] Section 1061(c)(4)(B)(ii) (emphasis added).

[71] *See, e.g.*, Prop. Reg. § 1.704-3(e)(3)(vii)(A).

[72] *See* New York State Bar Association Tax Section, Report No. 1220, *Aggregation Issues Facing Securities Partnerships under Subchapter K* 27 (Sept. 29, 2010).

and post-distribution appreciation. Rather, so long as the property remains Distributed API Property, all long-term capital gains and losses on the disposition of such property by an Owner Taxpayer are included in the calculation of API Gains or Losses.[73] (The Preamble states that the same rule applies if the Distributed API Property is distributed from one Passthrough Entity to another,[74] although this is not explicitly reflected in the Proposed Regulations.[75]) We believe that, like the amount of crystallized Incentive Allocation, the built-in gain as of the time Distributed API Property is distributed should be subject to Section 1061(a) and included in the calculation of an Owner Taxpayer's Recharacterization Amount. Once distributed, subsequent appreciation is no different than subsequent gains on crystallized Incentive Allocations.[76] Accordingly, we recommend that Treasury revise the Distributed API Property rules in the final regulations to treat subsequent, post-distribution gains in such circumstances in the same manner as the subsequent returns on the crystallized Incentive Allocations.

Fourth, we believe that a fund professional's use of loan proceeds to make a capital contribution to a fund should not per se preclude the interest so acquired from qualifying for the Capital Interest Exception. We note that the text of Section 1061 does not provide any such rule, nor do we believe such a categorical rule is justified by the

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[73] Prop. Reg. § 1.1061-4(a)(4)(i)(C); *see* Preamble at 49766.

[74] Preamble at 49766 ("If Distributed API Property is distributed from one Passthrough Entity to another and the upper-tier 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.").

[75] *See* Prop. Reg. § 1.1061-4(a)(3)(1)(A) (referring to "distributive share of net long-term capital gain from the partnership" in the calculation of the API One Year Distributive Share Amount).

[76] We note that while the recipients may be subject to a giveback obligation in the private equity fund context, such obligation is for the value of the distributed property at the time of the distribution, not for the property itself or for subsequent appreciation.

"commensurate" statutory standard – and the Proposed Regulations cite none.[77] In our experience, it is not uncommon for junior individual investment professionals to borrow to finance all or a portion of their capital commitment, either from third parties (often arranged and sometimes guaranteed by the management entity) or possibly from the management entity itself. In general, loans made to service providers by service recipients in order to acquire property are subject to limits imposed by Treasury Regulations Section 1.83-3(a)(2) under Section 83. Specifically, under these rules, if property is acquired in exchange for a nonrecourse loan secured only by the property, the IRS may treat such transaction as not an acquisition of property but instead the acquisition of an option. The relevant factors include the extent of risk that the purportedly transferred property will decline in value (e.g., has the property constantly increased, or is its value volatile), the likelihood that the purported purchaser will in fact pay the purchase price (e.g., has the purchaser paid some portion upfront such that even if the property declines in value she will complete the transaction to not lose her investment), and the type of property involved.[78] In addition, loans made to service providers by service recipients in order to acquire property likely are subject to minimum interest rate requirements under Section 7872.[79] So long as loans to an investment professional made or guaranteed by a service recipient comply with the general rules relating to loans in compensation contexts, otherwise have arm's-length terms and are

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[77] *Cf.* Preamble at 49762. Previously proposed Section 710(c)(2)(E) would have provided such a rule in an analogous situation. *E.g.*, H.R. 4213, 111th Cong. (as introduced in House of Representatives, Dec. 7, 2009) § 602(a). Regardless of the merits of that provision, we believe that the failure to include a similar provision in Section 1061 provides some indication that Congress did not intend such a rule to apply to Section 1061.

[78] Treas. Reg. § 1.83-3(a)(2); *see also* David W. Mayo, *Restricted Stock Notes*, 57 Tax Law. 61, 67 (2003).

[79] *See* Section 7872(c)(1)(B)(i).

respected as bona fide debt under general U.S. federal income tax principles, we see no principled reason why the fact that the resulting capital interests are financed with debt should be relevant for determining whether or not an interest qualifies for the Capital Interest Exception, and the Preamble provides no explanation.[80]

We recognize that debt recourse only to the capital interest itself may provide challenges that fully recourse debt would not. If the nonrecourse debt is treated as debt under the rules discussed above most of us believe it should be permitted to finance an interest eligible for the Capital Interest Exception (although we note that a third-party investor would be less likely than an employee to be able to obtain nonrecourse funding to acquire an interest in an private investment fund, and that a third-party lender would be less likely than a fund to provide such financing to such employees). To the extent Treasury is concerned about general partners accepting purported nonrecourse loans to finance fully their capital commitment, under general U.S. federal income tax principles such "loans" would be treated as options and, accordingly, excluded from the Capital Interest Exception under our proposed recommendation.[81]

Fifth, we believe that the Capital Interest Exception should apply where the GP Capital Commitment is made through a separate co-invest vehicle (referred to above as "Pinewood (Green Point Parallel) LP") rather than the main fund partnership. Typically, such co-invest vehicle invests in portfolio companies alongside the main fund partnership pro rata based on aggregate capital commitments. The interests in such a vehicle, held

[80] *See* Preamble at 49762.

[81] *See* Rev. Rul. 72-135, 1972-1 C.B. 200 (holding that a nonrecourse loan from a general partner to a limited partner to cover the limited partner's subscription in the partnership is a capital contribution from the general partner to the partnership).

both by the service company and its individual investment professional employees, are likely APIs absent an applicable exception, because such interest holders are permitted to purchase such interests as a result of their providing investment management services. However, as currently drafted, the Capital Interest Exception would not apply. First, allocations by the co-invest vehicle, even if strictly following capital accounts, would not be Capital Interest Allocations because such co-invest vehicle has no Unrelated Non-Service Partners.[82] Second, while such allocations would likely be Passthrough Interest Direct Investment Allocations because the co-invest vehicle (in a private equity context, for example) directly holds interests in portfolio companies which are not APIs,[83] such allocations would not be Passthrough Interest Capital Allocations because the co-invest vehicle does not itself hold any APIs.[84] We do not believe that this is an intended result, and to the extent that the co-invest vehicle's terms provide the fund managers with commensurate investment returns to the returns of the Unrelated Non-Service Partners in the main fund partnership, believe the result is not consistent with the purpose of the Capital Interest Exception. Accordingly, we recommend that Treasury revise the Capital Interest Exception to accommodate funds that utilize co-invest arrangements for the GP Capital Commitments, to remove the requirement that a Passthrough Entity hold an API for its allocations to qualify as Passthrough Interest Direct Investment Allocations and to

[82] Prop. Reg. § 1.1061-3(c)(4)(ii) (requiring that Unrelated Non-Service Partners hold an aggregate capital account balance of 5% or more of the aggregate capital accounts balances of the partnership).

[83] Prop. Reg. § 1.1061-3(c)(5)(iii).

[84] *See* Prop. Reg. § 1.1061-3(c)(5)(i) ("Passthrough Interest Capital Allocations are made by Passthrough Entities <u>that hold an API in a lower-tier Passthrough Entity</u>." (emphasis added)).

accommodate, perhaps through aggregation, co-invest vehicle structures that alone do not have Unrelated Non-Service Partners.

Sixth, we believe further consideration should be given to the rules in Proposed Regulations Section 1.1061-3(c)(6) as they relate to the sale of a portion of a partner's interest in a partnership in which the partner has both an API and an interest that qualifies for the Capital Interest Exception. *Example 5* in Proposed Regulations Section 1.1061-3(c)(7)(v) illustrates the application of those rules. In Year 1, a general partner was issued an API ("Class A units") and, in exchange for a contribution of $2,000, an interest that qualified for the Capital Interest Exception ("Class B units"). In Year 3, when the Class A units were worth $7,000, the general partner sold the Class B units for their fair market value of $3,000. The general partner's basis in its entire partnership interest at the time of the sale was still $2,000. Citing Treasury Regulations Section 1.61-6(a), the example concludes that the general partner's $2,000 tax basis in its entire partnership interest is required to be equitably apportioned between the Class A units and the Class B units based on their relative fair market values at the time of the sale. As a result, the general partner was required to recognize $2,400 of gain ($3,000 amount realized less $600 (30% x $2,000 basis)) on the sale of the Class B units. The example concludes that the entire $2,400 of long-term capital gain was Capital Interest Disposition Amount, since "Class B units are only entitled to allocations that are Capital Interest Allocations and are not entitled to allocations of API Gain or Loss."[85] As a result, the

[85] The portion of the gain that is treated as Capital Interest Disposition Amount is the portion of the long-term capital gain that would have been Capital Interest Allocations upon a hypothetical sale of the partnership's assets. *See* Prop. Reg. § 1.1061-3(c)(6)(ii). The example's conclusion was, thus, presumably based on the fact that 100% of the $1,000 of gain that would have been allocated to the Class B units on a hypothetical sale of assets would have been Capital Interest Allocations. *See also infra* Section IV.F.2.(b) & note 196 and accompanying text (discussing the complexities involved in applying this lookthrough rule).

general partner's $2,400 of gain was not subject to recharacterization under Section 1061(a).

Although the example did not address it, if the general partner subsequently sold its Class A units (and values remained the same), it would have only $5,600 of gain ($7,000 amount realized less $1,400 of remaining basis) subject to recharacterization under Section 1061, even though there was $7,000 of underlying gain in the Class A units. In contrast, if the partnership had sold all of its assets or if the general partner had sold both the Class A and Class B units in a single transaction, the general partner would have had $7,000 of gain subject to recharacterization under Section 1061(a). By selling the Class B units separately from the Class A units, the general partner was able to reduce the amount of gain subject to recharacterization under Section 1061(a).

The anomalous result follows from a discrepancy between the way the example calculates the general partner's gain from the sale of its interest (the "outside gain") and the way the gain from the hypothetical sale of the partnership's assets attributable to the interest transferred (the "inside gain") is calculated. Under the example, the general partner's outside gain is $2,400, but the inside gain associated with the transferred interest is treated as only $1,000. The potential discrepancy between outside gain and inside gain in a partnership can arise in a variety of contexts and has never been adequately addressed in guidance. For example, if a partner who holds both a preferred interest acquired for cash and a common interest acquired for a contribution of appreciated property sells the preferred interest, the outside gain might reflect some of the built-in gain from the contributed property, but the inside gain associated with the transferred interest might not, depending on one's interpretation of Treasury Regulations

Section 1.704-3(a)(7). Creating a discrepancy between outside gain and inside gain leads to distortions of the type illustrated in *Example 5*. We do not believe the rules are necessarily required to be applied in a manner that leads to such a discrepancy. For example, a different, possibly more appropriate, interpretation of the equitable apportionment required by Treasury Regulations Section 1.61-6(a) would permit an apportionment of all of the general partner's $2,000 basis to the Class B units so that the outside gain would match the $1,000 inside gain. Alternatively, Treasury Regulations Sections 1.704-3(a)(7) and 1.704-1(b)(2)(iv)(l) could be interpreted to match the inside gain associated with the transferred interest with the outside gain, resulting in a portion of the general partner's gain on the sale of the Class B units, which reflects some of the general partner's gain from its API, being subject to recharacterization under Section 1061(a). Either approach would eliminate the distortions that arise from creating a discrepancy between outside and inside gain. We have serious reservations with any approach that embraces those distortions. Further, if such an approach is to be embraced, it should not be introduced in an example to the Section 1061 regulations. Because the approach would have ramifications that are far broader than Section 1061, we believe it should be the subject of further study.

B. The Corporate Exception

1. Proposed Regulatory Framework

Section 1061(c)(4)(A) provides for the Corporate Exception to the definition of API. Proposed Regulations Section 1.1061-3(b)(2) provides two exclusions to the Corporate Exception. First, as previewed in Notice 2018-18, the Corporate Exception does not include corporations that have elected to be treated as S Corporations under

Section 1362(a).[86] Second, the Corporate Exception does not include passive foreign investment companies ("PFICs") with respect to which the shareholder has made a qualified electing fund ("QEF") election under Section 1295.[87] The S Corporation exclusion is proposed to apply to tax years beginning after December 31, 2017, and the QEF exclusion is proposed to apply to tax years beginning after August 14, 2020.[88]

The Preamble explains that Treasury included the QEF exclusion because a shareholder in a PFIC who has made a QEF election includes in her income her pro rata share of the ordinary income and long-term capital gain from the PFIC.[89] Because the same pro rata income inclusion applies to shareholders of S Corporations,[90] we believe Treasury's rationale for the S Corporation exclusion is the same. The Preamble asserts that the grant of regulatory authority under Section 1061(f), including statements in the legislative history that the Treasury should issue regulations to prevent the abuse of the purposes of Section 1061,[91] is sufficient to support this regulation.[92]

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[86] Prop. Reg. § 1.1061-3(b)(2)(i).

[87] Prop. Reg. § 1.1061-3(b)(2)(ii).

[88] Prop. Reg. §§ 1.1061-3(f)(2) & (3); *see also* Preamble at 49760–61; I.R.S. Notice 2018-18, Guidance Under Section 1061, Partnership Interests Held in Connection with Performance of Services 2018-12 I.R.B. 443 § 4.

[89] Preamble at 49760–61; *see generally* Section 1293(a)(1) (providing for separate statement of ordinary earnings and long-term capital gain of a qualifying electing fund and that such items retain their character in the hands of the shareholder of the qualifying electing fund).

[90] *See generally* Sections 1366(a) & (b) (providing for separate statement of certain items and retention of character).

[91] *See* Conference Report, *supra* note 5, at 422; *see also* Bluebook, *supra* note 26, at 203.

[92] Preamble at 49761.

2. *Comments and Recommendations*

Whether an S Corporation is a corporation for all purposes of the Code is not entirely clear. On the one hand, an S Corporation's taxable income is generally computed on the same basis as an individual.[93] Further, certain provisions of the Code applicable to "corporations" have been held not to apply to S Corporations[94] and Treasury has previously exercised its authority to exclude S Corporations from different tax regimes.[95] In addition, the Bluebook states that the Corporate Exception does not apply to S Corporations.[96] On the other hand, a number of courts have held in different contexts that S Corporations are included in the term "corporation" used in the Code[97] and various

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[93] Section 1363(b).

[94] *See, e.g.*, *Naporano* v. *United States*, 834 F. Supp. 694 (D.N.J. 1993) (holding that S Corporations are not included in "another corporation" in Section 345(c)(1)(A)).

[95] *See, e.g.*, Treas. Reg. § 1.6011-4(c)(3) (excluding S Corporations from the definition of "corporation" for the purposes of the reportable transactions rules, while Section 6707A specifies maximum penalties for all persons, with a separate maximum provided only for "natural persons"); Rev. Rul. 93-36, 1993-1 C.B. 187 (providing that the nonbusiness bad debt provisions in Section 166, applicable to "corporations," do not apply to S Corporations except in limited circumstances); I.R.S. Tech. Adv. Mem. 9245004 n.1 (July 28, 1992) (excluding S Corporations from the dividend-received-deduction in Section 243); I.R.S. Chief Counsel Advisory 201552026 (Dec. 24, 2015) (providing that S Corporations cannot take an ordinary loss under Section 165(g)(3), which applies to "a corporation affiliated with a taxpayer").

[96] *See* Bluebook, *supra* note 26, at 201.

[97] *See, e.g.*, *Eaglehawk Carbon, Inc.* v. *United States*, 122 Fed. Cl. 209 (2015) (holding that S Corporations are included in "corporation" in Section 6621(a)(1), specifying the overpayment rate); *United States* v. *BDO Seidman, LLP*, 492 F.3d 806, 825 (7th Cir. 2007) (holding that S Corporations are included in the term "corporation" in Section 7525(b)); *Giovanini* v. *United States*, 9 F.3d 783, 789 n.29 (9th Cir. 1993) (describing it as "generally accepted" that Section 381, which refers to "corporation," applies to S Corporations, which the IRS stipulated). We also note that courts have indicated that they generally read "corporation" in the Code broadly. *See, e.g.*, *United States* v. *Detroit Med. Ctr.*, 833 F.3d 671, 678 (6th Cir. 2016); *BDO Seidman*, 492 F.3d at 825 ("[W]hen a particular section of the IRC is intended to apply only to C corporations, Congress will use that term, rather than the generic 'corporation.'"); *Garwood Irrigation Co.* v. *Comm'r of Internal Revenue*, 126 T.C. 233, 236 (2006) ("[We] are left with the word 'corporation' with no cross-reference. The general definition of 'corporation' in section 7701(a)(3) and section 301.7701–2(b)(1), Proced. & Admin. Regs., does not distinguish between C and S corporations.").

Code provisions support this position.[98] In the context of Section 1061 and the Corporate Exception, commentators and at least one court have questioned whether Treasury has authority to carve S Corporations out of the Corporate Exception,[99] although others have indicated that it does.[100]

We agree with Treasury that the QEF exclusion and the S Corporation exclusion from the Corporate Exception are consistent with the purposes of Section 1061. As a policy matter, taxpayers should not be able to elect to benefit from passthrough treatment of income and avoid entity-level taxes[101] on the one hand while using such entities simultaneously to block the application of Section 1061(a). Allowing such structures would result in the Corporate Exception swallowing – and entirely circumventing – the

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[98] *See, e.g.*, Section 1361(a) (defining C Corporation as "a corporation which is not an S Corporation" (emphasis added)); Section 1371(a) (providing that except to the extent inconsistent with "this subchapter" subchapter C applies to S Corporations and their shareholders).

[99] *See, e.g.*, *Charleston Area Med. Ctr., Inc.* v. *United States*, 940 F.3d 1362, 1371 (Fed. Cir. 2019) ("While we question whether the regulations described in the Notice, if codified, would be proper in view of the government's position in this case that the Code incorporates the broad, common law meaning of 'corporation,' we leave that issue for another day."); Ginsburg, *supra* note 52, § 1505.2 ("Acting with considerable haste, but perhaps less considerable legal authority for the position, Treasury/IRS announced in Notice 2018-18 . . . . However questionable the legal authority for Notice 2018-18 and the intended regulations, excluding S corporations from Code § 1061's exception is sensible and we expect that most taxpayers will be reluctant to take a contrary position that is likely to be challenged by IRS."); Bruce A. McGovern & Cassady V. ("Cass") Brewer, *Recent Developments in Federal Income Taxation: The Year 2017*, 71 Tax Law. 725, 827 (2018); Monte A. Jackel, *Carried Away: The Proposed Carried Interest Regs, Part 3*, 168 Tax Notes Federal 1653, 1657 (Aug. 31, 2020) ("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."); Monte A. Jackel, *S Corporations and Carried Interests*, 165 Tax Notes Federal 987 (2019); Bruce Lemons and Richard Blau, *Are S Corporations 'Corporations' Under the Carried Interest Rules?*, 164 Tax Notes Federal 1567 (2019); Marie Sapirie, *How to Decide Whether an S Corp is a Corporation*, 160 Tax Notes 308 (2018).

[100] *See* Islame Hosny, *Interpretations by Treasury and the IRS: Authoritative Weight, Judicial Deference, and the Separation of Powers*, 72 Rutgers U.L. Rev. 281, 349 n.255 (2020).

[101] *See* Sections 1363(a) & 1293(a).

rule of Section 1061.[102] Accordingly, we agree with Treasury that Section 1061(f) provides ample authority for the regulations to carve out S Corporations and PFIC shareholders who have made QEF elections from the Corporate Exception.

C. The Self-Investment Exception

1. Proposed Regulations

Section 1061(b) provides for the Self-Investment Exception, to the extent provided by Treasury. The Proposed Regulations reserve with respect to the Self-Investment Exception.[103] The Preamble states that Treasury agrees with commenters[104] that this exception is intended to apply to family offices, "that is, portfolio investments made on behalf of service providers and persons related to the service providers."[105] Treasury states that it believes the Self-Investment Exception is sufficiently provided for through the rules relating to Passthrough Interest Direct Investment Allocations, but

[102] We note that the same considerations apply to a taxpayer who holds an API through a regulated investment company or a real estate investment trust, both of which are typically corporations but operate effectively as pass-through entities. *See* Sections 851(a), 852(b)(3), 856(a)(3) & 857(b)(3).

[103] Prop. Reg. § 1.1061-3(e).

[104] *See, e.g.*, Amy Lee Rosen, *5 Things Attys Hope to see in Proposed Carried Interest Rules*, Law360 Tax Auth. (Mar. 20, 2020), LEXIS 2020 Law360 80-139; Scott W. Dolson and Nelson D. Rodes, *Planning for New IRC Section 1061: Part 1*, Law360 Tax. Auth. (May 2, 2018), LEXIS 2018 Law360 122-156.

[105] Preamble at 49763. Along with the recommendations below, we also recommend that Treasury clarify the meaning "relatedness" for the purposes of Section 1061(c)(5)'s definition of "third party investor." The general definition in the Proposed Regulations for "Related Person" (which is based on Sections 707(b) and 267(b)) could be made to apply. Prop. Reg. § 1.1061-1(a) Definition of "Related Person"; *see* Preamble at 49758 ("[S]ection 1061 does not include a definition of related person for the remainder of section 1061. Accordingly, in defining *Related Person*, the proposed regulations use the general definition of a person or entity that is related under sections 707(b) or 267(b) of the Code."). However, we note that the legislative history of Section 1061(b) indicates that the narrower Section 1061(d) Related Person definition (which is based on Section 318(a)(1)) should apply. *See* Conference Report, *supra* note 5, at 420 & n.833; Bluebook, *supra* note 26, at 201 & n.1002.

invites comments as to whether such allocations properly implement the Self-Investment Exception.[106]

The Proposed Regulations define Passthrough Interest Direct Investment Allocations as allocations that consist only of long-term capital gains and losses derived from assets, other than APIs, held directly by a Passthrough Entity (such assets, its "Direct Non-API Investments").[107] Direct Non-API Investments also include property that had been Distributed API Property but now has a holding period exceeding three years and therefore is no longer Distributed API Property in the hands of the Passthrough Entity.[108] Such allocations must be made "in the same manner . . . based on each direct owner's capital account," the same test that applies for the Capital Interest Exception, based on each direct owner's capital account in the Passthrough Entity.[109]

Passthrough Interest Direct Investment Allocations come within the Capital Interest Exception, so long as the Passthrough Entity holds an API in a lower-tier

[106] Preamble at 49763.

[107] Prop. Reg. § 1.1061-3(c)(5)(iii)(A). As discussed in Section IV.A.2.(c) above, the Proposed Regulations require that the Passthrough Entity making Passthrough Interest Direct Investment Allocations holds an API, a requirement which we recommend Treasury remove.

[108] Preamble at 49762.

[109] Prop. Reg. § 1.1061-3(c)(5)(iii)(B) (cross-referencing Proposed Regulations Sections 1.1061-3(c)(3)(i) and (ii)). In the event that the Passthrough Entity is in a tiered structure, it can choose to make Passthrough Interest Direct Investment Allocations based on its direct owner capital accounts or based on its direct owner capital accounts reduced by each direct owner's share of the Passthrough Entity's capital account in lower tier entities. *Id.* §§ 1.1061-3(c)(3)(ii)(B)(2) & (3).

Passthrough Entity.[110] They are aggregated with the capital interest allocations discussed above and are excluded from the Recharacterization Amount.[111]

2. *Comments and Recommendations*

(a) Introduction

We agree with Treasury that the Self-Investment Exception is intended to accommodate family offices and similar arrangements in which the capital of related parties is managed. In addition, we do not believe that the Passthrough Interest Direct Investment Allocation provisions are sufficient to accommodate arrangements used for such purposes. To contextualize our recommendations and our overarching comment that Passthrough Interest Direct Investment Allocations are insufficient to account for the Self-Investment Exception, below we summarize the typical arrangements in family offices and management companies, and provide our applicable comments and recommendations regarding the Proposed Regulations and Section 1061(b) following each summary.

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[110] *See* Prop. Reg. § 1.1061-3(c)(2) (defining Capital Interest Gains and Losses to include Passthrough Interest Allocations); *id.* § 1.1061-3(c)(5)(i) (defining Passthrough Interest Allocations as allocations made by a Passthrough Entity that holds an API in a lower-tier Passthrough Entity and as including Passthrough Interest Direct Investment Allocations).

[111] The Proposed Regulations do not explicitly require aggregation. *See* Prop. Reg. § 1.1061-3(c)(2) ("Capital Interest Gains and Losses are Capital Interest Allocations that meet the requirements of paragraph (c)(4) of this section, Passthrough Interest Capital Allocations that meet the requirements of paragraph (c)(5) of this section, and Capital Interest Disposition Amounts that meet the requirements of paragraph (c)(6) of this section."). However, the provisions regarding calculation of the Recharacterization Amount, *id.* § 1.1061-4(a)(3)(i)(B)(3), and the reporting provisions, *id.* § 1.1061-6(b)(1)(ii), appear to treat it as an aggregated single number. We recommend revising the regulations to clarify either that such aggregation is appropriate or to provide that some or all of the components of Capital Interest Gains and Losses are to remain disaggregated.

(b) Family Offices

Typical Family Office Arrangements. In our experience, high net worth individuals typically create family offices to provide a variety of services to members of their family, including investment, financial, tax, insurance and estate planning advice, tax return preparation and regulatory compliance.[112] For the purposes of this Report, we will focus on the investment management piece of a family office's responsibilities. Figure 3 is a diagram of a typical sophisticated family office investment structure for the Purple Family.

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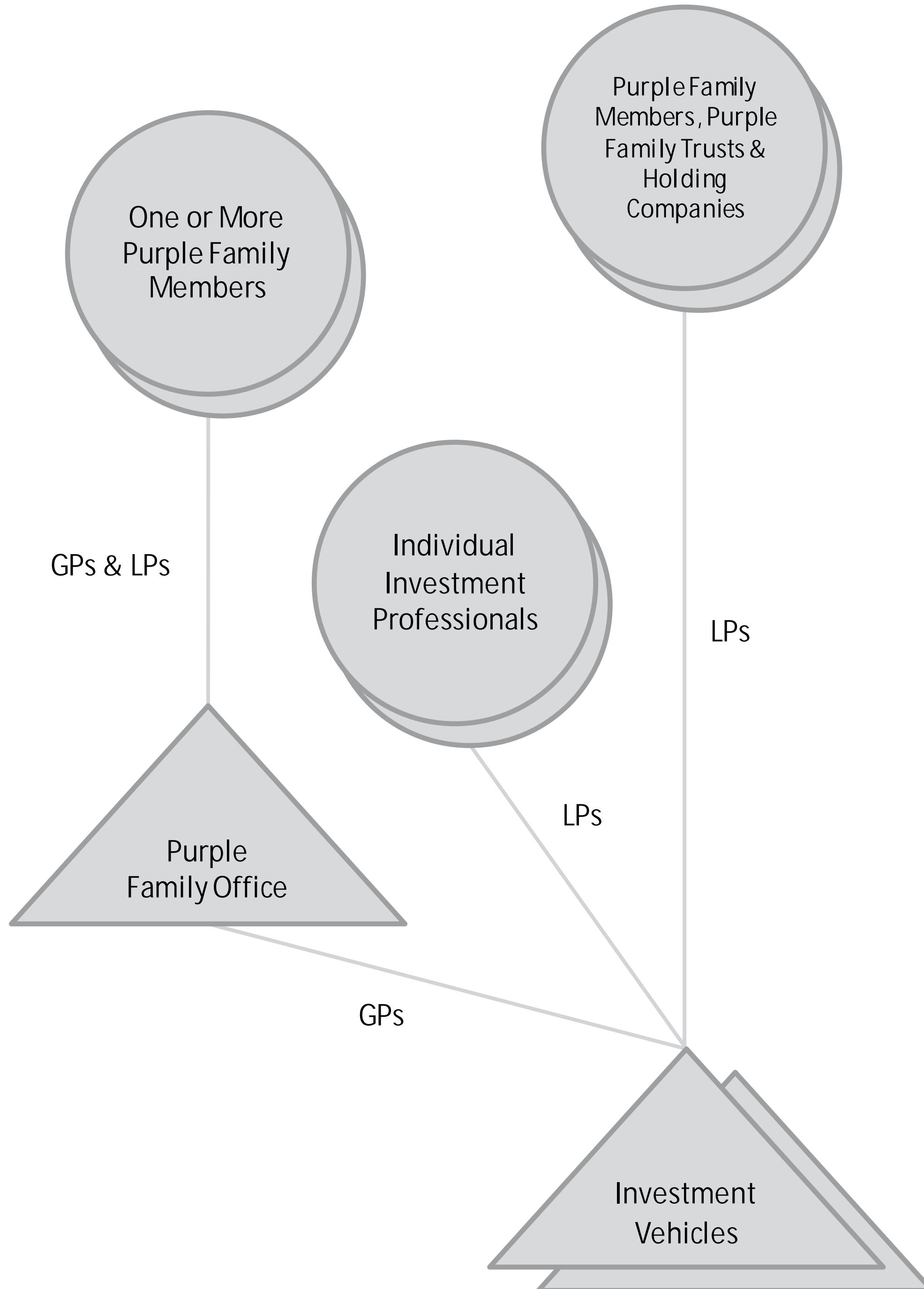
[112] *See, e.g.*, John J. Buttita, *A Practical Approach to Family Office Structure: Going Beyond* Lender, 132 J. Tax'n 13, 28 (2020) (discussing thoroughly the typical considerations relevant to, and the decisions made in, structuring a family office). Some family offices provide personal services to family members as well. *See id.*

Figure 3



We would expect the Purple Family to have set up and transferred substantial wealth to various estate planning and wealth transfer vehicles in the form of trusts and holding companies. Those entities will typically form Investment Vehicle partnerships

that will, in turn, make direct debt, equity and real estate investments, as well as subscribe as investor limited partners in, among other things, private equity funds and hedge funds.

The Purple Family Office entity will serve as the general partners of those Investment Vehicles. Typically, we expect that senior Purple Family members would control the family office (while many or all Purple Family members and entities will be "clients" of the family office by receiving, among other things, investment management services from it). Other Purple Family members may be admitted as limited partners into the Purple Family Office. The ownership and the control of the Purple Family Office will typically be structured such that it comes within the "family office" exclusion to the definition of "investment advisor" in the Advisers Act,[113] which allows the Purple Family Members and their investment professionals to avoid having to register with the Securities and Exchange Commission ("SEC").[114] Specifically, "family members" (the lineal descendants of a family member and their spouses) must control the Purple Family Office and "family clients" (family members as well as, e.g., key employees, family foundations and charitable trusts) must be the Purple Family Office's only clients.[115] Importantly, these restrictions mean that the Purple Family Office cannot raise capital from or return it to the public at large, but only from members of the family.

As the Investment Vehicles' general partner, the Purple Family Office will coordinate and execute the family's investment strategy, which is typically devised and

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[113] *See* 15 U.S.C. § 80b-2(a)(11)(G).

[114] *See* 17 C.F.R. § 275.202(a)(11)(G)-1.

[115] *See id.* §§ 275.202(a)(11)(G)-1(d)(4), (6), (7) & (8).

executed by employees (or executive officers) who are usually not, but may be, family members. In exchange, such employees receive partnership profits interests in the Investment Vehicles. Those partnership profits interests are typically set at 20% of profits (net income) earned on investments (mirroring the private equity and hedge fund incentive arrangements), and are sometimes subject to either or both of a hurdle (akin to the preferred return in a private equity fund) and a cap (typically 2 to 3% of assets under management).

Finally, family offices are most likely engaging in activities that would constitute an ATB if performed for another party. Although they are typically not engaged in raising capital because the family has already provided the investment funds, in our experience they return capital to family members frequently and thus are engaged in at least some Raising or Returning Capital Actions. Furthermore, the balance of their activity is typically investing in Specified Assets. Even though such activity may not be Developing Specified Assets as defined in Proposed Regulations Section 1.1061-2(b)(1)(ii), we believe this meets the ATB Activity Test,[116] at least once some capital is retuned.[117] At the same time, because ATB is defined with reference to Section 162,[118] many family offices are not engaged in a trade or business under Section 162

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[116] *See* Prop. Reg. §§ 1061-2(b)(1)(i)(A) & (B) (providing that while some Raising or Returning Capital Actions must occur (which is consistent with Section 1061(c)(2)), such actions are aggregated with Investing or Developing Actions when determining whether activities constitute an ATB); *id.* § 1.1061-2(b)(2)(iii) Example 3 (indicating that the ATB test can be met through significant Investing or Developing Actions, given some amount of Raising or Returning Capital Actions, even if the latter alone does not rise to the level of a Section 162 trade or business).

[117] *See* Preamble at 49760 ("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.").

[118] Prop. Reg. § 1.1061-2(b)(1).

because they are merely trading or investing for their own account,[119] though there are circumstances under which a family office becomes virtually indistinguishable from an investment firm.[120]

Comments and Recommendations. As discussed above, Section 1061(b) authorizes Treasury to promulgate regulations that would exempt from Section 1061(a) income or gain not held for portfolio investment on behalf of third-party investors, with a third-party investor being a person that holds an interest in a partnership that is not property held in connection with an ATB and that is not actively engaged, or related to a person that is actively engaged, in providing substantial investment services to such partnership or any ATB.[121] We believe that Section 1061(b) is intended to exempt the partnership profits interests granted to compensate and incentivize family office individual investment professionals who are members of the family and provide investment management services to themselves and/or their family members and not to third-party investors as defined in Section 1061(c)(5). As discussed below, the Passthrough Interest Direct Investment Allocations rule in the Proposed Regulations does not apply to such interests and likely will not apply at all to most family office structures, which are otherwise potentially subject to Section 1061(a). Accordingly, we recommend that Treasury exercise its authority under Section 1061(b) and include regulatory guidance, including a safe harbor, in the final regulations under which family member

[119] *See Higgins* v. *Comm'r of Internal Revenue*, 312 U.S. 212 (1941).

[120] *See Lender Management LLC* v. *Comm'r of Internal Revenue*, T.C. Memo. 2017-246, 114 T.C.M. (CCH) 638 (2017) (holding that a family office's investment operations were sufficiently elaborate and served enough different clients to qualify for a deduction for business expenses under Section 162).

[121] Section 1061(c)(5).

investment professionals in family offices are excluded from Section 1061(a)'s ambit, as intended by Section 1061(b).

The Passthrough Interest Direct Investment Allocations rule in the Proposed Regulations is quite narrow. It only exempts from Section 1061(a) allocations of long-term capital gains or losses derived from non-API assets held directly by a Passthrough Entity made to its direct owners on the basis of their capital accounts. In our experience, virtually no family offices will satisfy that test because family-member individual investment professionals hold profits interests, not capital interests, in the family office partnership.

We believe Section 1061(b) evidences Congress' intent that family-member investment professionals who work for family offices not be subject to Section 1061(a). Because of the high-level similarity between investment funds and family offices, we recommend that Treasury guidance provide objective safe harbors so family offices can structure their affairs and manage their investments with confidence that the interests held by family members come within the Section 1061(b) exemption. The SEC has created such a safe harbor for purposes of allowing family offices to not fall within the Advisers Act and its registration requirements.[122] We see no policy need to define family offices differently for income tax purposes than for securities law purposes.

[122] 17 C.F.R. § 275.202(a)(11)(G)-1; *see also* Securities and Exchange Commission, Family Offices 76 Fed. Reg. 37983-01, 37984 (Final Rule) (June 29, 2011) (explaining that the SEC views family offices as "not the sort of arrangement that the Advisers Act was designed to regulate" because disputes can "be resolved within the family unit or, if necessary, through state courts under laws designed to govern family disputes"); Securities and Exchange Commission, Family Offices 75 Fed. Reg. 63753-01, 63754 & n.13 (Proposed Rule) (Oct. 18, 2010) (stating in addition that applying the Advisers Act to family offices would intrude on family privacy).

However, given the similarities between typical family office structures and investment funds, we believe third-party investment professionals unrelated to the family should not come within the Section 1061(b) exemption. We do not believe that such third-party professionals should have better tax treatment by working for a sophisticated, fund-like family office as opposed to an investment fund. Rather, Section 1061(a) should apply to those professionals in the same way regardless of their work context. Accordingly, we recommend that, consistent with the broadly applicable rule in the Proposed Regulations, Treasury provide that only investment professionals providing services to their family, as defined under Section 267, come within the exemption.[123]

(c) Management Companies

In addition to family offices, we believe that certain arrangements involving management companies should be exempt from Section 1061(a) based on Section 1061(b). Below, we summarize such arrangements and then turn to our recommendation.

Typical Management Company Arrangements. For the purposes of this discussion, we are using the term "Management Company" to refer to the entities, typically partnerships, that provide investment management services to private equity funds or hedge funds – in the examples above, Green Point Manager and Orange Point Portfolio Manager. Management Companies receive management fees from the investment funds they manage, typically set at 1 to 2% of assets under management (or, as discussed for private equity funds, invested capital), and are typically controlled by the investment adviser's service company. Such income, as compensation for the investment management services, is characterized as ordinary income. Management Companies are

[123] *See* Prop. Reg. § 1.1061-1(a) Definition of "Related Person"; *see also* Preamble at 49758.

typically owned and controlled by a fund manager's service company (Pinewood Service Company in the examples above), which is typically owned and controlled by the senior investment professionals of the fund. Management Companies may also grant profits interests to more junior investment professionals that would entitle such professionals to a share of the operating profits or gain on a capital event, or both. Those service companies own and control all of the various fund-specific entities formed for each fund.

Service companies, particularly those with proven track records of success, may attract "GP stakes investments" which allow third parties to invest in their operations. Such investments are typically structured such that the service company sells both (1) a portion of its partnership profits interests in its funds' general partners (or of the entity holding all of a service company's partnership profits interests, such as Pinewood GenPar above) and (2) minority equity ownership stakes in its Management Companies (or in a holding company that holds equity in its Management Companies[124]). In our experience, selling such minority stakes is attractive to service companies because it provides them and their owners with liquidity while continuing to control and operate the business, which allows them to pursue additional investment ventures, and may allow the new generation of investment professionals to buy out founders approaching retirement. It also may give them access to operational and investment expertise of the GP stakes investor.[125] Receiving a GP stakes investment is a powerful signaling device to fund

[124] The investments may be primary investments in the Management Companies, secondary purchases of interests in the Management Companies from founders, or a combination thereof.

[125] We note that this often takes a strategic or consultative form, rather than the more formal provision of services. Some GP stakes investors, however, have affiliates that separately perform certain services. We do not believe that such services are implicated by the Proposed Regulations because they are not performed by the GP stakes investor themselves or a "Related Person" within the meaning of the Proposed Regulations.

investors, indicating the GP stakes investor's confidence in the service company's ability to attract investors and produce returns for many years to come, that the service company is becoming institutionalized and also that the fund will be subject to some level of oversight by the GP stakes investor.

Because Management Companies receive their fees at consistent intervals throughout the life of funds based on a percentage of capital commitments or invested capital, the GP stakes investors' investment in the Management Companies returns both predicable distributions and appreciation as a fund attracts additional investors. Additionally, investors in GP stakes investment funds are able to diversify their holdings into many different funds and investment strategies.

Recommendations. We believe that the gain realized in GP stakes investments, to the extent attributable to the transfer of interests in the Management Companies, should not be subject to Section 1061(a). For the reasons discussed below, exempting such transactions is appropriate based on Section 1061(b) and we recommend that Treasury revise the Proposed Regulations to implement such exemption.

A service company's (and its investment professionals') interest in a Management Company is an API. The Management Company is engaged in an ATB for its fund[126] – it both raises investor capital and develops specified assets. The service company's employees (or possibly partners) are the individual investment professionals engaging in such ATB and it is for such services that the service company receives an interest in the Management Company. But while the interest is an API, because the Management

[126] Indeed, it is the Management Company's actions, based on delegated authority from the fund's general partner, that are attributed to the general partner and which make the general partner's interest in the fund an API. *See* Prop. Reg. §§ 1.1061-2(b)(1)(i)(C) & 1.1061-2(b)(2)(v) Example 5.

Company's income is ordinary income, not capital gains, the service company will not have any Recharacterization Amount based on such income.

However, because such interest is an API, under the Proposed Regulations, the gain on a GP stakes investment, including the gain attributable to the sale of the service company's APIs in its Management Companies, will be included in the service company's (or individual investment professional's) API One Year Disposition Amount (if the service company or such individuals have held their APIs for at least one year) and, perhaps, its API Three Year Disposition Amount (if such holding period exceeds three years).[127] Although it is often the case that the service company would be well-established before being in a position to sell an interest to a third-party investor, such that the senior investment professionals would likely have at least a three-year holding period in their interests, it is possible that more junior investment professionals would have a shorter holding period in profits interests granted to them. Accordingly, as currently drafted, for such professionals the Proposed Regulations would require recharacterization of at least some of the gains from the sale of an interest in the Management Company in a GP stakes investment as short-term capital gain.

We believe that gain on an arm's-length taxable sale of an interest in a management company should <u>not</u> be subject to Section 1061(a), based on Section 1061(b). Neither the seller's interest in the Management Company nor the Management Company's entitlement to receive fee payments from the investment fund is an asset held for investment by third-party investors. In fact, management companies are operating businesses generating ordinary income in the ordinary course of their trade or business

[127] *See* Prop. Reg. §§ 1.1061-4(a)(4)(i)(A) & 1.1061-4(a)(4)(ii)(A).

and their value is generated in substantial part by the expectation that they will continue to carry on their activities, while Section 1061(a) is intended to recharacterize allocations of capital gain arising from investment returns to compensatory partnership interests received for investment management services.[128] Although as discussed below the GP stakes investor likely will be a third party within the meaning of Section 1061(c)(5), we recommend that Treasury define the safe harbor for beneficial ownership discussed above to include the minority interests held by GP stakes investors.

We also note that if the requirements for the Third-Party Purchaser Exception are met, the interests acquired by the GP stakes investor will not be APIs. Specifically, if the GP stakes investors (1) acquire such interests in taxable transactions for fair market value, (2) have not, do not and do not anticipate providing services to or for the benefit of the service company's funds[129] and (3) are not Related Persons with respect to anyone who provides services in the service company's ATB or anyone who provides services to or for the benefit of the various fund partnerships or partnerships below them,[130] then the

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[128] *See* House Report, *supra* note 5, at 277 ("The Committee is concerned about Federal tax issues arising from the use of carried interests in asset management businesses. . . . The arrangement requires the performance of services by individuals whose professional skill as fund managers generates capital income for investors in the fund. . . . Long-term capital gain allocated to individual partners may represent compensation for their services as fund managers.").

[129] As discussed above, GP stakes investors may give service companies advice and insights from time to time. *See supra* note 125 and accompanying text. We recommend that Treasury clarify that partnership interests acquired in compliance with Proposed Regulations Section 1.1061-3(d) are not transferred or held by such investors "in connection with the performance of substantial services" within the meaning of Section 1061(c)(1) (or that, at a minimum, the presumption of substantiality in Proposed Regulations Section 1.1061-2(a)(1)(iv) does not apply).

[130] Notably, the Proposed Regulations will typically require that purchaser not be a Related Person <u>or</u> a Section 1061(d) Related Person for the Third-Party Purchaser Exception to apply. Prop. Reg. § 1.1061-3(d)(2). If the purchaser is a Section 1061(d) Related Person, Section 1061(d) will apply unless the Section 1061(d) Inclusion Amount (as defined below in Section IV.E.1) is zero or deemed to be zero. *See id.* § 1.1061-5(c)(1)(A).

GP stakes investors' interests in the funds will not be APIs.[131] As drafted, the Third-Party Purchaser Exception would not apply if the GP stakes investors made a primary investment in the Management Companies and the general partners, rather than a taxable purchase of interests. Such investments are common, and we do not see a principled reason for this distinction.[132] It is also not clear under the Proposed Regulations whether the Third-Party Purchaser Exception applies if the GP stakes investors acquired the interests in, for example, a disguised sale, although under general U.S. federal income tax principles, we believe that such a disguised sale should qualify for the exception.[133] We recommend that Treasury clarify that the Third-Party Purchaser exception applies in both of those circumstances.

Furthermore, we recommend that Treasury revise the final regulations to explicate how the Third-Party Purchaser Exception applies in tiered structures. As drafted, it is not clear whether, even if an interest in an upper-tier partnership is not an API pursuant to the exception, allocations made to such interest of gain from lower-tier APIs held by the upper-tier partnership are excluded from Section 1061(a). Even if such gains are not generally subject to Section 1061(a), it is also unclear whether gains from APIs acquired by the upper-tier partnership (or lower-tier partnerships) following a Third-Party Purchaser Exception-eligible transaction and allocated to the interests held by third parties following such transaction remain excluded from Section 1061(a). Another

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[131] Prop. Reg. § 1.1061-3(d).

[132] *See* Preamble at 49763–64.

[133] *See* Monte A. Jackel, *Carried Away: The Proposed Carried Interest Regs, Part 2*, 168 Tax Notes Federal 1459, 1466 & n.6 (Aug. 24, 2020) (stating that disguised sales can qualify for the Third-Party Purchaser exception).

question regarding the exception's operation in tiered structures arises from the fact that the Preamble explicitly states that the Third-Party Purchaser Exception does not apply when the purchaser makes a contribution to an API Holder and in exchange receives an interest in such API Holder tied to the API. Rather, allocations to the purchaser on its interest in the API Holder remain API Gains and Losses.[134] By implication, allocations to a purchaser who purchased her interest in the API Holder from another interest-holder would seem not to be API Gains and Losses. The Proposed Regulations, however, collapse the Preamble's nuance into the phrase "taxable purchase for fair market value" and thereby do not clearly establish this point.[135]

Finally, as drafted, the Third-Party Purchaser Exception is limited to purchasers of partnership interests.[136] We see no principled reason why, if S Corporations and PFICs with respect to which the shareholder has made a QEF election are treated as Passthrough Entities for the purposes of Section 1061, third-party purchasers of interests in such entities would not be eligible for the Third-Party Purchaser Exception, and the Preamble provides no explanation for making such a distinction.[137]

D. Exclusion of Section 1231 Gains

1. Section 1231

In general, Section 1231 provides that if Section 1231 gains exceed Section 1231 losses for a year, such gains and losses shall be treated as long-term capital gains or

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[134] Preamble at 49764.

[135] *See* Prop. Reg. § 1.1061-3(d).

[136] *See* Prop. Reg. § 1.1061-3(d) ("If a taxpayer acquires an interest in a partnership (target partnership) . . . ." (emphasis added)).

[137] *See* Preamble at 49763–64.

losses.[138] Section 1231 gains and Section 1231 losses are gains and losses realized on the sale or conversion of property used in a trade or business.[139] Property used in a trade or business generally is depreciable property or real property that meets a one-year holding period requirement.[140] Notably, the holding period requirement for Section 1231 property is set out in Section 1231(b)(1) and not by cross reference to Section 1222.

2. *Proposed Regulations*

Section 1061(c)(3) includes "real estate held for rental or investment" ("Investment Real Estate") in the definition of Specified Asset. Accordingly, an investment fund otherwise structured as a private equity fund that solicits third-party investors and executes an investment strategy of investing solely in Investment Real Estate would be an ATB, and the general partner's interest in the fund would be an API, as would any individual investment professionals' interests in such general partner (such fund herein referred to as the "Red Fund," managed by "Red Fund GP" as general partner).

When Red Fund disposes of one of its Investment Real Estate assets at a gain, it will likely recognize Section 1231 gain, if the Investment Real Estate is both "held for rental or investment" under Section 1061(c)(3) and is "used in a trade or business" under Section 1231(a)(3)(A)(i). Such Section 1231 gain will be treated as long-term capital gain (if Section 1231 gains exceed Section 1231 losses for the year and it is not subject to the Section 1231 loss recapture rules of Section 1231(c)),[141] and Red Fund GP generally will

[138] Section 1231(a)(1).

[139] Section 1231(a)(3)(i).

[140] Section 1231(b).

[141] Section 1231(a)(1).

be allocated a portion of such gain corresponding to the carry it earned on the investment.[142]

By its terms, Section 1061(a) requires Owner Taxpayers to take their net long-term capital gain "with respect to" APIs and subtract from it the portion that would still be long-term capital gain if "3 years" was substituted for "1 year" in Sections 1222(3) and (4). Section 1231 gain is long-term capital gain regardless of the holding periods specified in Section 1222.[143] Strictly applying Section 1061(a), therefore, Red Fund GP's Owner Taxpayers would include their allocable portions of such Section 1231 gain in both Section 1061(a)(1) as long-term capital gain with respect to its API and Section 1061(a)(2) regardless of Red Fund's holding period in the Investment Real Estate.[144]

[142] As noted above, Section 1231 defines property used in a trade or business as property subject to the depreciation allowance under Section 167 and real property. Red Fund likely would claim depreciation deductions prior to the disposition, reducing its basis in the Investment Real Estate. Such deductions would be allocated to investor limited partners, which would decrease their outstanding capital accounts, but would generally not decrease their committed capital which would be returned in step (1) of a waterfall. We note that this set of facts further demonstrates how in a typical fund arrangement, distributions to investor limited partners do not follow capital accounts and, accordingly, capital accounts should not be the touchstone for whether an interest qualifies for the Capital Interest Exception. *See supra* Section IV.A.2.(c).

[143] We note, however, that there is a one-year holding period specified in Section 1231(b)(1), which is not referenced in Section 1061(a)(2). In addition, the definition of "capital asset" for the purposes of Section 1222 excludes property used in a trade or business subject to Section 167 depreciation and real property used in a trade or business. Section 1221(a)(2).

[144] This means that often the Owner Taxpayers' Recharacterization Amount would not change, since amounts would be added in Section 1061(a)(1) and then subtracted under Section 1061(a)(2). However, because the Proposed Regulations provide that when the amount in Section 1061(a)(1) is zero or negative, the Recharacterization Amount is zero and Section 1061(a) does not apply, Prop. Reg. § 1.1061-4(b)(1), including Section 1231 gains could result in a Recharacterization Amount and Section 1061(a) applying. For example, if, excluding Section 1231 gains, an Owner Taxpayer's One Year Gain Amount was ($10) and the Three Year Gain Amount was ($20) (and so Section 1061(a) would not apply), but there was $15 of Section 1231 gain, including the Section 1231 gain results in a Recharacterization Amount of $5 (based on a One Year Gain Amount of $5 ($15 + ($10)) and a Three Year Gain Amount of ($5) (($20) + $15)). *See id.* § 1.1061-4(b)(2) (providing that when the Three Year Gain Amount is zero or less, it is zero for the purposes of calculating the Recharacterization Amount).

The Proposed Regulations, however, generally exempt all Section 1231 gain from Section 1061(a). The Preamble states: "Section 1061(a) applies to assets that produce capital gains or losses that are treated as long-term capital gain under paragraphs (3) and (4) of section 1222."[145] Accordingly, the Proposed Regulations exclude Section 1231 gain from Red Fund's calculation of the API One Year Distributive Share Amount, because Section 1231 gain is not long-term capital gain under Section 1222.[146] Similarly, the Proposed Regulations exclude any other income taxed at favorable rates without reference to Sections 1222(3) and (4) (including, notably, qualified dividend income).[147]

3. *Comments and Recommendations*

The Preamble states that Proposed Regulations, based on Section 1061(a)(2)'s cross-reference to Section 1222, exclude Section 1231 gains from Section 1061(a)'s ambit.[148] We are not convinced that this is the best reading of Section 1061, and we strongly believe that Section 1231 gains should be subject to Section 1061(a) as a policy matter.[149]

Section 1061(a)(1) refers to "net long-term capital gain" received "with respect to" an API. It does not reference capital assets or Section 1222, and nothing in Section 1061 explicitly indicates a limited scope. Furthermore, the definition of Specified Assets

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[145] Preamble at 49765.

[146] Prop. Reg. §§ 1.1061-4(a)(3)(i)(B)(1) & 1.1061-4(b)(6)(i); *see also id.* § 1.1061-4(c)(2)(vi) Example 6.

[147] Prop. Reg. §§ 1.1061-4(b)(6)(ii)–(iv).

[148] Preamble at 49754 ("The proposed regulations provide that API Gains and Losses do not include long-term capital gain determined under sections 1231 . . . .") & 49765 (including Section 1231 gains in list within section entitled "Items Not Taken Into Account for Purposes of Section 1061(a)").

[149] In contrast, there is a consensus among our group that Section 1061(a) should not apply to qualified dividend income or Section 1256 gains, neither of which provide favorable rates for gains that arise from the disposition of assets. *See* Prop. Reg. §§ 1.1061-3(c)(6)(ii)–(iii).

including "real estate held for rental or investment"[150] explicitly demonstrates that Congress intended to include investment activities that often give rise to Section 1231 gains within the ambit of Section 1061. On its face, the reference to Section 1222 in Section 1061(a)(2) can fairly be read as excluding certain Section 1222 capital gains from Section 1061(a)'s reach, rather than limiting Section 1061(a) to such gains by implication. The legislative history also supports reading Section 1061 as applying to gains from *property*,[151] and neither the House Report nor the Conference Report mention Section 1222 in the discussion of Section 1061.[152]

We also do not believe that preferential treatment for certain investment activities and returns is justified as a policy matter. The policy behind Section 1061(a) of taxing gains on property held for less than three years as short-term capital gain applies equally to gains realized on the disposition of property held for use in a trade or business, particularly in the case of real estate, which is an asset the management of which could cause Section 1061(a) to apply. While the underlying assets may be different, the economic arrangements – and fund managers' ability to receive preferential long-term capital gains rates on their incentive portion of investment returns – is the same. Section 1061(a) arises from Congress' determination that "the use of carried interests in asset management businesses" can lead to unfair results and, accordingly, its decision that "the lower rates that apply to long-term capital gain from sales or exchanges of capital assets

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[150] Section 1061(c)(3).

[151] *See* House Report, *supra* note 5, at 277 ("If the holder of an applicable partnership interest is allocated gain from the sale of <u>property</u> held for less than three years, that gain is treated as short-term capital gain and is subject to tax at the rates applicable to ordinary income." (emphasis added)).

[152] *Cf.* Bluebook, *supra* note 26, at 200 n.1001 (stating that "net long-term capital gain" in Section 1061(a)(1) is defined in Section 1222(7)).

of partnerships should not be available to holders of applicable partnership interests unless an extended holding period requirement has been met."[153] We see no principled reason why carried interest comprised on Section 1231 gain should be exempt from recharacterization and recommend that Treasury revise the regulations accordingly.

If Treasury decides to not exclude Section 1231 gains from being subject to Section 1061(a), we recommend that it address the following two complexities. First, the holding period of property used in a trade or business under Section 1231 is not necessarily as sharply defined as it is for other common investment assets, such as securities. This is particularly the case for self-constructed property, such as developed real estate, which has a holding period that begins over the course of the entire project.[154] Second, whether and how the Section 1231 netting rules apply to Section 1231 gains that are subject to Section 1061 is not necessarily straightforward. For example, can a taxpayer use a Section 1231 loss to offset an item of Section 1231 gain that is subject to short-term capital gain treatment under Section 1061 or must the taxpayer first offset Section 1231 gains not subject to such treatment with the Section 1231 loss?[155]

Finally, if Treasury does not remove the Section 1231 gains exemption, we note that as written the Proposed Regulations do require Owner Taxpayers in certain circumstances to include Section 1231 gains and losses (and all other capital gain listed in

[153] House Report, *supra* note 5, at 277.

[154] *See, e.g.*, Rev. Rul. 75-524 ("[T]he holding period of an asset begins on the date of acquisition and that such acquisition occurs progressively, in the case of a building under construction, as construction (erection) of the building is completed.").

[155] We note that, because net Section 1231 losses are treated as ordinary loss, Section 1231(a)(2), the answer to this question in this context may be particularly acute, but the question of whether amounts included in the Recharacterization Amount can still be used to offset capital gains and losses not within Section 1061(a)'s ambit applies more generally. We suggest that Treasury provide guidance on this point in the final regulations.

Proposed Regulations Section 1.1061-4(b)(6)) in their Section 1061(a) Recharacterization Amount. Specifically, if Red Fund distributed the Investment Real Estate to Red Fund GP, which in turn distributed it to its Owner Taxpayers, such Investment Real Estate would be Distributed API Property. If the Owner Taxpayers sold such Investment Real Estate while it remained Distributed API Property, all "long-term capital gains or losses recognized" must be included in the Owner Taxpayers' API One Year Disposition Amount (and therefore in their Recharacterization Amount calculation), even though it would all be Section 1231 gain.[156]

E. Transfers Subject to Section 1061(d)

1. Proposed Regulations

Section 1061(d) provides a rule that applies to a "taxpayer" who "transfers" any API directly or indirectly to certain "related" parties, specifically to family within the meaning of Section 318(a)(1) or to persons who "performed a service within the current calendar year or the preceding three calendar years in any applicable trade or business in which or for which the taxpayer performed a service."[157] Such taxpayer must include in gross income as short-term capital gain "the taxpayer's long-term capital gains with respect to such interest for such taxable year attributable to the sale or exchange of any asset held for not more than 3 years as is allocable to such interest" (the "Section 1061(d) Inclusion Amount") minus amounts treated as short-term capital gain under Section 1061(a) with respect to the transfer of such API (to prevent double counting) (such resulting amount, the "Section 1061(d) Recharacerization Amount").[158] As discussed

[156] Prop. Reg. § 1.1061-4(a)(4)(i)(C).

[157] Sections 1061(d)(1)–(2).

[158] Section 1061(d)(1).

above, Section 1061(d) does not specify the types of transfers to which it applies (e.g., taxable versus non-taxable), how to determine attribution, the mechanics of the "sale or exchange" determination (e.g., deemed sale or only actual sales), or which assets are relevant (e.g., the ultimate underlying assets versus partnership interests).

Proposed Regulations Sections 1.1061-5(a), (b) and (e) delineate situations in which the rule is to apply. Specifically, they specify that the rule applies to (1) both Owner Taxpayer transferors and Passthrough Entity transferors, (2) transfers of APIs (by both types of transferors) and of Distributed API Property (only by Owner Taxpayer transferors[159]), (3) a broad range of transfers, whether or not gain is otherwise recognized, including but not limited to "contributions, distributions, sales and exchanges, and gifts" and (4) three categories of transferees – family (as defined in Section 318(a)(1)), a person who performed a service in the current year or prior three years in an ATB with respect to the transferred API,[160] and Passthrough Entities to the extent persons in the first two categories directly or indirectly own an interest in them.[161] Proposed Regulations Section 1.1061-5(e)(2) excludes from the rule, however, Section 721(a) contributions, because all applicable Unrealized API Gains and Losses must be allocated to the transferor under Proposed Regulations Section 1.1061-2(a)(1)(ii)(B).[162]

[159] We do not see a principled reason for not applying Section 1061(d) in tiered partnerships to transfers of Distributed API Property by Passthrough Entities to Section 1061(d) Related Persons of the ultimate Owner Taxpayer.

[160] We agree with Treasury's decision to specify that the ATB must be the ATB with respect to the transferred API (or, presumably, the API with respect to which the Distributed API Property was distributed). While Section 1061(d)(2)(B) can be read as indicating that potentially unrelated ATBs could trigger the rule ("any applicable trade or business in which or for which the taxpayer performed a service"), we believe that the Proposed Regulations appropriately target the rule to potentially abusive situations.

[161] Prop. Reg. §§ 1.1061-5(a), (b) & (e).

[162] *See also* Preamble at 49756 & 49768.

Proposed Regulations Sections 1.1061-5(a)(1)–(2) and (c) specify the mechanics for calculating the Section 1061(d) Inclusion Amount: the transferor must determine the amount of "net long-term capital gain" from assets held for three years or less that the partnership would have allocated to the transferor had the partnership sold all of its property in a taxable transaction for cash equal to such property's fair market value immediately prior to the transfer.[163] If the transferred API is in an upper-tier entity, such calculation "must be applied at the level of any lower-tier Passthrough Entities."[164] Furthermore, if the resulting amount is less than or equal to zero, the rule does not apply.[165] The Section 1061(d) Recharacterization Amount is the Section 1061(d) Inclusion Amount minus any amount already treated as short-term capital gain under Proposed Regulations Section 1.1061-4.[166]

Regardless of whether the transfer is a taxable event, the Owner Taxpayer must include the Section 1061(d) Recharacterization Amount in its gross income as short-term capital gain. To the extent that the transfer is a taxable event, the Proposed Regulations provide that capital gain otherwise recognized on the transfer is treated as short-term capital gain at least up to the Section 1061(d) Recharacterization Amount.[167] For

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[163] Prop. Reg. § 1.1061-5(c)(1)(A). As discussed below, the Proposed Regulations include somewhat inconsistent terminology and do not accommodate all of the transfers to which they state that the rule applies. We recommend that Treasury revise these provisions to clarify the rule's mechanics in the final regulations.

[164] Prop. Reg. § 1.1061-5(c)(1)(B).

[165] Prop. Reg. § 1.1061-5(c)(1)(A).

[166] Prop. Reg. § 1.1061-5(a)(2). The Lookthrough Rule does not apply if Section 1061(d) applies, *id.* §§ 1.1061-4(b)(9)(i)(A) & (B), so this amount could be less than it otherwise would be.

[167] Prop. Reg. § 1.1061-5(c)(2).

example, if the transferor would otherwise recognize $100 of long-term capital gain on the transfer, and the Section 1061(d) Recharacterization Amount is $80, she will recognize $80 of short-term capital gain and $20 of long-term capital gain. Furthermore, if the transferor would have otherwise recognized $60 of long-term capital gain, she would recognize $80 of short-term capital gain and $0 of long-term capital gain.

Finally, if the nature of the transfer is such the that transferee's basis is determined in whole or in part by reference to the transferor's basis, the Proposed Regulations provide that the transferee's basis is increased by the Section 1061(d) Recharacterization Amount. Such increase applies before any increase permitted under Section 1015(d).[168]

2. *Comments and Recommendations*

We appreciate Treasury's effort to give effect to Section 1061(d) despite the opaque drafting of the statutory provision. Below, we first respond to Treasury's characterization of Section 1061(d)'s function. Then, regarding the Proposed Regulations as drafted, should Treasury adhere to its position on Section 1061(d)'s purpose, we recommend that Treasury revise Proposed Regulations Section 1.1061-5 in certain respects to provide complete, consistent guidance with respect to the rules therein and clarify how those rules apply in additional, common situations.

(a) Section 1061(d)'s Function

In the Preamble, Treasury states that "Section 1061(d) accelerates the recognition of capital gain on a direct or indirect transfer that would not otherwise be a taxable event

[168] Prop. Reg. § 1.1061-5(d).

and recharacterizes certain long-term capital gain as short-term capital gain."[169] But Treasury does not explicitly tie this conclusion – that Section 1061(d) is an acceleration provision that can override nonrecognition treatment (as well as a recharacterization provision) – to the statutory text. We are not convinced that Treasury's reading is the best reading of Section 1061(d) and some of us believe that its reading contravenes Section 1061(d). Indeed, we are not convinced that a best reading exists, because Section 1061(d)'s convoluted language is susceptible to numerous different readings.

The text of Section 1061(d) does not reveal an obvious purpose. Furthermore, the sparse legislative history does not shed any light on its purpose.[170] Commentators have analyzed its provenance, with several concluding that it is grafted from a prior, very different legislative proposal regarding carried interest,[171] and practitioners have highlighted its confusing drafting and/or treated it as essentially a scrivener's error.[172]

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[169] Preamble at 49756; *see also id.* at 49768 ("[T]he Treasury Department and the IRS interpret section 1061(d)(1) to require that gain equal to the amount described in that section be recognized and included in income as short-term capital gain on the transfer of an API to a Section 1061(d) Related Person even if the transfer is not a transaction in which gain is otherwise recognized under the Code.").

[170] House Report, *supra* note 5, at 280; Conference Report, *supra* note 5, at 422; Bluebook, *supra* note 26, at 203 (each repeating the statutory text (with the exception of reading "long-term capital gains" in Section 1061(d)(1)(A) as "net long-term capital gain") in identical paragraphs).

[171] *See, e.g.*, Eric Yauch, *Legislative Past Could be Carried Interest's Regulatory Prologue*, 168 Tax Notes Federal 1075, 1075–76 (Aug. 10, 2020) (tying Section 1061(d) to a previous legislative proposal by Representative Camp, discussing how Section 1061(d) worked within that proposal, and contrasting such proposal with the approach of the rest of Section 1061).

[172] *See, e.g.*, McKee, *supra* note 7, § 9.02[1][d] ("Searching for the purpose and effect of the special conversion rule in § 1061(d) is difficult. It seems to be intended to disfavor certain transfers involving related parties, but the legislative history is entirely silent as to its purpose. . . . Again, there is nothing helpful beyond the bare language of the Code. . . . If that was Congress's intent, additional drafting is needed, for the words of the existing statute fail to carry that water."); Jackel, *supra* note 99, at 1654 ("Ever since its enactment, there has been confusion as to precisely what this provision was intended to address.").

One possible reading is that Section 1061(d) is a narrow recharacterization lookthrough provision similar to Section 751. Specifically, it applies when an API Holder sells all or part of her API to a related party under Section 1061(d)(2). While the API Holder's holding period in the API would typically determine whether the gain on the sale is short-term or long-term capital gain, Section 1061(d) requires a lookthrough for sales to related-party buyers, such that the portion of the gain "attributable to the sale or exchange of any asset held for not more than 3 years" is included by the API Holder as short-term capital gain.[173] For example, take an API Holder who has a holding period in the API exceeding three years and a Passthrough Entity that is planning to sell an underlying asset with a holding period of less than three years. To avoid Section 1061(a), the API Holder sells a narrow portion of her API corresponding to the right to receive gain from the sale of the underlying asset.[174] If such sale is to a related party, any "long-term capital gains" recognized by the API Holder that are "attributable to the sale or exchange of any asset held for not more than 3 years," that is, all of the gain, is recharacterized as short-term capital gain.[175]

Interpreting Section 1061(d) as recharacterizing, but not accelerating, gains is consistent with its reference to "sale or exchange."[176] Likewise, Section 1222(3) defines

[173] Section 1061(d)(1)(A).

[174] The Lookthrough Rule in the Proposed Regulations may capture this situation, though no other statutory provision explicitly addresses it. *See* Prop. Reg. § 1.1061-4(b)(9); *see also infra* Section IV.F.2.(b).

[175] *See* Jack S. Levin and Donald E. Rocap, *Structuring Venture Capital, Private Equity and Entrepreneurial Transactions* ¶ 1006.4.2(1) (Aug. 2019).

[176] Section 1061(d)(1)(A).

long-term capital gain by reference to recognized income from a sale or exchange,[177] and nothing in Section 1061(d) (or its legislative history) explicitly overrides the reference to recognized gains, in contrast with explicit acceleration provisions in the Code.[178] And under the Once an API, Always an API Rule, a nonrecognition transfer (for example, a contribution or distribution of an API in a nonrecognition transaction) does not purge the Section 1061(a) taint from the transferred property,[179] making it unnecessary for Section 1061(d) to accelerate recognition to ensure that API gains are captured by Section 1061.

A second possibility is that Section 1061(d) is a recharacterization and an assignment of income provision, providing that for nonrecognition transfers, the transferor rather than the transferee includes the API gain when ultimately realized. To that end, perhaps it locks in at the time of the nonrecognition transfer the amount of such gain that will ultimately be recognized. (At the same time, Section 1061(d) does not purport to override other general exceptions to assignment of income principles, such as Section 351.)

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[177] Section 1223(3) ("The term 'long-term capital gain' means gain from the sale or exchange of a capital asset held for more than 1 year, if and to the extent such gain is taken into account in computing gross income." (emphases added)). This requirement can also be read to limit the types of transfers to which Section 1061(d) applies. For example, a gift is not a sale or exchange within the meaning of Section 1222(3) and, accordingly, there would be no long-term capital gains for Section 1061(d) to capture on such a transfer. *See, e.g.*, Leo N. Hitt, *Rethinking the Obvious: Choice of Entity After the Tax Cuts and Jobs Act*, 16 Pitt. Tax Rev. 67, 94 (2018) ("Section 1061(d) provides an aggregate approach in the event of the sale of an applicable partnership interest to a related person." (emphasis added)).

[178] *See, e.g.*, Section 897(e); Section 1291(f). We also note that in Representative Camp's legislative proposal, from which Section 1061(d) is believed to be taken, the parallel provision recharacterized, but did not accelerate, gains. *See* H.R. 1, 113th Cong. § 3621 (2014) (proposed Section 1061(e)). A different provision from Representative Camp's Legislative Proposal, not incorporated into Section 1061, required acceleration of gains. *See id.* (proposed Section 1061(b)(3)).

[179] Prop. Reg. § 1.1061-2(a)(1)(i); *see also* Section 1061(c)(1) (stating that API status is present "except as provided in this paragraph or paragraph (4)" and contemplating such status following transfers to related non-service providers); Preamble at 49755 ("The proposed regulations provide that once a partnership interest is an API, it remains an API and never loses that character, unless one of the exceptions to the definition of an API applies.").

A third possibility is Treasury's reading, that Section 1061(d) is a recharacterization and acceleration provision. Section 1061(d) states, "the taxpayer shall include in gross income . . . for such taxable year," which appears to be referencing the year of the transfer. In addition, it is reasonable to read "transfers any applicable partnership interest, directly or indirectly" as not being limited to taxable transactions, especially to the extent that the word transfer is not so limited elsewhere in Section 1061.[180] Furthermore, Treasury is not alone in its reading of Section 1061(d) as an acceleration provision as well as a recharacterization provision.[181]

A fourth possibility is that Section 1061(d) is a proration provision. Specifically, it applies when an API Holder transfers an API and within "such taxable year" but following the transfer, gain from the sale of an asset "held for not more than 3 years" is allocated "to such interest."[182] Such Section 1061-short term capital gain is then allocated between the API Holder and the buyer based on relative ownership for the year; the API Holder includes such amount in gross income as short-term capital gain (1) to the extent it exceeds amounts already treated as short-term capital gain under Section 1061(a) and

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[180] Specifically, Section 1061(c)(1) defines API as "any interest in a partnership which, directly or indirectly, is transferred to (or is held by) the taxpayer in connect with the performance of substantial services by the taxpayer or any other related person, in any applicable trade or business," and thereby encompasses situations where someone related to a service provider is transferred a partnership interest, regardless of whether such interest was transferred by the partnership or the service provider.

[181] *See, e.g.*, McKee, *supra* note 7, § 9.02[1][d] ("The use of the word 'transfer' rather than 'sale or exchange' seems to suggest the scope of this rule may not be limited to taxable sales."); Boris I. Bittker and Lawrence Lokken, *Federal Taxation of Income, Estates and Gifts* (Thomson Reuters/Tax & Accounting, 2d/3d ed. 1993-2019 & 2020 Cum. Supp. No. 2) ("A holder of an applicable partnership interest recognizes short-term capital gain on the transfer, whether directly or indirectly, of her partnership interest to a related person."); Blake D. Rubin, Andrea M. Whiteway and Maximilian Pakaluk, *Observations and Comments on Code Sec. 1061*, New York University Annual Institute on Federal Taxation § 7.04[11] (2020) ("One possibility is that this provision was intended to create an income inclusion in the case of an otherwise nontaxable transfer to a family member or co-worker, such as by gift.").

[182] Section 1061(d)(1)(A).

(2) up to the amount of the API Holder's "long-term capital gains with respect to such interest for such taxable year."[183] Notably, however, API Holders could avoid this possible Section 1061(d) rule by structuring transfers and underlying asset sales to straddle a taxable year.

* * *

Our Executive Committee members all agree that as written, the Proposed Regulations under Section 1061(d) creates many traps for the unwary. Specifically, as discussed below, the broad definition of "transfer" combined with the overriding of nonrecognition treatment could lead to significant, adverse tax impacts on transferors as well as otherwise uninvolved, passive interest holders in a variety of innocuous, common transactions. We urge Treasury to carefully consider whether such result is appropriate and aligns with Section 1061(d)'s language, function and origins.

We now turn to recommendations on Proposed Regulations Section 1.1061-5 as drafted, should Treasury adhere to its interpretation of Section 1061(d) as both a recharacterization and acceleration provision.

(b) Internal Revisions

First, as discussed above, the Proposed Regulations provide that the rule applies to transfers by Passthrough Entities of APIs and by Owner Taxpayers of Distributed API Property. The Proposed Regulations, however, do not provide for how to calculate the Section 1061(d) Inclusion Amount with respect to such transfers and instead provide rules only for Owner Taxpayers transferring APIs. For example, Proposed Regulations Section 1.1061-5(c)(1)(A) references both "Owner Taxpayer" and "partner" and looks at

[183] Section 1061(d)(1)(A).

how much net long-term capital gain from assets held for three years or less would be allocated to the "partner" if the "partnership" sold its assets in a taxable sale. Furthermore, Proposed Regulations Section 1.1061-5(a)(2) states that the amount subtracted from the Section 1061(d) Inclusion Amount to avoid double counting is the amount included in the Owner Taxpayer's API One Year Disposition Gain Amount but not in its API Three Year Disposition Gain Amount with respect to such interest. However, a Passthrough Entity transferor will include such amounts in the API One Year Distributive Share Amount and Three Year Distributive Share Amount, and accordingly they will not be included in the Owner Taxpayer's Disposition Gain Amounts at all.[184]

We believe that the Section 1061(d) Inclusion Amounts should be the amounts that would be allocated to each of the Passthrough Entity's direct or indirect Owner Taxpayers in a deemed taxable sale of assets by the lower-tier entity in which the Passthrough Entity holds its API. We also believe that the amounts such Passthrough Entity includes in the API One Year Distributive Share Amount, but not in the API Three Year Distributive Share Amount, for each Owner Taxpayer should be subtracted from the aforementioned amounts to calculate an Owner Taxpayer's Section 1061(d) Recharacterization Amount. We recommend Treasury revise the proposed regulations accordingly.

Similarly, no guidance is given on how to determine the Section 1061(d) Inclusion Amount for Distributed API Property – there is no partnership, partners or allocations present at all in such a transfer. We would expect the Section 1061(d) Inclusion Amount to be the amount of long-term capital gain the Owner Taxpayer would

[184] *See* Prop. Reg. § 1.1061-4(a)(3)(i)(A).

have recognized on a taxable sale for cash at the Distributed API Property's fair market value, and recommend Treasury revise the Proposed Regulations accordingly.[185]

Second, Proposed Regulations Section 1.1061-5(c)(1)(B) provides that the calculations for an Owner Taxpayer that transfers an Indirect API must be done "at the level of any lower-tier Passthrough Entities." In typical investment fund arrangements, there will be multiple levels of intermediate Passthrough Entities. We recommend that Treasury align the Section 1061(d) rule for tiered partnerships with the rules for tiered partnerships elsewhere in the Proposed Regulations, such as in the Lookthrough Rule, which explicitly specifies that it only applies to the "assets of the partnership in which the API is held."[186]

Third, Proposed Regulations Section 1.1061-5(c)(1)(B) specifies that the Section 1061(d) Inclusion Amount is calculated by reference to "the amount of net long-term capital gain from assets held for three years or less." As discussed above, the Proposed Regulations elsewhere exclude amounts treated as capital gains or losses without regard to Sections 1222(3) and (4) (for example, Section 1231 gains).[187] On the one hand, Proposed Regulations Section 1.1061-5(c)(1)(A) refers to capital gain at the partnership level, which should not include such amounts because the calculation of the Section 1061(d) Inclusion Amount is at the partner level, not the partnership level. On the other hand, Proposed Regulations Section 1.1061-4(a)(3)(i)(A) uses the term "net long-term

[185] The basis adjustment allowed under Proposed Regulations Section 1.1061-5(d) does not accommodate transfers by Passthrough Entities of APIs and by Owner Taxpayers of Distributed API Property. We believe that it should.

[186] Prop. Reg. § 1.1061-4(b)(9)(i)(B)(2); *see also id.* § 1.1061-2(a)(1)(ii)(B).

[187] *See supra* Section IV.D; Prop. Reg. § 1.1061-4(b)(6).

capital gain" from which non-Sections 1222(3) and (4) capital gain is subtracted,[188] indicating that the term does include such amounts. To the extent Treasury intends such amounts to be taken into account for the purposes of calculating the Section 1061(d) Inclusion Amount, we recommend that the Proposed Regulations be clarified by explicitly so providing.[189] And to the extent Treasury does not intend such amounts to be included, we recommend revising the Proposed Regulations to explicitly exclude amounts specified in Proposed Regulations Section 1.1061-4(b)(6) from the Section 1061(d) calculations.

Additionally, we do not believe Section 1061(d) should apply to or include gain that would be subject to the Capital Interest Exception. Section 1061(d)(1) by its terms applies to APIs, and Section 1061(c)(4)(b) excludes certain capital interests from the definition of API. By extension, gains that would otherwise come within the Capital Interest Exception under the Proposed Regulations should not be included in the Section 1061 Inclusion Amount, and we recommend Treasury revise the regulations to so provide.

Fourth, Proposed Regulations Section 1.1061-5(c)(2) provides that "the capital gain recognized" on an otherwise taxable transfer is characterized as short-term capital gain. As written, it is not clear whether this means that the Section 1061(d) Recharacterization Amount recharacterizes only otherwise long-term capital gain or whether it sets the total amount of short-term capital gain recognized on the transfer. For

[188] Prop. Reg. § 1.1061-4(a)(3)(i)(B)(1).

[189] Notably, on a taxable sale of an API, any gain inherent in the API that reflects underlying Section 1231 gain would be subject to recharacterization.

example, if an otherwise taxable transfer would result in the transferor recognizing $70 of long-term capital gain and $30 of short-term capital gain without applying Section 1061 at all, the Recharacterization Amount is $0 and the Section 1061(d) Recharacterization Amount is $50, it is not clear whether the transferor should recognize (1) $50 of short-term capital gain and $50 of long-term capital gain or (2) $80 of short-term capital gain and $20 of long-term capital gain.[190] We believe that the second is intended and recommend that Treasury clarify the regulation to resolve this ambiguity.[191]

(c) Additional Clarifications

First, we recognize Treasury's desire to define "transfer" for the purposes of Section 1061(d) broadly to avoid circumvention and abuse. However, we believe that the open-ended non-exhaustive list in Proposed Regulations Section 1.1061-5(b), without additional examples, carve-outs or safe harbors will cause many innocuous situations to be caught by Section 1061(d), going far beyond any intended ambit of its rule.

As discussed above, sophisticated and established fund managers often form fund-specific general partner and management entities for each fund. Additionally, such managers often have an aggregation vehicle (e.g., Pinewood GenPar in the examples above) that holds controlling interests in the fund-specific vehicles and receives incentive payments from each fund. Over the life of a fund manager like Pinewood, the complexity and tiers of such vehicles will ebb and flow – forming any upper-tier layers may well add

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[190] Similarly, if the otherwise recognized amounts were the same but the Section 1061(d) Recharacterization Amount were $80, it is not clear whether the transferor should recognize (1) $80 of short-term capital gain and $20 of long-term capital gain or (2) $110 of short-term capital gain and $0 of long-term capital gain.

[191] *Cf.* Preamble at 49756 ("Section 1061(d) . . . recharacterizes certain long-term capital gain as short-term capital gain."); Prop. Reg. § 1.1061-5(f)(2) Example 2 (presenting a situation where all of the non-Section 1061 gain on the taxable transfer is long-term capital gain).

unnecessary complexity for a new fund manager establishing its first fund, such structures may well make sense in anticipation of receiving a GP stakes investment, and an established fund with numerous tiers and various silos (enabling different GP stakes investments at different times) may well want to consolidate and simplify its structure in anticipation of a public offering. These expansions and contractions will often entail divisions and mergers of general partner and other upper-tier entities, along with other restructuring transactions.

Furthermore, as discussed above, individual investment professionals employed by (or principals of) the fund manager receive a portion of the fund's incentive allocations. A particular professional's portion is often tied to (or weighted toward) the incentive allocations received by the fund or funds for which such individual works, and are almost always subject to a vesting schedule. In addition, it is not uncommon for upper-tier structures to provide for an unallocated carried interest or reserve pool which is allocated among employees and principals shortly before a disposition. Investment professionals may well leave before their rights are fully vested (and, to the extent that new funds are formed, investment professionals will continually be subject to some vesting requirement for some fund). Upon departure, their unvested interests are forfeited to the fund manager (and/or the reserve pool), and it is not uncommon for them to sell their vested interests to the fund manager or particular upper-tier entities, rather than remaining entangled in the affairs of a former employer's funds and subject to their economic performance.

We believe that these arrangements and reorganizations should not trigger Section 1061(d). In particular, we recommend that Treasury revise the Proposed Regulations to

explicitly account for Section 731 distributions. While the Proposed Regulations do indicate that Section 731 distributions of property do not trigger Section 1061(d),[192] they do not specify whether Section 731 distributions of partnership interests (including APIs), the mechanism through many of the above shifts and arrangements are implemented, also do not trigger Section 1061(d).

We believe the best reading of the Proposed Regulations is that such transfers do not trigger Section 1061(d), based on the definition of "Section 1061(d) Related Person." Specifically, the Preamble states that "taxpayer" in Proposed Regulations Section 1.1061-5(e) should be read as "Owner Taxpayer."[193] Therefore, we believe that if a Passthrough Entity in which an Owner Taxpayer holds an Indirect API distributes an API it holds to such Owner Taxpayer, the Proposed Regulations provide that the determination of whether the distribution triggers Section 1061(d) will depend on whether the transferee – the Owner Taxpayer – is a Section 1061(d) Related Person to the Owner Taxpayer (and, notably, not to the Passthrough Entity), and an Owner Taxpayer cannot be a Section 1061(d) Related Person to itself.[194] We recommend that rather than leaving it implicit in the definition of Section 1061(d) Related Person, Treasury explicitly provide that such distributions do not trigger Section 1061(d).

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[192] We infer this from the fact that Proposed Regulations Section 1.1061-5(a)'s list of transfers to which the rule applies does not include distributions of Distributed API Property, it does include transfers of already-distributed Distributed API Property by Owner Taxpayers, and it would not make sense for Section 1061(d) to be triggered on both the distribution of the property and the subsequent transfer by the Owner Taxpayer. To avoid any doubt, we recommend that Treasury explicitly clarify and confirm this reading in the final regulations.

[193] Preamble at 49768 ("For these purposes, a taxpayer is the same taxpayer used for computation purposes (as opposed to the taxpayer used for determining whether the elements of an API are met), that is, an Owner Taxpayer."). As discussed below in Section IV.H.6, we recommend that Treasury codify the various meanings of "taxpayer" stated in the Preamble for different portions of Section 1061 and the Proposed Regulations into the final regulations.

[194] *See* Prop. Reg. § 1.1061-5(e).

Second, we recommend that Treasury provide guidance limiting Section 1061(d) calculations to vested portions of transferred APIs. It seems unfair as a policy matter for Section 1061(d) to force a departing employee of a fund manager with a 25% vested interest in an API to recognize short-term capital gain on the forfeiture of the remaining interest based on a Section 1061(d) Recharacterization Amount calculated for the assets underlying the entire interest. Such amount could far exceed such employee's amount realized on a sale of the vested portion of the interest. Additionally, this could result in double taxation – for example, if the transfer is a fully taxable cash purchase for the fair market value of the 25% vested interest, the transferee's basis would be set at that amount, even though the transferor is subject to tax on 100% of the interest's fair market value. If the transferee transfers such interest (e.g., to a replacement employee), such transfer may well trigger Section 1061(d), under which the same deemed gain would be taxed twice.[195]

In addition, it appears that in a tiered partnership the amount of gain required to be recognized under Section 1061(d) could exceed the amount of gain inherent in the API transferred.[196] This is because in the case of tiered partnerships the Section 1061(d)

[195] The Proposed Regulations' definition of Section 1061(d) Related Person is unclear as to whether the anticipated provision of services is sufficient to come within the definition. *See* Prop. Reg. § 1.1061-5(e)(1)(ii) ("A person that performed a service within the current calendar year." (emphases added)); *cf. id.* § 1.1061-3(d)(3) (defining "service provider" for the purposes of the Third-Party Purchaser Exception to include persons who anticipate providing services in the future). We recommend that Treasury clarify in the final regulations whether the determination is made as of the time of the transfer or at the end of the current calendar year.

[196] *See* Prop. Reg. § 1.1061-5(a) ("[R]egardless of whether gain is otherwise recognized on the transfer under the Internal Revenue Code, the Owner Taxpayer shall include in gross income as short-term capital gain . . . ."). An example of the Section 1061(d) rule in the proposed regulations indicates this possible result. *See id.* § 1.1061-5(f)(2) Example 2 ("Because [individual] A recognized gain greater than the amount required under paragraph (a) of this section, there is no gain to accelerate . . . ."); *cf.* Preamble at 49756 ("Section 1061(d) accelerates the recognition of capital gain on a direct or indirect transfer that would not otherwise be a taxable event and recharacterizes certain long-term capital gain as short-term capital gain.").

deemed gain in the top tier seems to be the sum of the gains in each of the lower tier entities, without regard to losses either in those entities or that may be inherent in other lower tier entities.[197] We think there should be a cap on the amount that would be taxed equal to the gain that would be realized if the directly transferred API were sold for its fair market value by the Owner Taxpayer.

Third, the Proposed Regulations provide that Section 1061(d)'s rule applies to gifts and that the basis step-up applies prior to a step-up under Section 1015(d).[198] They are silent, however, on transfers at death and basis step-ups under Section 1014. We recommend that Treasury explicitly include transfers at death and the attendant basis step-up in the Proposed Regulations to avoid disputes about whether or not the rule applies to them. We see no principled reason why, if gifts are treated as transfers subject to Section 1061(d), transfers at death would not be. We also recommend that Treasury provide additional guidance on other common transfers, such as transfers to a family trust, upon divorce, to non-grantor trusts, and to C corporations.

Finally, we note that the basis adjustment rule in Proposed Regulations Section 1.1061-5(d) seems to assume that (to the extent an API rather than Distributed API Property) is transferred, the partnership that issued the API has a Section 754 election in effect for the year that includes the transfer (or, if not, is otherwise required to adjust the relevant inside basis). We recommend that Treasury revise the basis adjustment to

[197] *See* Prop. Reg. §§ 1.1061-5(c)(1)(A)–(B).

[198] Prop. Reg. §§ 1.1061-5(b) & (d).

explicitly coordinate with Section 743 so that basis adjustments will be allocated to the assets that results in the recognition of gain under Section 1061(d).

F. Holding Periods

1. Proposed Regulations

The Proposed Regulations generally provide that for the purposes of Section 1061, the holding period of the direct owner of the asset controls in determining the Recharacterization Amount.[199] Consistent with this rule, for Distributed API Property (capital assets distributed to an API Holder with respect to its API), the partnership's holding period (and the holding period of any lower-tier partnerships) is tacked on to the API Holder's holding period in the property for the purposes of calculating the Recharacterization Amount, in accordance with Section 735(b). As a result, Distributed API Property may have a less than three-year holding period even if distributed to a holder of an API who has a greater than three-year holding period in the API.

As an exception to the general rule, Proposed Regulations Section 1.1061-4(b)(9) sets forth the Lookthrough Rule. This rule applies if an API Holder disposes of all or part of an API in which the holder has a holding period of more than three years in a taxable transaction, recognizes capital gain, Section 1061(d) does not apply and either (1) any intermediate Passthrough Entities have a holding period of three years or less in their APIs or (2) the underlying assets of the partnership in which the API is an interest meet the "Substantially All Test."[200]

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[199] Prop. Reg. § 1.1061-4(b)(8)(ii); *see also* Preamble at 49767 (stating that this rule is consistent with Section 702(b) and Revenue Ruling 68-79).

[200] Prop. Reg. § 1.1061-4(b)(9)(i).

The Substantially All Test examines whether at least 80% of the partnership's underlying assets, by fair market value, have a holding period to the partnership of three years or less and, if sold, would produce capital gains or losses based on Sections 1222(3) and (4).[201] If the partnership has held an interest in a lower-tier Passthrough Entity for more than three years, it must include in its calculations the value of such lower-tier entity's assets that the lower-tier entity would include if it were applying the Substantially All Test, that is, as if the partnership owned such assets directly.[202]

If that test is met, the API Holder includes the entire amount of capital gain recognized on the sale of its API in its API One Year Disposition Amount (or the Passthrough Entity includes such capital gain in the API One Year Distributive Share Amount calculation). The API Holder includes a fraction of such gain, specifically, the fraction of the gain corresponding to the proportion of the gain that is attributable to assets that, if sold, would produce capital gain based on Sections 1222(3) and (4) and have holding periods that exceed three years, in its API Three Year Disposition Amount.[203] (Correspondingly, a Passthrough Entity includes such fraction in the API Three Year Distributive Share Amount calculation.[204]) In contrast, if the Lookthrough Rule applies because one of the Passthrough Entities has a holding period of three years or less, none of the gain is included in the API Holder's API Three Year Disposition

[201] Prop. Reg. § 1.1061-4(b)(9)(i)(C)(1). Cash, cash equivalents, unrealized receivables under Section 751(c) and inventory items under Section 751(d) are excluded in determining this percentage. *Id.*

[202] Prop. Reg. § 1.1061-4(b)(9)(i)(C)(2).

[203] *See* Prop. Reg. §§ 1.1061-4(b)(9)(ii)(B) & (C)(1).

[204] *See* Prop. Reg. §§ 1.1061-4(b)(9)(ii)(B) & (C)(1).

Amount (or, for Passthrough Entities, in the API Three Year Distributive Share Amount calculation).[205]

Along with the holding period rules for applying Section 1061(a), the Proposed Regulations also include a new rule for divided holding periods in the case where a partnership interest is comprised of, in whole or in part, one or more profits interests as defined in Revenue Procedure 93-27.[206] Specifically, Proposed Regulations Section 1.1223-3(b)(5) provides that the portion of the holding period to which a profits interest relates is determined based on the fair market value of the profits interest upon the disposition of all or part of the interest, rather than the fair market value at the time that the interest is acquired.

2. *Comments and Recommendations*

(a) Distributed API Property

We agree with Treasury that property distributed with respect to an API and subsequently disposed of by the distributee should be included in the Recharacterization Amount calculations to avoid circumventing Section 1061(a).[207] We recommend three small modifications to the Distributed API Property rules.

First, the Preamble states that partnerships should subtract capital gain or loss from property that had been Distributed API Property but no longer was at the time of disposition when calculating the API One Year Distributive Share Amount because such

[205] Prop. Reg. §§ 1.1061-4(b)(9)(ii)(B) & (C)(2).

[206] Prop. Reg. § 1.1223-3(b)(5)(ii).

[207] *See* Preamble at 49766–67 ("[A]bsent such a rule, section 1061 could be circumvented by the partnership's distribution of an asset to the API Holder prior to the sale of the asset in situations in which the asset has been held by the partnership for three years or less.").

gain is excluded from the calculation of Recharacterization Amount.[208] However, this is not reflected in the text of the Proposed Regulations, which would include such amounts in the API One Year Distributive Share Amount.[209] This omission should not generally increase the Recharacterization Amount because, once included in the API One Year Distributive Share Amount, it should also be included in the API Three Year Distributive Share Amount, because such amount does not come within Proposed Regulations Section 1.1061-4(a)(3)(ii)(B). However, to the extent Treasury intends for such amounts to be entirely excluded from the calculation of Recharacterization Amount (and thus not be available to offset other gains or losses), we recommend that the regulations be revised accordingly.

Second, in contrast with the Distributive Share Amount calculations, if Distributed API Property is distributed to an Owner Taxpayer and such Owner Taxpayer sells it while it is still Distributed API Property, the gain or loss on such sale is included in the calculation of such Owner Taxpayer's API One Year Disposition Amount,[210] but the gains or losses on the sale of property that used to be but no longer is Distributed API Property is not included in such Owner Taxpayer's API Three Year Disposition Amount.[211] We believe it is asymmetrical that gain from property that used to be

[208] Preamble at 49764 ("Second, the partnership reduces this amount by . . . amounts that are not taken into account under these proposed regulations for purposes of calculating the Recharacterization Amount. . . . [This includes] long-term capital 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 more than three years.").

[209] *See* Prop. Reg. §§ 1.1061-4(a)(3)(A), 1.1061-4(a)(3)(B) & 1.1061-4(b)(6).

[210] Prop. Reg. § 1.1061-4(a)(4)(i)(C).

[211] Prop. Reg. § 1.1061-4(a)(4)(ii). In contrast, gains from an Owner Taxpayer's sale of an API held for more than three years is included in both its API One Year Disposition Amount and its API Three Year Disposition Amount (assuming the Lookthrough Rule does not apply). *Id.* § 1.1061-4(a)(4)(ii)(A).

Distributed API Property can be offset by API losses if it is not distributed to the Owner Taxpayer[212] but cannot if it is so distributed. We recommend that Treasury remove this asymmetry in the final regulations.

Third, the Proposed Regulations define Distributed API Property as "property distributed by a Passthrough Entity to an API Holder with respect to an API," and "[c]apital gains or losses from the disposition of Distributed API Property" are included in the definition of API Gains and Losses.[213] Accordingly, such capital gains and losses are excluded from the Capital Interest Exception.[214] However, a Passthrough Entity could make in-kind distributions to its interest holders "commensurate with" their capital contributed, and accordingly such distributions to API Holders should come within the Capital Interest Exception.[215] We recommend that Treasury consider providing guidance as to the scope of "with respect to an API" that delineates between distributions of property where the property should retain the Section 1061 taint and distributions of

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[212] *See* Prop. Reg. §§ 1.1061-4(a)(3)(i)(A) & (ii) (stating that the API One Year Distributive Share Amount is the API Holder's "API Holder's distributive share of net long-term capital gain from the partnership for the taxable year," which would include gain from property that used to be but no longer is Distributed API Property, and that the API Three Year Distributive share is defined by reference to the API One Year Distributive Share). The Preamble indicates that such amounts should be excluded under the Passthrough Capital Allocations component of the Capital Interest Exception. *See* Preamble at 49762 ("Also, if a Passthrough Entity received Distributed API Property from a lower-tier entity and the property is no longer Distributed API Property because it has been held for more than three years, the property is included in the Passthrough Entity's direct investment at that time."); *cf.* Prop. Reg. § 1.1061-3(c)(5)(iii) (defining Passthrough Interest Direct Investment Allocations without reference to former Distributed API Property). As discussed above in Section IV.C.2, this exclusion is rigid and narrow and, accordingly, unlikely to apply (and in any event, we see no principled reason why the rules of the Capital Interest Exception must be met for gains from former Distributed API Property to be excluded).

[213] Prop. Reg. § 1.1061-1(a) Definitions of "Distributed API Property" and "API Gains and Losses" (5).

[214] *See* Prop. Reg. § 1.1061-3(c)(3)(iii)(A) (excluding "[a]mounts that are treated as API Gains and Losses" from the definitions of Capital Interest Allocations and Passthrough Interest Capital Allocations).

[215] Section 1061(c)(4)(B).

property where such taint is not necessary or appropriate because they come within the Capital Interest Exception. We suggest that such guidance also address such delineation in the context of tiered structures where, for example, an initial distribution could be within the Capital Interest Exception but a subsequent distribution may be an in-kind payment with respect to carried interest.

(b) The Lookthrough Rule

First, we understand the Lookthrough Rule to be included to function as an anti-abuse provision, preventing proceeds from sales of partnership interest that have a greater than three-year holding period where substantially all of the assets of the partnership have shorter holding periods from avoiding Section 1061(a), which we believe is appropriate.[216] We note, however, that the Lookthrough Rule will create enormous complexity in the case of indirectly held APIs, particularly if the relevant taxpayer does not control a partnership that issued an API.[217]

In a tiered partnership structure, taxpayers will often have to request information regarding the fair market value of assets to (1) determine whether the Substantially All Test is met and (2) if so, calculate the adjustment amount under Proposed Regulations Section 1.1061-4(b)(9)(ii)(C). In situations where such assets are held by a lower-tier entity that is not controlled by the Passthrough Entity that disposes of the API or by an entity that issued such API, that information may be difficult to obtain. Furthermore, while the Proposed Regulations require a Passthrough Entity to request this

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[216] We believe Treasury has ample authority under Section 1061(f) to promulgate the Lookthrough Rule. *Cf.* Jackel, *supra* note 99, at 1662 & 1664 (stating that the regulatory authority for the rule is "far from clear" and "subject to some doubt" though recognizing that without it, "the taxing regime of the proposed regulations will be easily manipulated").

[217] *See* Prop. Reg. § 1.1061-4(b)(9)(i)(B).

information,[218] they do not appear to contemplate that such information might not be received (and that the partnership might otherwise be unable to substantiate the information). In contrast, as discussed below in the context of reporting requirements in tiered arrangements, the Proposed Regulations impose punitive consequences in other situations where information is not received.[219] The Proposed Regulations also do not appear to impose reporting obligations on an entity that has not issued APIs itself.

To avoid administratively burdensome reporting requirements on entities that may not be aware of an upstream API, and to avoid requiring fruitless requests and attendant delays, we recommend that Treasury either:

- Limit the Lookthrough Rule to situations in which a Passthrough Entity controls all of the relevant lower-tier Passthrough Entities (or only applying it to lower-tier Passthrough Entities it controls); or, alternatively,
- Both drop the "Substantially All Test" in the context of multiple tiers of partnerships (i.e., determine the applicability of the Substantially All Test with respect to the assets held by the partnership whose interest was sold) and limit the Lookthrough Rule for indirectly-held APIs to situations in which Proposed Regulations Section 1.1061-4(b)(9)(i)(B)(1) applies (i.e., only apply the Lookthrough Rule if an API is held by a lower-tier Passthrough Entity for three years or less).

We believe that these changes would appropriately limit the administrative burden associated with applying the Lookthrough Rule to partnership structures that are less

[218] Prop. Reg. § 1.1061-6(b)(1)(v).

[219] *See* Prop. Reg. § 1.1061-6(a)(2) (enumerating the consequences but not mentioning Lookthrough Rule calculations).

susceptible to manipulation by an API Holder and would help ensure that Owner Taxpayers and Passthrough Entities are able to comply with the rules in practice.

If these suggestions are not adopted, the required information should be added as a mandatory field on all Schedules K-1 for partnerships and S corporation and for required PFIC annual information statements regardless of whether a Passthrough Entity has issued or holds an API. Required information could include API One Year Disposition Amounts, API Three Year Disposition Amounts, and, if the assets are readily able to be valued (for example, publicly traded stock or securities, or recently appraised real estate), unrealized API One Year Disposition Amounts (i.e., amounts that would give rise to API One Year Disposition Amounts if sold as of the end of the taxable year) and unrealized API Three Year Disposition Amounts (i.e., amounts that would give rise to API Three Year Disposition Amounts if sold as of the end of the taxable year).

We note that similar issues apply with respect to determining the Capital Interest Disposition Amount, which provides its own lookthrough rule.[220] The Once an API, Always an API Rule means that long-term capital gain or loss recognized on the sale or disposition of a Passthrough Interest is API Gain or Loss unless it is determined under the Proposed Regulations to be a Capital Interest Disposition Amount. Therefore, as with the

[220] In particular, to calculate the Capital Interest Disposition Amount, the Proposed Regulations require that a seller of a direct or indirect API perform a hypothetical liquidation and determine the amount of Capital Interest Gain or Loss from the deemed liquidation that is allocated to the interest sold (or the portion of the Passthrough Interest sold) as Capital Interest Allocations and Passthrough Interest Capital Allocations. Prop. Reg. § 1.1061-3(c)(6)(ii). The Proposed Regulations include a direction that, "[t]o calculate this in tiered entities, determine the capital gain or loss from a lower-tier Passthrough Entity." *Id.* § 1.1061-3(c)(6)(ii)(A). Although Examples 4 and 5 indicate that any hypothetical liquidation at a lower tier is notional only, the information required to perform the calculation may be difficult to obtain if the seller holds an indirect API though several tiers of Passthrough Entities. *See id.* §§ 1.1061-3(c)(7)(iv) Example 4 & (v) Example 5; *cf. supra* Section IV.A.2.(c) (discussing the ramifications of Example 5 as drafted).

Lookthrough Rule, the failure to obtain relevant information may have a disproportionately punitive impact.[221] We therefore recommend that Treasury make similar adjustments as recommended above for the Lookthrough Rule in Proposed Regulations Section 1.1061-3(c)(6) to temper the consequences imposed on interest holders by third parties over which they have no control.[222]

Second, we note that calculating the adjustment amount once the Substantially All Test is met requires determining the "total net capital gain" that a partnership would recognize if it liquidated its assets for their fair market values.[223] We believe that this should be "net long-term capital gain," and recommend Treasury clarify this in the final regulations (as drafted, a taxpayer could argue that short- and long-term capital gains and losses could be netted against each other).

Third, we believe that the Substantially All Test's application to tiered entities likely does not work as intended where lower-tier partnerships own assets whose sale proceeds are treated as capital gain without regard to Sections 1222(3) and (4). For example, take a situation where (1) an Owner Taxpayer has held an API in an upper-tier partnership for four years, (2) the upper-tier partnership's sole asset is a 50% non-API interest in a lower-tier partnership, which it has held for two years and (3) the lower-tier partnership, in turn, holds assets with a fair market value of $100, but only $10 of which

[221] Prop. Reg. § 1.1061-3(c)(6)(i).

[222] For example, taxpayers could be allowed to use any reasonable approach to determining the proportionate amount of capital gain from the sale of an indirect API that is from Capital Interest Allocations and Passthrough Interest Capital Allocations if they do not control all of the relevant lower-tier Passthrough Entities. Alternatively, the rule deeming all gain or loss to be API Gain or Loss could be relaxed in situations in which the proportionate amount of long-term capital gain that would be allocable to API Gain or Loss in a hypothetical liquidation would be immaterial.

[223] Prop. Reg. § 1.1061-4(b)(9)(ii)(C)(1).

is attributable to assets with a holding period not exceeding three years that would produce capital gain based on Section 1222 if sold. Under those facts, the Substantially All Test would be met (the numerator would be $50 (the fair market value of the 50% interest, which itself is a capital asset subject to Section 1222) and the denominator would be $50 (since the interest is the only asset), resulting in a percentage of 100%), the Lookthrough Rule would apply if the Owner Taxpayer sold its API, and all of the capital gain realized on the sale would be included in the Owner Taxpayer's Realization Amount calculation (because the adjustment amount would be zero[224]). However, if the upper-tier partnership had held its interest for more than three years, the Substantially All Test would not have been met (the upper-tier partnership would include only $5 in the numerator, resulting in a percentage of 10%), the Lookthrough Rule would not apply, and none of the gain would be included in the Owner Taxpayer's Realization Amount calculation.

This divergence occurs because the Lookthrough Rule operates from the Owner Taxpayer down, and stops at passthrough interests held for less than three years. We do not see a principled reason for the Owner Taxpayer to have its entire gain subject to Section 1061(a) under the first set of facts, despite the fact that 90% of the gain is attributable to assets that are not otherwise subject to Section 1061(a). Notably, the Preamble does not discuss the Substantially All Test's tiered rule.[225] We believe that a

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[224] The adjustment amount calculation turns on the upper-tier partnership's disposition of the assets included in the numerator. Prop. Reg. § 1.1061-4(b)(9)(ii)(C)(1). To avoid ambiguity, we recommend that Treasury clarify that in tiered structures, the numerator also include the gain that a lower-tier entity would recognize on the disposition of assets included in the Substantially All Test under Proposed Regulations Section 1.1061-4(b)(9)(i)(C)(2).

[225] *See* Preamble at 49767 & 49772.

better approach would be to account for and exclude from the Substantially All Test the value and gain associated with assets that are otherwise excluded from Section 1061(a) under the Proposed Regulations. While we recognize that a bottom-up approach would be somewhat more burdensome,[226] it would be consistent with the approach taken in other parts of the Proposed Regulations where Owner Taxpayers look through tiers of entities, such as the Capital Interest Disposition Amount.[227] Furthermore, we believe it would appropriately capture situations where an API Holder's direct holding period is longer than three years but the vast majority of the assets on which its API's value is based have shorter holding periods, and allowing the former to trump the latter would circumvent Section 1061(a), which is the overarching intent of the Lookthrough Rule.[228]

G. Reporting Requirements

1. *Proposed Regulations*

To allow Owner Taxpayers to calculate, report and pay tax based on accurate Recharacterization Amounts, and to enable the IRS to verify the accuracy of such amounts, Proposed Regulations Section 1.1061-6 provides reporting obligations for Owner Taxpayers and Passthrough Entities. The Preamble states that Treasury intends for

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[226] *See* Preamble at 49773.

[227] *See* Prop. Reg. § 1.1061-3(c)(6)(ii).

[228] *See* Preamble at 49772–73 ("Pursuant to its regulatory authority to prevent inappropriate avoidance of section 1061, the proposed regulations include a limited lookthrough rule that is applied to the sale of an API that has been held for more than three years at the time of the disposition. . . . The interest approach with no Lookthrough Rule looks solely to the holding period in the API, regardless of the holding period of the assets held by the partnership that would produce capital gain or loss on disposition. This approach would allow taxpayers to avoid section 1061 characterization for long-term capital gains on assets that are not held for the more than three years by the partnership. This result would encourage distortive behavior in investment funds, which might look to create partnerships for different investors solely for tax purposes. That is, the partners of that investment partnership would not be subject to section 1061 if they had owned their APIs for more than three years, irrespective of how long the investment partnership had held an asset that it sold.").

only Owner Taxpayers to calculate Recharacterization Amounts, enabling them to net amounts subject to Section 1061(a) from multiple APIs against each other.[229]

The Proposed Regulations do not specify the particular information that Owner Taxpayers will be required to provide to the IRS. Instead, Treasury delegates to the IRS the authority to determine the information and manner of reporting that it deems necessary for it to determine whether an Owner Taxpayer has complied properly with Section 1061 and the regulations thereunder.[230]

In contrast, the Proposed Regulations, while seeking to minimize a Passthrough Entity's reporting obligations,[231] impose more specific reporting and information-seeking obligations on Passthrough Entities that issue APIs.[232] Such Passthrough Entities must report to each of its API Holders and the IRS each such API Holder's (1) API One Year Distributive Share Amount; (2) API Three Year Distributive Share Amount; (3) non-Sections 1222(3) and (4) capital gains and losses excluded from Section 1061(a) under Proposed Regulations Section 1.1061-4(b)(6); (4) gains and losses that qualify for the Capital Interest Exception; and (5) API Holder Transition Amounts.[233] In addition, if an

[229] Preamble at 49756–57. Treasury refers to this as the "partial entity" approach.

[230] Prop. Reg. § 1.1061-6(a)(1). To calculate its Recharacterization Amount, an Owner Taxpayer will combine and net all of its API One Year Distributive Share Amounts and its API Three Year Distributive Share Amounts, add to such combined amounts its API One Year Disposition Amount and its API Three Year Disposition Amount, respectively, and then subtract the latter from the former. *See id.* §§ 1.1061-4(a)(1) & (2). Accordingly, we expect the IRS to require Owner Taxpayers to report each of the relevant numbers in that calculation.

[231] *See* Preamble at 49774–75.

[232] The Proposed Regulations also delegate to the IRS broad authority to require reporting of "information in such time and in such manner as the Commissioner may require" to confirm compliance with Section 1061. Prop. Reg. § 1.1061-6(b)(1).

[233] Prop. Reg. §§ 1.1061-6(b)(1)(i)–(iv).

API Holder disposed of its interest,[234] the Passthrough Entity must also report "any information" required by the API Holder to account for such disposition under Section 1061, including for such API Holder to apply the Lookthrough Rule and to determine its Capital Interest Disposition Amount.[235]

In the case of tiered structures, if a Passthrough Entity requires information from a lower-tier entity to comply with its reporting requirements, it must request such information by the 30th day following the end of the relevant tax year or 14 days after receiving a request from an upper-tier entity (if applicable), whichever is later.[236] A lower-tier entity, in turn, must provide such information by the date on which such lower-tier entity's information returns are due, except if it received the request within 14 days of such due date, in which case the IRS is authorized to specify the timing and manner of its reporting.[237]

If an Owner Taxpayer does not receive the necessary information from a Passthrough Entity, and it is not otherwise able to substantiate to the IRS amounts that lower its Recharacterization Amount, the Owner Taxpayer must ignore such amounts in

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[234] Proposed Regulations Section 1.1061-6(b)(1)(v) reads "disposition . . . of an interest." Since, however, the Owner Taxpayer's API One Year Disposition Amount and API Three Year Disposition Amount include gains and losses from the "disposition or all or a portion of an API," Prop. Reg. §§ 1.1061-4(a)(4)(i)(A) & (ii)(A), we recommend that Treasury clarify that Passthrough Entities report disposition information for partial dispositions as well.

[235] Prop. Reg. § 1.1061-6(b)(1)(v).

[236] Prop. Reg. §§ 1.1061-6(b)(2)(i) & (iii).

[237] Prop. Reg. §§ 1.1061-6(b)(2)(iii)(B)(1) & (2) (specifying that such information must be provided no later than the date on which the entity is required to furnish information under Sections 6031(b) and 6037(b), as applicable). We note that not all lower tier entities will necessarily have information return obligations specified in Sections 6031(b) and 6037(b), particularly given that Proposed Regulations Section 1.1061-6(b)(2)(ii) contemplates Passthrough Entities requesting information from entities in which it does not hold an API. As discussed below in Section IV.G.2.(b), we recommend that Treasury modify these deadlines, and we recommend that deadlines include alternative deadlines in the event that the entity is not a partnership or S Corporation.

its calculations, thereby perhaps artificially inflating its Recharacterization Amount.[238] Similarly, if a Passthrough Entity is unable to obtain the necessary information from a lower-tier entity, it must make the same adjustments.[239]

2. *Comments and Recommendations*

(a) Owner-Level Netting

As discussed above, an Owner Taxpayer calculates its Recharacterization Amount based on the excess of (1) its combined net API One Year Distributive Share Amount from all its APIs plus its API One Year Disposition Amount (the sum, its "One Year Gain Amount") over (2) its combined net API Three Year Distributive Share Amount from all its APIs plus its API Three Year Disposition Amount (the sum, its "Three Year Gain Amount").[240] Accordingly, each Passthrough Entity must report to each API Holder, among other things, its API One Year Distributive Share Amount, which is defined as its share of "net long-term capital gain from the partnership for the taxable year," excluding amounts not subject to Section 1061(a) under the Proposed Regulations (e.g., Section 1231 gains) or distributed on interests excluded from the definition of API.[241]

Despite the Preamble's statement that API gains and losses "flow through [Passthrough Entities] and are netted at the Owner Taxpayer Level to determine the

[238] Prop. Reg. § 1.1061-6(a)(2).

[239] Prop. Reg. § 1.1061-6(b)(2)(vi).

[240] If an Owner Taxpayer's One Year Gain Amount is zero or results in a loss, the Recharacterization Amount is zero and Section 1061(a) does not apply. Prop. Reg. § 1.1061-4(b)(1). If an Owner Taxpayer's Three Year Gain Amount results in a loss, it is treated as zero for purposes of calculating the Recharacterization Amount. *Id.* § 1.1061-4(b)(2).

[241] Prop. Reg. § 1.1061-4(a)(3)(i).

Recharacterization Amount,"[242] the inclusion of only "net long-term capital gain" in the definition for the API One Year Distributive Share Amount means that API Holder often cannot offset a net capital loss from one API against a net capital gain from another API. That is, although the Proposed Regulations net the aggregate API One Year Distributive Share Amounts against aggregate API Three Year Distributive Share Amounts at the Owner Taxpayer level, the definition of API One Year Distributive Share requires netting by each partnership, implicitly excluding many capital losses from being accounted for in the Recharacterization Amount.

For example, take an Owner Taxpayer whose API One Year Disposition Amount is zero and owns two APIs, each in a separate partnership. Assume that the first partnership allocated a long-term capital loss of $3 to the Owner Taxpayer for the year, and the other partnership allocated a long-term capital gain of $6 for the year. Under the partial entity approach, the Owner Taxpayer should be able to use the loss to offset the gain, resulting in "net long-term capital gain with respect to such interests" of $3.[243] Under the Proposed Regulations, however, the first partnership would report an API One Year Distributive Share Amount of $0, the Owner Taxpayer's distributive share of net long-term capital gain from the partnership, and the other partnership would report an API One Year Distributive Share Amount of $6. Accordingly, the Owner Taxpayer's One Year Gain Amount would be $6.

We recommend that Treasury revise the definition of API One Year Distributive Share Amount in Proposed Regulations Section 1.1061-4(a)(3) in the final regulations to

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[242] Preamble at 49757.

[243] Section 1061(a)(1).

include "net long-term capital gain and loss" in order to be consistent with the stated goal of the partial entity approach.[244]

(b) Reporting in Tiered Arrangements

We believe that there are several issues with the reporting requirements in tiered arrangements. These issues arise from the fact that, in many cases, an upper-tier Passthrough Entity will need to request information through several tiers of Passthrough Entities in order to complete its reporting to its partners (both API holders and non-API holders) either because it has directly issued an API or because it has received a request to provide information by an Owner Taxpayer or another upper-tier Passthrough Entity.

With respect to reporting by partnerships that have directly issued APIs, as a practical matter, it appears they must request information that they need from any lower-tier Passthrough Entities within 30 days of the close of the end of the taxable year. And any lower-tier Passthrough Entities are required to pass on requests to further lower-tier Passthrough Entities within 14 days of receiving them. But no Passthrough Entity is required to furnish the requested information earlier than the due date of its return. This will not leave sufficient time for any upper-tier Passthrough Entities to incorporate the information received from lower-tier Passthrough Entities into their tax reporting and returns. Additionally, the nature of the rules for determining Capital Interest Gains and Losses (in particular, the reliance on 704(b) capital accounts to determine whether particular allocations are "commensurate with capital," discussed above in Section IV.A.2.(c)) complicates tiered reporting dynamics, making it less likely that upper-tier

[244] We also recommend that Treasury clarify whether and how capital losses from an API recognized in a prior year, but limited pursuant to Section 1211, are intended to affect the Owner Taxpayer's computation of its Recharacterization Amount.

Passthrough Entities and/or Owner Taxpayers will receive, or alternatively be able to substantiate and determine, any missing information.

The Proposed Regulations are punitive to Owner Taxpayers in requiring Owner Taxpayers or upper-tier Passthrough Entities who do not receive (and cannot otherwise determine and substantiate to Treasury's satisfaction) necessary information to include in the API One Year Distributive Share amounts that would otherwise be excluded. As drafted, the Proposed Regulations appear to disallow these deductions from the API One Year Distributive Share if Owner Taxpayer (or an upper-tier Partnership) is only unable to substantiate a part of the required information.

Finally, we note that all of these issues are more acute in the context of structures involving regulated investment companies ("RICs") and real estate investment trusts ("REITs"). Although the Proposed Regulations helpfully permit RICs and REITs to report capital gain dividends with information that facilitates look-through treatment,[245] such information is required to be reported with the payor's capital gain designation, which is generally required to be made within 30 days of the end of the payor's taxable year.[246] If the RIC or REIT requires information from a lower-tier Passthrough Entity (for example, holding period information or whether any capital gains were of a type not taken into account for purposes of Section 1061(a)) in order to complete this reporting, it may not be able to obtain such information early enough to include with its capital gain designation. Additionally, it is not clear how the rules for reporting in tiered arrangements are meant to be coordinated with the rules for RICs and REITs (for

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[245] Prop. Reg. §§ 1.1061-6(c)(1)–(2).

[246] Prop. Reg. § 1.1061-6(c)(3).

example, if information requested by an Owner Taxpayer requires a Passthrough Entity to obtain information from RICs or REITs).

We suggest the following changes to the Proposed Regulations to address these concerns:

- If information is timely requested by an Owner Taxpayer or upper-tier Passthrough Entity and the requestor does not control all relevant lower-tier partnerships that would in turn be required to furnish information, but the requested information is not provided by a certain cutoff date (for example, 60 days prior to the due date for the requestor's returns), the requestor is allowed to use any reasonable approach to estimate the required information. Requested information that is furnished timely but after the cutoff date (for example, 60 days prior to the due date for the requestor's returns) by a non-controlled lower-tier Passthrough Entity could be disregarded by the requestor for the purposes of the current taxable year (such information could be taken into account in the following taxable year).
- A requirement that upper-tier Passthrough Entities disclose to the IRS their inability to obtain requested information could be retained (and extended to Owner Taxpayers), so that the IRS could impose failure to furnish penalties on any lower-tier Passthrough Entities, as appropriate. If information were obtained after the cutoff date but not incorporated into the requestor's reporting or returns, this could also be disclosed to the IRS.
- We suggest clarifying that gains and losses allocated to the API Holder that are excluded from Section 1061(a) under Proposed Regulations Section

1.1061-4(b)(6) and that are separately reported elsewhere on Schedule K-1 be considered substantiated.

- We suggest that regulations clarify how an Owner Taxpayer or Passthrough Entity may be able to substantiate unreported amounts to the satisfaction of the Secretary. Specifically, the regulations should provide an opportunity to substantiate and utilize some but not all of the required disclosure items.
- We suggest that RICs and REITs be permitted to supplement their capital gain designations, upon request by an Owner Taxpayer or upper-tier Passthrough Entity, and report the One Year Amounts Disclosure and Three Year Amounts Disclosure set out in Proposed Regulations Sections 1.1061-6(c)(1)(i) and (ii) until the extended due date of their returns.

H. Additional Comments and Recommendations

1. Presumption That Services are Substantial

Section 1061(c)(1)'s definition of API requires that the taxpayer receive or hold the partnership interest "in connection with the performance of substantial services." Proposed Regulations Section 1.1061-2(a)(1)(iv) provides that if any partnership interest is transferred to or held by a taxpayer in connection with the provision of services by the taxpayer or a Related Person, such services are presumed to be substantial. The Preamble states that this "presumption is based on the assumption that the parties have economically equated the services performed with the potential value of the partnership interest."[247] We respectfully believe that creating such presumption, and doing so without providing whether it is rebuttable or how to rebut it, is inconsistent with Section

[247] Preamble at 49755; *see also id. at* 49759.

1061(c)(1) which by its terms exempts de minimis service arrangements (e.g., a one-time finder's fee in the form of a profits interest) from turning on Section 1061. We accordingly recommend Treasury provide guidance regarding how the presumption operates and examples of situations where services are provided but Section 1061 does not apply.

2. *Clarification of ATB Activity Test Example 6*

Proposed Regulations Section 1.1061-2(b)(2)(vi) provides an example of whether the ATB Activity Test is not satisfied. In the example, a partnership owns a hardware store, is engaged in buying hardware wholesale and selling it to customers, and grants the manager of the hardware store a partnership profits interest in connection with managing the store. The hardware is not a specified asset, and neither is the hardware store because the partnership does not hold it for rental or investment purposes.[248] Accordingly, the ATB Activity test is not met – the partnership engages in Raising or Returning Capital Actions, but does not take any Investing or Developing Actions because it does not hold any Specified Assets (other than working capital, which is not included for the purposes of the ATB Activity Test[249]). We agree with Treasury's analysis and conclusion in this example.

We recommend that Treasury provide a second example to analyze how to apply the ATB Activity Test where a partnership holds a single investment in Specified Assets. For example, in our experience, it is common for an investment fund to form a

[248] The example specifies that the partnership also does not fall into other categories where it may be involved in an ATB, such as being a Related Person to anyone who takes Specified Actions.

[249] Prop. Reg. § 1.1061-2(b)(1)(iii).

partnership to own a business operated by a C corporation which, in turn, owns the business assets (e.g., the store) rather than owning such assets directly. In such a situation, the partnership's ownership of equity in the C corporation would be Specified Assets.[250] It would also not be uncommon for the hardware store manager (in the example) to have been involved in sourcing the deal for the investment partnership. Nevertheless, we think the ATB Activity Test should still not be met by the holding partnership, and recommend that Treasury so provide in the final regulations. Specifically, the manager's actions sourcing the investment may well be within the scope of Developing Specified Assets as defined in the Proposed Regulations,[251] but it is unlikely that they rise to the level of a trade or business under Section 162.[252] Furthermore, the manager's actions are service to the hardware store business, rather than in the investment fund's ATB, a distinction that we urge Treasury to recognize in the final regulations.[253]

3. *Partnership Transition Amounts*

Proposed Regulations Section 1.1061-4(b)(7) provides a transition rule to accommodate the fact that before January 1, 2018, investment funds had no income tax-

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[250] Prop. Reg. § 1.1061-1(a) Definition of "Specified Assets" (1).

[251] *See* Prop. Reg. § 1.1061-2(b)(1)(ii).

[252] Prop. Reg. § 1.1061-2(b)(1).

[253] We note that we believe the Proposed Regulations appropriately indicate that an interest that is granted "for the provision of services to or for the benefit of a partnership," Rev. Proc. 93-27, 1993-24 I.R.B. 63 § 4.01 (emphasis added), does not necessarily mean that it is "transferred to (or held by) the taxpayer in connection with the performance of substantial services by the taxpayer, or any other related person, in any applicable trade or business," Section 1061(c)(1). The former encompasses any services, the latter only particular services. *See* Preamble at 49757 ("[T]axpayers should not equate an interest that meets the definition of an API with an interest the receipt of which would not be treated as a taxable event under Revenue Procedure 93-27.").

related reason to track, separate and allocate a portion of the partnership's unrealized appreciation in capital assets to the general partner's profits interest, on the one hand, and its capital interest, on the other.[254] Pursuant to the transition rule, funds in existence on January 1, 2018 will be permitted to elect irrevocably to treat all of the capital gains and losses ultimately realized from all assets that they had held for three years as of January 1, 2018 as Partnership Transition Amounts.[255] Such amounts, when realized, are subtracted from API Holders' API One Year Distributive Share Amount for the year of realization.[256] As a carryover, such amounts will not be subject to recharactertization as short-term capital gain. Allocations of such amounts to API Holders cannot exceed the amount that such API Holders would have received under the fund's partnership agreement in effect on March 15, 2018 with respect to the calendar year ending December 31, 2017.[257]

The policy behind this transition rule is unclear. We appreciate Treasury seeking to minimize the burdens associated with the change in law. Nevertheless, because the three-year holding period is required to have been met as of January of 2018, we do not believe the transition rule will measurably lessen the recordkeeping burden on funds. In addition, whether and for whom the transition rule will be beneficial is unpredictable, as demonstrated by the following examples.

First, an example of a situation when election may be beneficial. The potential One Year Gain Amount of $100 comprises (1) a Partnership Transition Amount of $100

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[254] *See* Preamble at 49765.

[255] Prop. Reg. § 1.1061-4(b)(7)(iii).

[256] Prop. Reg. §§ 1.1061-4(a)(3)(i)(B)(2) & 1.1061-4(b)(7)(i).

[257] Prop. Reg. § 1.1061-4(b)(7)(ii).

long-term capital gain, (2) $75 gain from sale of two-year asset and (3) ($75) loss from the sale of a three-year asset that is not a Partnership Transition Amount. The potential Three Year Gain Amount is $25, comprised of (1) plus (3). If the partnership makes the election and excludes (1) entirely, the One Year Gain Amount is $0 and Section 1061(a) does not apply under Proposed Regulations Section 1.1061-4(b)(1). If the partnership does not make the election, the Recharacterization Amount would be $75, so the election results in the Recharacterization Amount being reduced by $75.

Second, an example of a situation when election may not be beneficial. The potential One Year Gain Amount comprises (1) Partnership Transition Amount of ($100) loss from sale of an asset with a holding period exceeding three years, (2) $75 gain from sale of two-year asset and (3) $75 gain from the sale of a three-year asset that is not a Partnership Transition Amount. If the election is not made, the One Year Gain Amount is $50 and the Three Year Gain Amount is limited to zero.[258] If the partnership makes the election and excludes (1), the One Year Gain Amount is $150, the Three Year Gain Amount is $75 and Section 1061(a) applies to recharacterize $75. As such, the election results in an additional $25 being included in the Recharacterization Amount.

Because the Partnership Transition Amounts election is irrevocable, and because the impact on any given taxpayer is highly dependent on the gains or losses recognized in a given year, we do not expect many taxpayers to make this election unless significant analysis is completed to determine such election's impact (and having to complete such analysis eliminates Treasury's intended benefit, reduced taxpayer burden).[259] We

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[258] Prop. Reg. § 1.1061-4(b)(2).

[259] *See* Preamble at 49765.

recommend that Treasury clarify the purpose of this transition relief, provide examples as to situations in which they believe the election will assist taxpayers with their compliance burdens under the regulations and consider providing a mechanism for revoking a previously-made election.

4. *Mandatory Revaluations*

Because capital accounts are the starting point for determining whether allocations constitute Capital Interest Gains and Losses and qualify for the Capital Interest Exception, the Proposed Regulations introduce the concept of "Unrealized API Gains and Losses." Unrealized API Gains and Losses arise in connection with certain events (generally, revaluations and property contributions), do not lose their character as such until they are recognized, and are required to be treated as API Gains and Losses when recognized.[260] Unrealized API Gains and Losses in connection with a given event are all unrealized capital gains and losses that would be allocated to the API Holder with respect to its API if all relevant assets were sold for fair market value on the date of the event.[261] These include:

- Unrealized capital gains and losses that are allocated to an API holder with respect to an API pursuant to a capital account revaluation;
- In the case of a Passthrough Entity that contributes property to another Passthrough Entity, any unrealized capital gain or loss in the contributed property (i.e., any "forward" Section 704(c) layer); and, notably,

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[260] Prop. Reg. § 1.1061-2(a)(1)(ii)(A).

[261] Prop. Reg. § 1.1061-1(a) Definition of "Unrealized API Gains and Losses".

- In the case of a tiered passthrough structure in which there is a revaluation of an upper-tier Passthrough Entity or in the case of a contribution of an API to a Passthrough Entity, the capital gains or losses that would be allocated directly or indirectly to the API Holder by the lower-tier Passthrough Entity if each lower-tier Passthrough Entity had sold its property for fair market value on the date of revaluation or contribution.

The Proposed Regulations impose a requirement to determine Unrealized API Gains and Losses, presumably on the Passthrough Entity that has the revaluation or property contribution giving rise to the Unrealized API Gain or Loss (though this is not entirely clear from the "must be determined" language).[262] Revaluations for purposes of Section 1061 are mandatory for all property, including property held through lower-tier Passthrough Entities, which may or may not even be aware of the existence of an API issued by an upper-tier Passthrough Entity. It is not clear how an upper-tier Passthrough Entity would obtain the relevant information to determine and track the realization of Unrealized API Gains with respect to capital gains and losses from the sale of property by lower-tier Passthrough Entities unless every Passthrough Entity in the chain revalued for purposes of Section 704(b) at the time of a triggering event and applied Section 704(c) to the ultimate sale of revalued property. This requirement is not reasonable except in the case of controlled lower-tier Passthrough Entities.[263] Further, outside of a controlled partnership context, it is unclear what abuse this requirement could be

[262] Prop. Reg. § 1.1061-2(a)(1)(ii)(B); *see also* Preamble at 49758 ("[T]hese regulations require that a revaluation . . . be made through each relevant tier of partnerships.").

[263] *See also* New York State Bar Association Tax Section, Report No. 1202, *Report on the Request for Comments on Section 704(c) Layers Relating to Partnership Mergers, Divisions and Tiered Partnerships* 39–41 (Jan. 22, 2010) (discussing partnership revaluations in tiered structures and recommending mandatory revaluation only when tiered entities are controlled).

addressing. Finally, it is not clear what the consequences would be if the revaluations are not done and the information is not provided.

The administrative burden associated with this provision would be significant. For example, in the case of a revaluation at an upper-tier Passthrough Entity that directly or indirectly holds many lower-tier Passthrough Entities (e.g., a fund of funds), a revaluation at the upper-tier appears to cause a revaluation for each lower-tier partnership.

The requirement to revalue for purposes of Section 1061 differs from the general revaluation rule in the Section 704(b) capital account maintenance regulations which permit (but do not mandate) revaluations and which do not require revaluation through tiers of partnerships. This difference can potentially cause a conflict between the requirement in the Proposed Regulations to allocate API Gains and Losses to match the prior allocation of corresponding Unrealized API Gains and Losses and the allocation provisions under Section 704(c). The Proposed Regulations seem to acknowledge this potential conflict and provide that if a partnership is required to revalue assets for purposes of Section 1061, then it will be permitted to revalue its assets for purposes of Section 704(b) as if an event under Treasury Regulations Section 1.704-1(b)(2)(iv)(f)(5) had occurred.[264]

Additionally, it is not clear that a Section 704(b) revaluation would eliminate all potential conflicts and uncertainties between allocations under Section 704(c) and the rules relating to Unrealized API Gains and Losses. For example, under the Proposed Regulations, Unrealized API Gains or Losses seem to be contemplated as a static number – that is, Unrealized API Gains and Losses do not appear to be adjusted to reflect

[264] Prop. Reg. § 1.1061-2(a)(1)(ii)(B).

adjustments to the corresponding Section 704(b) value of revalued property to reflect depreciation, amortization, etc. Although the exclusion for Section 1231 gain and loss from the definition of API Gains and Losses may mitigate some of this uncertainty, it is not clear that it eliminates all potential mismatches, including, for example, mismatches that may arise with respect to Unrealized API Gains and Losses attributable to an investment in an operating partnership (or real property that is ultimately disposed by way of a sale of partnership interests). In general, allocations made for purposes of Section 1061 should be conformed to allocations made for purposes of Section 704(b), so that any allocation of Unrealized API Gains and Losses should mirror the allocation of the corresponding items under Section 704(b) and Section 704(c).

We recommend that the mandatory Section 1061 revaluation rules be eliminated. If an upper-tier partnership revalues for Section 704(b) purposes, the Section 1061 regulations should rely on the long-standing principles of Section 704(c) to ensure that the proper gains and losses are allocated to the partners at the time of the revaluation. In order to more accurately accomplish this result, it should be optional for a lower-tier partnership to revalue pursuant to Section 704(b) when an upper-tier partnership has revalued its assets. If Treasury believes that the current Section 704(c) rules are inadequate to address potential abuses under Section 1061, anti-abuse regulations may be written to address tiered partnership issues but should only apply in controlled partnership scenarios; if any such anti-abuse regulations are written, we would suggest that any requirement to perform revaluation through tiers be <u>notional</u> (i.e., performed only at the level of the partnership whose property contribution or revaluation gives rise

to the Unrealized API Gain or Loss, even if calculated by reference to notional revaluations at lower-tier entities).

5. Unrealized API Gain and Distributed API Property

As discussed above, the Proposed Regulations include the Distributed API Property rules to avoid circumvention of Section 1061(a) through distributions of assets underlying an API.[265] The Proposed Regulations also provide that Unrealized API Gains and Losses must be tracked and do not lose their character until they are realized.[266] To avoid circumvention of this rule, the Proposed Regulations clearly express Treasury's intent that Unrealized API Gains and Losses never be converted into amounts that come within the Capital Interest Exception.[267] Furthermore, the Preamble explicitly states that this means that Unrealized API Gains and Losses, like API Gains and Losses,[268] retain that taint as they are allocated through tiers of partnerships.[269] The Proposed Regulations provide special tracking rules for when assets with Unrealized API Gains and Losses are contributed to other entities.[270] We recommend that Treasury clarify that the Unrealized API Gains and Losses taint persists when a lower-tier partnership distributes an interest to an upper-tier partnership in respect of such upper-tier partnership's API in the lower-tier partnership as an incentive payment. In such a situation, all pre- and post-distribution allocations by the lower-tier partnership could be made pro rata based on capital accounts

[265] *See* Preamble at 49766–67; *supra* Section IV.F.2.(a).

[266] Prop. Reg. § 1.1061-2(a)(1)(ii)(A).

[267] Prop. Reg. § 1.1061-3(c)(3)(iii)(A); *see* Preamble at 49756.

[268] Prop. Reg. § 1.1061-2(a)(1)(iii).

[269] Preamble at 49754.

[270] Prop. Reg. §§ 1.1061-2(a)(1)(ii)(B), 1.1061-3(c)(7)(vi) Example 6 & 1.1061-5(e)(2).

at the upper-tier partnership, and therefore possibly without the taint applying, so that Section 1061(a) would not capture gains recognized by the lower-tier partnership on its assets.

6. Definitions of "Taxpayer" and "Person"

Finally, the word "taxpayer" appears in four different contexts within Section 1061. The Preamble, rather than the Proposed Regulations, sets forth Treasury's determination that (1) "taxpayer" in Section 1061(a) means Owner Taxpayers,[271] (2) "taxpayer" in the definition of API in Section 1061(c)(1) refers to both Owner Taxpayers and Passthrough Taxpayers,[272] and (3) "taxpayer" in Section 1061(d) refers to Owner Taxpayers.[273] Furthermore, the Preamble is silent on Treasury's apparent conclusion that "taxpayer" in the Capital Interest Exception in Section 1061(c)(4)(B) means any partner.[274] For clarity, we recommend that Treasury include explicit rules regarding who is a "taxpayer" for each relevant part of Section 1061 in the final regulations.

The Preamble's discussion of the Section 1061(d) rule also states that the Proposed Regulations "use the term 'person' as the term in generally used under Section 7701(a)(1)."[275] We recommend that Treasury include such statement in the final

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[271] Preamble at 49754, 49755, 49756–57 & 49771.

[272] Preamble at 49755, 49756–57 & 49771.

[273] Preamble at 49768. We believe that this conclusion for Section 1061(d) is directly supported by the statutory text, which contemplates the taxpayer including amounts in her gross income. Section 1061(d)(1).

[274] *See* Preamble at 49755–56, 49761–63 & 49772 (referencing "owner taxpayers"); Prop. Reg. §§ 1.1061-3(c)(3)(i) (referencing "partners"), 1.1061-3(c)(3)(ii)(A) (referring to interests held by API Holders) & 1.1061-3(c)(3)(ii)(B) (providing rules for tiered structures, indicating that Passthrough Entities can hold interests that come within the Capital Interest Exception).

[275] Preamble at 49768.

regulations, as well as specifying whether it applies throughout the regulations or only to the use of "person" in the Section 1061(d) rules.[276]

[276] *Cf.* Prop. Reg. §§ 1.1061-1(a) Definitions of "API Holder", "Owner Taxpayer", "Related Person" (referencing "another person or entity") and "Unrelated Non-Service Partners", 1.1061-3(a), 1.1061-3(d)(1)(i), 1.1061-6(b)(2)(ii) & 1.704-3(e)(3)(vii)(A) (each using "person").

V. Appendices

A. Appendix I – Private Equity Waterfalls

Assume:

- Green Point has four limited partners, M, N, O and P. M, N and O are third-party investor limited partners and P is the vehicle for Green Point GP's Capital Commitment.
- Green Point acquires two portfolio companies, Company A in Year 1 for $500 and Company B in Year 2 for $300.
- The limited partners invested as follows:

	Company A		Company B		Total		Preferred Return (8%)		
	$ 500	%	$ 300	%	$ 800	%	A	B	Total
M	$ 300	60%	$ 200	67%	$ 500	62.5%	$ 24	$ 16.00	$ 40.00
N	$ 75	15%	$ 85	28%	$ 160	20.0%	$ 6	$ 6.80	$ 12.80
O	$ 100	20%	$ -	0%	$ 100	12.5%	$ 8	$ -	$ 8.00
P	$ 25	5%	$ 15	5%	$ 40	5.0%	$ -	$ -	$ -

- Green Point sells Company A in Year 2 (after the investment in Company B) for $800 and sells Company B in Year 3 for $400. (Both sales are one year following the investments.)
- Green Point exempts allocations to P from the distribution waterfall.

Return-All-Capital Waterfall Distributions

Year 2

	M	GP	N	GP	O	GP	P
Initial Allocation	$ 480		$ 120		$ 160		$ 40
Return of Capital	$ 480		$ 120		$ 100	$ -	N/A
Preferred Return					$ 8	$ -	N/A
GP Catch Up (100%)					$ -	$ 2	N/A
80%/20% split					$ 40	$ 10	N/A
Total	$ 480		$ 120		$ 148	$ 12	$ 40
Unreturned Capital	$ 20		$ 40		$ -		$ -
		GP Carry Total:			$ 12		

Year 3

	M	GP	N	GP	O	GP	P
Initial Allocation	$ 250		$ 80		$ 50		$ 20
Return of Capital	$ 20	$ -	$ 40	$ -	$ -	$ -	N/A
Preferred Return	$ 40	$ -	$ 12.80	$ -	$ -	$ -	N/A
GP Catch Up (100%)	$ -	$ 10	$ -	$ 3.20	$ -	$ -	N/A
80%/20% split	$ 144	$ 36	$ 19.20	$ 4.80	$ 40	$ 10	N/A
Total	$ 204	$ 46	$ 72	$ 8	$ 40	$ 10	$ 20
		GP Carry Total:		$ 64			

Overall

	$	% Return
M	$ 684	137%
N	$ 192	120%
O	$ 188	188%
P	$ 60	150%
		% of Profit
GP	$ 76	19%

Deal-by-Deal Waterfall Distributions

Year 2

	M	GP	N	GP	O	GP	P
Initial Allocation	$ 480		$ 120		$ 160	$ -	$ 40
Return of Capital	$ 300	$ -	$ 75	$ -	$ 100	$ -	N/A
Preferred Return	$ 24	$ -	$ 6	$ -	$ 8	$ -	N/A
GP Catch Up (100%)	$ -	$ 6	$ -	$ 2	$ -	$ 2	N/A
80%/20% split	$ 120	$ 30	$ 30	$ 8	$ 40	$ 10	N/A
Total	$ 444	$ 36	$ 111	$ 9	$ 148	$ 12	$ 40
		GP Carry Total:		$ 57			

Year 3

	M	GP	N	GP	O	GP	P
Initial Allocation	$ 266.67		$ 113.33		$ -	$ -	$ 20
Return of Capital	$ 200	$ -	$ 85	$ -	$ -	$ -	N/A
Preferred Return	$ 16	$ -	$ 6.80	$ -	$ -	$ -	N/A
GP Catch Up (100%)	$ -	$ 4	$ -	$ 1.70	$ -	$ -	N/A
80%/20% split	$ 37.33	$ 9.33	$ 15.87	$ 3.97	$ -	$ -	N/A
Total	$ 253.33	$ 13.33	$ 107.67	$ 5.67	$ -	$ -	$ 20
		GP Carry Total:		$ 19			

Overall

	$	% Return
M	$ 697	139%
N	$ 219	137%
O	$ 148	148%
P	$ 60	150%
		% of Profit
GP	$ 76	19%

B. Appendix II – Hedge Fund Loss Recovery Account Mechanism

The following table demonstrates how the Loss Recovery Account mechanism would work with both a soft hurdle and a hard hurdle. This example assumes a $100 initial investment and a 20% Incentive Allocation; it ignores Management Fee obligations as well as the investment returns that would be allocated to the general partner's capital account.

		Year 0	Year 1	Year 2	Year 3	Year 4	Year 5	% of Gain
	Investor Capital Account Allocation		10	-10	-18	25	25	
Straight 20%	Investor Capital Account	$ 100	$ 108	$ 98	$ 80	$ 100	$ 120	62.5%
	GP Incentive Allocation		$ 2	$ -	$ -	$ 5	$ 5	
	GP Capital Account		$ 2	$ 2	$ 2	$ 7	$ 12	37.5%
	High-Water Mark	$ 100	$ 110	$ 110	$ 110	$ 110	$ 130	
	Loss Recovery Account	$ -	$ -	$ 12	$ 30	$ 5	$ -	
High-Water Mark – Soft Hurdle	Investor Capital Account	$ 100	$ 108	$ 98	$ 80	$ 105	$ 125	78%
	GP Incentive Allocation		$ 2	$ -	$ -	$ -	$ 5	
	GP Capital Account		$ 2	$ 2	$ 2	$ 2	$ 7	22%
High-Water Mark – Hard Hurdle	Investor Capital Account	$ 100	$ 108	$ 98	$ 80	$ 105	$ 126	81%
	GP Incentive Allocation		$ 2	$ -	$ -	$ -	$ 4	
	GP Capital Account		$ 2	$ 2	$ 2	$ 2	$ 6	19%