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Report No. 1453
October 25, 2021

The Honorable Richard E. Neal
Chairman of Ways and Means Committee
U.S. House of Representatives
1102 Longworth House Office Building
Washington DC 20515

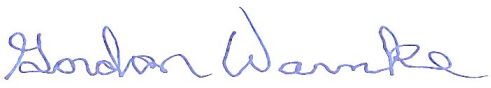
Re: *Report No. 1453 – Comments on Selected Partnership-Related Provisions of the House Proposals for the Build Back Better Act*

Dear Mr. Neal:

I am pleased to submit our Report No. 1453 commenting on selected partnership-related tax provisions contained in the budget reconciliation legislation known as the "Build Back Better Act" released by the House Ways and Means Committee on September 13, 2021.

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

Respectfully submitted,



Gordon E. Warnke
Chair

Enclosure

cc: Offices of the Honorable Kevin Brady,
Ranking Member of the Ways and Means Committee;

Offices of the Honorable Ron Wyden,
Chairman of the United States Senate Committee on Finance;

Offices of the Honorable Mike Crapo,
Ranking Member of the United States Senate Committee on Finance;

Mr. Andrew Grossman, Chief Tax Counsel,
Ways and Means Committee;

Mr. Derek Theurer, Chief Tax Counsel,
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Mr. Praveen Ayyagari, Tax Counsel,
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Ms. Elle Collins, Tax Counsel,
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Mr. Daniel Winnick, Tax Counsel,
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Ms. Ji Prichard, Tax Counsel,
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Mr. Joe Boddicker, Tax Counsel
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Mr. Adam Carasso, Senior Adviser Tax and Economic,
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Mr. Colin Casey, Tax Clerk,
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Ms. Sarah Schaefer, Senior Adviser Tax Policy,
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Mr. Thomas A. Barthold, Chief of Staff,
Joint Committee on Taxation;

Mr. Robert P. Harvey, Deputy Chief of Staff,
Joint Committee on Taxation;

The Honorable Lily Batchelder
Assistant Secretary (Tax Policy),
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Mark Mazur, Deputy Assistant Secretary (Tax Policy),
Department of the Treasury;

The Honorable William M. Paul,
Acting Chief Counsel, Internal Revenue Service;

Mr. Thomas C. West, Jr., Deputy Assistant Secretary,
Department of the Treasury;

Mr. Krishna P. Vallabhaneni,
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Mr. Roger F. Pillow, Senior Counsel,
Office of Tax Policy, Department of the Treasury;

Mr. Brett York, Deputy Tax Legislative Counsel,
Department of the Treasury;

Mr. Jose Murillo, Deputy Assistant Secretary,
Department of the Treasury;

Mr. Kevin Nichols, Tax Counsel,
Department of the Treasury (Office of Tax Policy)

Report No. 1453

New York State Bar Association Tax Section

Report on Selected Partnership-Related Provisions of the House Proposals for the Build Back Better Act

October 25, 2021

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I. Introduction

This report (the "Report")[1] comments on selected partnership-related tax provisions (the "Proposals") contained in the budget reconciliation legislation known as the "Build Back Better Act" released by the House Ways and Means Committee on September 13, 2021 pursuant to instructions in S. Con. Res. 14, the Concurrent Budget Resolution for FY2022.[2] We have limited our comments to the technical aspects of these provisions and have not attempted to evaluate or comment on the merits of the tax policies motivating them.

Part II of this Report discusses the Proposals relating to partnership interests held in connection with the performance of services. A summary of our recommendations regarding these matters is contained at the beginning of Part II. Part III of this Report addresses selected other proposals relating to the taxation of partnerships and its partners. Given the relative brevity of Part III and the less dense nature of the discussion therein, no summary of the recommendations in this part is provided.

II. Proposals on Partnership Interests Held in Connection with the Performance of Services

Section 1061,[3] which was enacted in 2017, generally extends from one to three years the holding period required to be satisfied for capital gain recognized with respect to an "applicable partnership interest" ("API") to be treated as long-term capital gain. An API generally includes any partnership interest transferred or held in connection with the performance of services in an "applicable trade or business" ("ATB"). An API generally does not include certain capital interests, interests purchased by unrelated third parties and interests held by corporations. In 2020, we commented on proposed regulations issued under section 1061 (the "Prior 1061 Report").[4]

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[1] The principal drafter of this Report was James Brown. Substantial contributions were made by Catherine Chen, Denise Sohn and Libin Zhang, and helpful comments were provided by Jennifer Alexander, Kimberly Blanchard, Robert Cassanos, Peter Connors, Jason Factor, Stephen Foley, Kathleen Gregor, Marty Hamilton, Stephen Land, Andrew Needham, Benjamin Oklan, Deborah Paul, Yaron Reich, Stuart Rosow, Michael Schler, Eric Sloan, Linda Swartz, Joseph Toce, Gordon Warnke, Sara Zablotney and Ari Zak. This Report reflects solely the views of the Tax Section of the New York State Bar Association and not those of the Executive Committee or House of Delegates of the New York State Bar Association. References to "we", "us" or "our" in this Report refer to the Executive Committee of the Tax Section of the New York State Bar Association.

[2] S.Con.Res.14—117th Congress (2021-2022). This legislation was approved by the House Ways and Means Committee on September 15, 2021 and reported to the House of Representatives with a favorable recommendation by the House Budget Committee on September 25, 2021. As explanations of the legislation, on September 13, 2021, the staff of the Joint Committee on Taxation released the "Description of the Chairman's Amendment in the Nature of Infrastructure Financing (Subtitle F), Green Energy (Subtitle G), the Social Safety Net (Subtitle H), and Prescription Drug Pricing (Subtitle J)" (the "JCT Report") and, on September 28, 2021, the House Budget Committee released Report 117-130 (the "House Report" and collectively, the "Reports").

[3] Unless otherwise indicated, "Section" (and "§") references are to the Internal Revenue Code of 1986, as amended (the "Code") or Treasury Regulations promulgated thereunder.

[4] New York State Bar Association Tax Section, Report No. 1442, *Report on Proposed Regulations under Section 1061* (Oct. 5, 2020).

The Proposals would expand materially the scope of section 1061. We are providing comments on only the more significant aspects of this proposed expansion.

A. Summary of Principal Recommendations

This summary of our recommendations reflects our attempt to ensure that the Proposals modifying section 1061, if revised as we have suggested, would achieve what we perceive to be their core objective, without being either over broad or under inclusive. Striking that balance is of necessity a complex task, given the nature of the issues involved and the multitude of variations that exist regarding partnership arrangements, and is made more difficult by our uncertainty about the exact intended scope and consequences of those Proposals. For those reasons, the complexity of our recommended revisions to those Proposals is, we think, unavoidable.

1. Clarification of Corporation Exception from Section 1061

We support the proposed amendment to section 1061(c)(4) that would codify the clarification that an API includes a partnership interest to the extent held directly or indirectly by an S corporation, [5] and we suggest consideration be given to making a similarly limiting statutory (i) clarification with respect to a passive foreign investment company ("PFIC") for which a qualified electing fund ("QEF") election has been made and (ii) change in respect of a corporation taxed under the provisions of subchapter M.

2. Revised Holding Period Exception

We assume that the holding period exception contained in proposed section 1061(b)(2)(A)[6] has two purposes. First, it is intended to ensure generally that short-term capital gain treatment applies to all gain[7] that is realized in respect of an API and is otherwise eligible for long-term capital gain treatment if the gain is attributable to an asset to which the taxpayer has not been exposed economically for longer than five years. Second, it is intended generally to permit long-term capital gain treatment for all gain attributable to assets to which the taxpayer has been exposed economically for longer than five years.

Recognizing that existing law does not provide for a perfect mechanic to measure economic exposure to an asset, we further assume that a reasonable proxy for such measure, at least as a starting place, is the existing law for determining its holding period, including those aspects of existing law that generally provide for the tacking of holding period in a carryover basis transaction. We recognize, of course, that some aspects of holding period tacking are vulnerable to manipulation, as illustrated by planning strategies that are now commonly used to avoid the application of section 1061, and our recommendations include suggestions for when the existing holding period rules should be made subject to specified overrides to better match how holding period is measured for purposes of section 1061 with economic exposure.

[5] S.Con.Res.14—117th Congress (2021-2022) § 138149(b)(3).
[6] S.Con.Res.14—117th Congress (2021-2022) § 138149(a).
[7] References to "gain" throughout are intended to cover items subject to recast under section 1061(a).

In the case of a chain of partnerships, proposed section 1061(b)(2)(A), clause (iii), applies a dual, two-prong test at each partnership level to determine the period of economic exposure of the taxpayer holding an API (the "API taxpayer") to the relevant asset, testing both the date of the acquisition of each partnership interest in the chain and the date of that partnership's acquisition of the asset (including a partnership interest in a lower-tier partnership) that it holds directly. Similarly, existing law generally determines the holding period of an asset by reference to the asset's direct holder (rather than by reference to the asset's indirect holder). However, we believe that the purposes of this provision would be better achieved if the rule were stated as a single test that looks at the indirect holding period of the API taxpayer in the assets to which the gain is attributable.[8] We refer to the "Look-Through Rule" as being the principle of looking at the indirect holding period of the API taxpayer in the assets giving rise to the gain realized in respect of such API, whether such assets are held by a first-tier or lower-tier partnership.

Assuming that the Look-Through Rule accurately measures the requisite economic exposure of the API taxpayer to the relevant asset, we believe that the concept of "substantially all" contained in proposed section 1061(b)(2)(A) can be eliminated without undermining the purpose of the holding period exception. For this reason, and because in the case of many common fact patterns the inclusion of the "substantially all" concept would result in short-term capital gain treatment for gain on assets to which an API taxpayer has had economic exposure for longer than five years, we recommend tying the gain being tested under section 1061 to both the portion of an API in respect of which the gain is recognized and the specific asset (or assets) to which the gain is attributable.

To better match the holding period rules for the purpose of determining whether under section 1061 the API taxpayer has been economically exposed to the relevant asset for five years or less, we recommend that specified overrides to the normal holding period rules be used when applying the holding period exception. These overrides are a core aspect of our recommendations and the basis for our conclusion that the purpose of section 1061 can be achieved without having to rely on the concept of "substantially all," which we see as largely unworkable in its current form. A principal objective of the Report is to bring these overrides to your attention as a possible approach to crafting the holding period exception in a manner that, when combined with the elimination of the "substantially all" concept, allows taxpayers to satisfy the exception if they economically achieve more than five years of exposure to the relevant assets and otherwise prevent taxpayers from shoehorning themselves into meeting the exception.

To simplify the presentation of our recommendations for the holding period exception, the summary below relies on existing holding period rules as a proxy for measuring the economic exposure of an asset and layers onto those rules specified overrides. We acknowledge, however, that implementing the substance of our recommendations for measuring this economic exposure could alternatively be achieved by retaining the concept of "acquired" that is used in the

[8] A similar approach is taken in section 1202(g) for purposes of determining whether a partner in a partnership that sells qualified small business stock is eligible for the partial exclusion for gain from such sale. Under the section 1202(g) rules, a partner in the partnership would be eligible for the partial exclusion only if it held an interest in the partnership on the date that the partnership acquired the qualified small business stock and at all times thereafter until the disposition of the stock.

proposed version of section 1061(b)(2)(A) and providing exceptions to the definition of "acquired" to address situations, for example, involving no change in economic exposure.

Also know that the specific recommendations outlined immediately below are intended as an illustration of how, in our view, the holding period exception could be implemented in a manner that might be more workable and more effective than how the exception would operate in its currently proposed form, depending on what purpose the holding period exception is intended to serve. In that respect, these recommendations are intended to function more as a roadmap to our observations, contained in the discussion section of the Report, about (i) the proposed holding period exception, (ii) its likely consequences if enacted as proposed, (iii) its possible alternative intended purposes and (iv) how it might be modified to better achieve its purpose, depending on what that is.

Subject to the foregoing, we recommend modifying proposed section 1061(b)(2)(A) to:

- Remove the "substantially all" requirement from clauses (i) and (ii) of section 1061(b)(2)(A) and further revise those clauses to provide that "net applicable partnership gain" would be determined without regard to gain realized with respect to an API if both (i) the portion of such API in respect of which such gain is realized has a five-year holding period and (ii) the asset on which such gain is realized has a five-year holding period, consistent with the Look-Through Rule and holding period rules as reflected in the more specific recommendations below;
- Provide that, if portions of an API were acquired at different times and represent interests in different direct or indirect assets of the partnership, clause (i) of section 1061(b)(2)(A) would be applied to gain recognized in respect of an asset by reference to the holding period of the portion of API related to that asset;
- Replace clause (iii) of section 1061(b)(2)(A) with an articulation of the Look-Through Rule (i.e., that in the case of tiered partnerships, clauses (i) and (ii) of section 1061(b)(2)(A) will be applied in a manner that results in the API taxpayer realizing long-term capital gain only if and to the extent the API taxpayer's indirect holding period in the assets to which such gain is attributable is longer than five years), and provide in the legislative history that the intention of section 1061(b)(2)(A), including the tiered partnership rule of clause (iii), is to implement the Look-Through Rule, and that the provision should be interpreted accordingly;[9]
- Turn off the Look-Through Rule in the case of certain lower-tier partnerships described below in the flush language at the end of this section; and
- Provide a holding period rule (or define "acquired") as discussed above and elaborated further below.

Second, to prevent API taxpayers from avoiding the application of section 1061 by reason of either a tacked holding period of another taxpayer or a special allocation arrangement (such as a so-called "carry waiver"), we further recommend modifying these holding period determinations,

[9] Alternatively, instead of retaining the three clauses of section 1061(b)(2)(A), the provision could be redrafted to simply state the Look-Through Rule.

solely for purposes of section 1061, as follows, subject to the qualifications in the flush language below at the end of this section:

- With respect to the API taxpayer, the holding period of an asset contributed by a partner to a partnership in a carryover basis transaction would not include the holding period of the contributing partner except to the extent that the API taxpayer had a direct or indirect interest in such asset during the holding period of the contributing partner (the "No Tacking Rule");[10]
- If the amount of gain allocated in respect of an API is determined for purposes of section 704(b) in whole or part by reference to the gain recognized on an asset other than the asset generating the gain being allocated, the holding period used for determining the character of gain so allocated, to the extent the amount of such gain allocated is determined by reference to the gain on the other asset, would be the shorter of the holding period of the asset generating the gain or the holding period of the asset in respect of which the amount of allocated gain is determined (and as of the time such other gain was recognized) (the "No Special Allocation Rule");[11] and
- The No Tacking Rule and the No Special Allocation Rule would apply with respect to an API taxpayer on a look-through basis in the case of lower-tier partnerships in tiered partnership structures.

Finally, we recommend that, subject to appropriate regulatory exceptions, the Look-Through Rule, the No Tacking Rule and the No Special Allocation Rule would not apply in respect of specified partnerships ("No Look-Through Partnerships"). How exactly "No Look-Through Partnerships" should be defined depends on the intended scope of the holding period exception, which is unclear. While we do not have a recommended definition for "No Look-Through Partnerships," we suggest that the definition include one or more of the following criteria: (i) partnerships that are portfolio investments of the fund issuing the API and that are conducting operating businesses, (ii) partnerships for which the relevant information is difficult to obtain and (iii) partnerships with respect to which the look-through rules would be impractical to administer. A possible example would be a partnership if either (i) a profits interest granted by

[10] If Congress believes that the No Tacking Rule should operate more similarly to the treatment of other transactions involving an economic exchange of assets in which no gain or loss is recognized, the rule could be qualified by permitting tacking of the contributor's holding period in respect of the API taxpayer for purposes of section 1061 to the extent that, as a result of the contribution, the API taxpayer's interest in the partnership's assets before the contribution decreased (thereby increasing the contributing partner's interest in such assets), in which case the contributed asset's holding period in respect of the API taxpayer would include the shorter of the holding period of the contributing partner in such contributed assets or the holding period (as determined for purposes of section 1061 in respect of the API taxpayer) in the assets in respect of which the API taxpayer's interest decreased. This modification should not be adopted, however, if Congress' intends that, for purposes of section 1061, the holding period of such contributed asset in respect of the API taxpayer start when the taxpayer is first economically exposed to the asset and without regard to the taxpayer's holding period in the assets that, by reason of the contribution, are economically exchanged (without recognition) to obtain such exposure.

[11] Note that this No Special Allocation Rule would not apply to disproportionate allocations that are made to one partner by reason of the amount of allocations made to another partner, if the amount of such allocations are not measured by reference to the gain recognized on an asset other than the asset generating the gain being allocated. An example of this type of allocation, which would not be affected by the No Special Allocation Rule, is a so-called "catch up" allocation that is commonly made to an API holder such that, after the allocation, the holder will have been allocated an amount that is measured by reference to the amount of allocated to other investors.

such partnership to an individual in connection with the performance of substantial services would not be treated as an API (because, for example, the partnership owns an operating business as opposed to specified assets as defined in section 1061(c)(3)) or (ii) none of the API taxpayer and other persons involved in an ATB related to the API taxpayer directly or indirectly control the partnership (for example, the partnership is a portfolio investment of a fund of funds in which the API taxpayer holds an API). In our experience, these types of partnerships have not been the subject of and are not particularly vulnerable to section 1061 tax planning.

3. Exceptions to Gain Acceleration under Proposed Section 1061(d)

We do not have enough confidence in our understanding of the purpose of proposed section 1061(d)[12] to make a comprehensive recommendation on how it should be revised. Our limited recommendation is that the provision should be modified so as to not apply if the transferred API would satisfy the holding period exception (which we assume is an oversight) or if the transferor would continue to be subject to tax on the API (as API) after the transfer (because, e.g., the transferee is a wholly owned S corporation). However, we lacked consensus on how else the provision should be changed if at all.

Assuming proposed section 1061(d) reflects Congress' judgment that an API subject to section 1061(a) should be treated as compensation, a majority of us recommend that proposed section 1061(d) be revised so that it does not trigger gain in a transaction otherwise qualifying for nonrecognition if the transferred API retains its character as API, though a significant minority of us recommend that gain be triggered in that case, unless the transferor would continue to recognize gain on the API when the gain is ultimately recognized. If the transfer of an API would result in the transferred interest no longer being treated as an API (because, e.g., the transfer is to a regular C corporation or tax exempt entity), a majority of us recommend that gain be triggered, though a significant minority of us believe such transfers should not trigger gain. As discussed below, this divergence of views reflects, we believe, our lack of consensus about the tax policies motivating proposed section 1061(d) as well as divergent opinions on the relevance of other considerations.

4. Rules for Distributions in Kind

We recommend that proposed section 1061 be clarified, consistent with current law, to provide that proposed section 1061(a) would apply to gain from property distributed in respect of an API, when recognized after the distribution, unless at the time of such recognition the property would satisfy the holding period exception under proposed section 1061(b)(2).[13] We recommend that, for purposes of determining when such distributed property would be treated as meeting the holding period exception, the holding period for such property would start on the later of (i) the start of the holding period for such property in the hands of the distributing partnership, with respect to the API taxpayer, immediately before the distribution (i.e., the holding period for purposes of applying clause (ii) of our revised proposed section 1061(b)(2)(A)) or (ii) the start of the holding period for the various portions of the API in respect of which the property is

[12] S.Con.Res.14—117th Congress (2021-2022) § 138149(c).
[13] S.Con.Res.14—117th Congress (2021-2022) § 138149(a).

distributed (i.e., the holding period for purposes of applying clause (i) of our revised proposed section 1061(b)(2)(A)).[14]

We also recommend that, if an API taxpayer's indirect interest in a partnership asset is reduced by reason of a distribution of that asset and as a result of the distribution the API taxpayer's indirect interest in another asset with a longer holding period than the period of the distributed asset is increased, the holding period with respect to the API taxpayer in the assets in respect of which the holder's indirect interest increased, to the extent of such increase, would be reset consistent with how indirect changes in economic interest are handled under the No Tacking Rule. Again, however, we recommend that this modification not apply to assets held by a No Look-Through Partnership.

Finally we recommend clarification be provided as to how gain on property distributed in respect of an API prior to the general effective date of these changes should be treated if the gain is recognized after the effective date of the changes.

5. Statutory Exceptions for Capital Interests and Enterprise Value

We recommend that current section 1061(c)(4)(B) be amended to clarify that the capital interest exception to API treatment applies without regard to whether the partnership has third-party investors, provided that the allocations in respect of such capital interest are made commensurate with capital.

We recommend that proposed section 1061(b)(4)[15] be changed so that, subject to appropriate regulatory exceptions, proposed section 1061(a)[16] would not apply to gain attributable to any asset not held for portfolio investment on behalf of third-party investors. In addition, we recommend that, in the accompanying legislative history, Congress' express its intention that goodwill and enterprise value of a partnership performing the services of an ATB, as well as the partnership's other assets used in connection with such ATB (if not held for portfolio investment on behalf of third party investors), should not be subject to section 1061, effective as of the original effective date of section 1061.

B. Discussion of Section 1061 Proposals and Recommendations

1. Expansion of Applicability to Amounts Otherwise Taxed at Long-Term Rates

The Proposals would modify section 1061(a) to extend the application of section 1061 to "net applicable partnership gain" ("NAPG"), which generally would include, in addition to net long-term capital gain, all gross income treated as long-term[17] capital gain or subject to tax at the rate

[14] For example, for this purpose, if the API taxpayer's indirect interest in the distributed property immediately before the distribution is less than the amount of such property received in the distribution, the holding period of the excess in the hands of the API taxpayer immediately after the distribution would be reset in the hands of the API taxpayer consistent with how indirect changes in economic interest are handled under the No Tacking Rule.

[15] S.Con.Res.14—117th Congress (2021-2022) § 138149(a).

[16] *Id*.

[17] We note that the proposed statutory language omits "long-term" in its reference to amounts "treated as capital gain" but we assume amounts treated as short-term capital gain are not intended to be included in NAPG.

applicable to net capital gain, in each case to the extent recognized with respect to an API. These additional amounts would include, for example, qualified dividend income, gain from section 1256 contracts, and section 1231 gain.

We support this proposed change because it would treat more uniformly amounts recognized with respect to an API and would thereby eliminate the incentive to structure APIs and partnership transactions in a manner that aims to generate income of a character not subject to recast under section 1061. In addition, to the extent that section 1061 is intended to encourage longer holding periods, this proposed change would reinforce that incentive. We note, however, that the proposed change would not limit the deductibility of specified income under section 199A, even though this deduction is otherwise not permitted for income from services "that consist of investing and investment management, trading, or dealing in securities (as defined in section 475(c)(2)), partnership interests, or commodities."[18]

2. Clarification of the "Corporate Exception" from Section 1061

Section 1061 statutorily excludes from the definition of an API partnership interests held by a "corporation," without explicitly limiting this exclusion to "C" corporations. Notice 2018-18[19] announced an intent for regulations to be issued that would clarify that the exception for corporations does not include S corporations. Subsequently issued proposed and final regulations under section 1061 provide that the corporate exception does not apply to S corporations, with an effective date that is the same as the effective date of section 1061's application.

The proposed regulations issued under section 1061 further provided that the exception for corporations does not include a PFIC with respect to which the shareholder has made a QEF election.[20] This exception was included in final regulations, effective for taxable years beginning after August 14, 2020.[21]

The Proposals would amend section 1061(c)(4) to codify the clarification that the corporate exception is limited to C corporations and would apply to tax years beginning after December 31, 2021. Consistent with our Prior 1061 Report, we support this amendment. We recommend consideration be given to when it should be treated as effective and whether a similarly limiting statutory clarification should be provided with respect to PFICs and change made in respect of corporations taxed under the provisions of subchapter M.

[18] Section 199A(d)(2)(B). In other words, though a purpose of proposed section 1061 is to treat allocations in respect of API more similarly to services income, the proposed modification to section 1061(a) would not prevent an API taxpayer from taking a section 199A deduction for an allocation of income in respect of API (e.g., ordinary dividend income from a real estate investment company) even though services income from an investment management business is not eligible for that deduction.

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

[20] Proposed Treas. Reg. § 1.1061-3(b)(2)(ii).

[21] Treas. Reg. § 1.1061-3(b)(2)(ii); Treas. Reg. § 1.1061-3(f)(3).

3. New Holding Period Rules

a) Background

Section 1061 currently recasts long-term capital gain recognized in respect of an API into short-term capital gain by substituting "3 years" for "1 year" in section 1222 when determining the holding period for the assets generating that gain. As noted, section 1061 therefore does not currently generally apply to amounts treated as long-term capital gain without regard to the holding period of the asset generating the gain. In addition, the recast under section 1061 generally is based only on the holding period of the asset generating the gain and not on the holding period of other assets, subject to a limited look-through rule for certain gain on an API.[22]

The Proposals would adopt a different approach to determining the relevance of holding period to the application of section 1061. Instead of looking to the holding period of the asset generating gain to determine the application of section 1061, the Proposals would require that a certain period of time pass after the acquisition of specified assets in order for gain to be protected from recast under section 1061.

More specifically, under the Proposals, all NAPG would be treated as short-term capital gain subject to a "holding period exception." This exception would exclude from NAPG amounts that are realized after the date that is five years after the latest of (i) the date on which the taxpayer acquired substantially all of the API with respect to which the amount is realized, (ii) the date on which the partnership in which the API is held acquired substantially all of its assets and (iii) if the partnership in which the taxpayer holds an API owns other partnerships, the dates determined by applying rules similar to (i) and (ii) in the case of each such other partnership. The five-year period would be modified to a three-year period for (i) taxpayers with a modified adjusted gross income of less than $400,000 and (ii) income with respect to any API that is attributable to a real property trade or business.

b) Discussion

While the scope of the holding period exception is unclear in several respects, in many circumstances it would clearly not cover gain from assets held for longer than five years. We understand that the purpose of excluding some of these gains from the exception is to curtail the use of common tax planning strategies that are intended to avoid the application of section 1061.

One example of such tax planning includes utilizing arrangements, some of which are commonly referred to as "carry waivers,"[23] that provide for special allocations that decrease or eliminate the

[22] Treas. Reg. § 1.1061-1(b)(9).

[23] Special allocation arrangements are typically implemented in either of two forms, which can be illustrated as follows. Assume the commercial arrangement between a general partner ("GP") and limited partners of an investment partnership (or "fund") is that the GP is allocated and distributed 20% of partnership profits and the balance of profits are allocated and distributed pro rata to capital invested. The first type of arrangement (a "Hard Wired Participation") is a provision of the partnership agreement that, in this example, would limit allocations and distributions of gain in respect of carry to the lesser of 20% of partnership profits or 100% of gain not subject to recast under section 1061 (e.g., QDI, section 1231 gain and gain from assets held for longer than three years, collectively "1061 Exempt Gain"). Because all rights are defined at the start of the partnership, the GP's entitlement to more than 20% of 1061 Exempt Gain from an asset by reason of the GP receiving no allocation of non-1061

allocation of gain to an API holder from assets held for three years or less and increase by a commensurate amount the allocation to them of gain from assets held for more than three years. Another example of such tax planning includes utilizing a portfolio company partnership arrangement whereby the partnership structures securities held by it in a manner intended to increase gain from assets that are contributed to the partnership, on a tax-free basis, by taxpayers unrelated to the partnership's direct or indirect API holders and that have a holding period that is longer than three years and to decrease by a commensurate amount gain from assets with a shorter holding period.[24]

It is not clear whether some of the consequences of the Proposals are intended. If they are unintended, we have also suggested for your consideration modifications that would avoid those consequences and, we believe, still curb the tax planning noted above. More importantly, however, regardless of how narrowly Congress decides that the exception should be applied, we would ask that its intended scope be made clear, either in the statutory language enacted or in Congress' directions to the Department of the Treasury (the "Treasury") on how the scope should be defined in regulations.

i. Meaning of "Acquired"

Our first question about the intended scope of the holding period exception relates to what the term "acquired" is intended to mean, for purposes of determining when either substantially all of an API held would be treated as acquired or substantially all of a partnership's assets held would be treated as acquired. The holding period of an asset generally includes the holding period of an asset exchanged for it in a nonrecognition transaction and therefore starts when the tacked period

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Exempt Gain from a different asset does not change the holding period of the GP's API under section 1223. In that sense, the GP has a "floating" interest in the profits of underlying assets, depending on whether they produce 1061 Exempt Gain. Another common type of special allocation arrangement is an "Elective Participation" arrangement, which is implemented on a case-by-case basis only when non-1061 Exempt Gain is recognized. Under an Elective Participation, the GP waives the right to receive distributions from particular assets (and on that basis is not allocated gain with respect to such assets) on or around the time that the gain is recognized and is granted at that time a special profits interest entitling the GP to profits and distributions equal to the amount waived (but limited to the amount of profits that arise after the waiver). Of note, these Elective Participation arrangements pre-date section 1061 and were and are commonly used for non-tax purposes, such as to avoid creating GAAP liabilities where a sponsor clawback is expected. Some arrangements incorporate elements of both forms of special allocation provisions, by tailoring the conditions for making distributions and allocations based on other factors, such as the amount of undrawn investor capital or the holding period of remaining assets.

[24] This planning strategy can be illustrated as follows. Assume that for non-tax reasons the fund wants to acquire, through a new holding company, a corporate target worth $100 and to permit target's existing shareholders to exchange 30% of their interest for interest in the acquirer in a tax-free manner. Assume too that target shareholders have held their stock for longer than three years. To minimize the amount of the fund's gain from assets held for three-years or less (i.e., gain from assets purchased for cash), the fund could structure the acquisition as follows: (i) fund purchases 70% of target for $70, (ii) immediately before or after the purchase, target recapitalizes the purchased shares into preferred stock with a capped upside and value equal to $70 and (iii) fund contributes purchased shares to a new partnership and target shareholders contribute their remaining shares to the same partnership. If target is sold within three years of the acquisition, gain in excess of the preferred stock's capped return would be attributable to a holding period that's longer than three years. (Of course, this strategy does not change the amount of built-in gain allocable to the contributing partner under section 704(c).) We note that the tax benefit available from this tax planning is directionally proportionate to the amount of rolled over assets with a longer holding period.

starts.[25] By contrast, under a literal reading of the holding period exception, assets received in nonrecognition transactions would be treated as having an acquisition date as of the time of actual acquisition rather than the date that their holding period starts.

Investment funds commonly recapitalize their corporate investments, exchanging one type of stock for another on a tax-free basis, and frequently combine their portfolio corporations with other corporations in tax-free exchanges. Similarly, investment funds commonly invest in partnerships that receive assets from third parties in a tax-free contribution. And investment fund managers, which often have several tiers of entities, commonly restructure those entities for various non-tax reasons. Although these transactions would typically result in the holding period of the acquired asset starting at the beginning of the holding period of the asset exchanged (or, in the case of a tax-contribution to a partnership, at the beginning of the contributing partner's holding period), it appears that these transactions would cause the stock or partnership asset received in the tax-free transaction to have a new acquisition date for purposes of the holding period exception. In other words, in the case of many common transactions, a literal reading of the holding period exception would reset the start date of the requisite holding period under the holding period exception without regard to whether other holding period rules would provide for a tacked holding period.

We note that "acquired" for this purpose appears only to cover acquisitions by the API holder[26] of an API and acquisitions of assets by any partnership directly or indirectly held by the API taxpayer. For example, "acquired" appears not to cover an acquisition of an asset (including another corporation or partnership) by a corporation held by a partnership that is directly or indirectly held by an API taxpayer, whether such acquisition is taxable or tax-free.

One possible justification for disregarding tacked holding periods under section 1061 would be that many of these transactions, although tax-free, result in an API taxpayer obtaining economic exposure to either new assets or assets that are meaningfully different from the assets exchanged in the transaction. In other words, perhaps the requisite five-year holding period under section 1061 is intended to key off of when economic exposure begins and to restart when it meaningfully changes. For example, the survivor of a tax-free reorganization of a fund's portfolio corporation might be very economically different than the pre-transaction portfolio corporation. Treating acquisition date (as opposed to the date that the holding period of the relevant asset begins) as the start of the requisite holding period for purposes of the proposed holding period exception would very roughly tie satisfaction of the exception to the period that the API taxpayer has undisturbed economic exposure to the fund's underlying assets.

If the term "acquired" is intended to achieve that purpose, however, we note that it would do so in a highly imperfect manner. It would restart the period by reason of many transactions involving no economic change, and it would not restart the period in the case of many transactions that are economically transformative. Examples of the former include a fund's contribution of assets to a new wholly owned entity, or a transfer of an API to a new entity that does not involve any change in the economic exposure to the transferring API holder with

[25] Section 1223(1).

[26] We use the term "API holder" to refer to any holder of an API, whether it is an API taxpayer or a pass-through entity in which API taxpayers, directly or indirectly, hold an interest.

respect to the API transferred. Both of those types of transactions are commonly done. Examples of the latter include acquisitions by corporations, which could be either tax-free or taxable, that result in the acquirer being in a completely new business and are also commonly done. We recommend that these types of transactions not reset the start of the requisite five-year period when applying the holding period exception.

Perhaps more likely is the possibility that the use of the term "acquired" is intended only to prevent an API taxpayer from using a partnership structure to benefit from another taxpayer's holding period for purposes of satisfying the holding period exception for the API held. Under current law, for example, if a partnership held by a fund acquires in a tax-free transaction from a third-party an asset with a holding period that is longer than three years, any gain attributable to the asset's subsequent appreciation and allocated to the fund would not be subject to recast in the hands of an API holder in the fund, even if the fund acquired the asset within the last three years. By contrast, under the proposed holding period exception, the start of the requisite period for the asset acquired from the third party would be its acquisition date.[27] If the intended consequence of using the term "acquired" is limited to preventing API taxpayers from obtaining a holding period benefit in these types of partnership transactions, restarting the holding period in the case of other common transactions, outside of the partnership context, would be a collateral and unintended cost of preventing API taxpayers from benefiting from another taxpayer's longer holding period for partnership assets.

Provided that the purpose of the term "acquired" is intended only to prevent an API taxpayer from piggybacking off of another taxpayer's holding period for assets contributed to a partnership, we recommend tailoring the exception to simply prevent that result. One possible approach would be to provide simply that, for purposes of section 1061, the holding period for assets contributed to a partnership starts, with respect to a direct or indirect API taxpayer, at the time of contribution to the extent that the API taxpayer's economic exposure to the contributed asset increases as a result of the contribution.[28] For example, under this approach, if an investor contributes appreciated property to a partnership in a carryover basis transaction and an API taxpayer receives a profits interest on the future income and appreciation on the contributed property, even though the property would have a tacked holding period (and the built-in gain would all be allocated back to the contributing partner under section 704(c)), for purposes of applying section 1061 in respect of the API taxpayer on future gain allocated to the holder, the property would be treated as acquired on the contribution date.

If this approach were adopted, its application could be limited so that the holding period reset applies only if and to the extent that the holding period of assets in respect of which an API taxpayer's interest decreased as a result of the contribution is both shorter than the requisite five-

[27] If the use of the term "acquired" is intended primarily to prevent non-contributing direct or indirect API taxpayers from benefiting from the holding period of assets contributed by unrelated partners, we note that the first prong (and when necessary, third prong) of the holding period exception would achieve that aim for transactions in which the API taxpayers acquire directly or indirectly partnership interest contemporaneously with the tax-free contribution of assets with the longer holding period, which in our experience is the type of transaction most commonly involving this tax planning.

[28] If, as a result of our recommendation, a partnership interest has a split holding period for purposes of section 1061, when attributing gain to the portion of such interest with different holding periods, such gain should be treated as recognized in respect of the portion of such interest to which it economically relates.

year holding period and shorter than the holding period of the contributed assets.[29] In other words, if before a third-party contribution of an asset, all the assets of the partnership have a holding period that is longer than five years, then the contribution by third-party partner would not restart the holding period of the contributed assets with respect to the partnership's API taxpayers, provided that the API taxpayers' interests in the contributed asset by reason of the contribution is not greater than the decrease in the API taxpayers' interest in the assets of the partnership by reason of the contribution.[30] In that case, for purposes of applying section 1061 to gain in respect of such API, the partnership's holding period in the new asset would start under the normal holding period rules (i.e., tack with the contributor's holding period).

The rationale for this qualification is that the economic exchange of a portion of the API taxpayer's share of partnership assets for a portion of the contributing partner's assets is effectively a nonrecognition transaction (by reason of the "entity" approach for taxing partnerships) and should thus not restart the API taxpayer's holding period with respect to the assets economically exchanged. This limitation on the No Tacking Rule should not be adopted, however, if Congress intends for the holding period of such contributed asset in respect of the API taxpayer to start when the taxpayer is first economically exposed to the asset and without regard to the taxpayer's holding period in the assets that, by reason of the contribution, are economically exchanged to obtain such exposure.

We suggest that, for other transactions consideration be given to relying on normal holding period rules to apply the scope of the holding period exception except in cases where the transaction results in a sufficient change in economic interest that Congress (or Treasury through the adoption of regulations) believes that no tacking of holding period should be permitted for purposes of section 1061. That approach would minimize unintended consequences of adopting the new holding period exception.[31] If this approach is adopted, we also suggest that it not apply to a No Look-Through Partnership, subject to appropriate regulatory exceptions, since we do not

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[29] For example, suppose an investment fund holds an interest worth $100 in a partnership that has held its assets for three years, and an API holder has a 20% profits interest in the investment fund, which means that 20% of the profits from the underlying partnership are allocated to the API holder. Also suppose an unrelated third party contributes $100 of assets that it has held for six years to the underlying partnership for an interest in the underlying partnership that is identical to the interest held by the investment fund, resulting in the operating partnership having a long-term holding period in the contributed assets. Assume that an API holder's profits interest with respect to the investment fund's interest in the underlying partnership remains unchanged, in the sense that it will continue to receive 20% of the appreciation above the fund's $100 investment. Economically, the contribution resulted in the investment fund exchanging half of its interest in the assets of the underlying partnership for an equal portion of the contributed asset, even though no such exchange is treated as having occurred for tax purposes. If for purposes of section 1061 it is decided that the holding period of the contributed assets in respect of the API holder should not be six year (i.e., the API holder should not fully benefit from the tacked holding period of the contributor), we suggest consideration be given to resetting the start of the holding period for the contributed assets for that purpose to the start of the period applicable to the assets economically exchanged, i.e., three years ago.

[30] Note that this modification to the No Tacking Rule would not limit the ability of the partnership to make special allocations to the API taxpayer of the income and gain from the contributed asset, except to the extent that such allocations are not the result of a decrease in the API taxpayer's interest in the historic assets. In other words, the No Tacking Rule would prevent tacking in respect of the API taxpayer to the extent the API taxpayer's increase in profits interest in the contributed asset was greater than its decrease in profits interest in the historic assets.

[31] If our recommendation for eliminating "substantially all" from section 1061(b)(2)(A) is adopted, we recommend that divided holding period of API be dealt with by providing that, for any gain recognized in respect of any portion of an API attributable to such gain, clause (i) of section 1061(b)(2)(A) be applied based on the holding period for such portion and without regard to any other portion.

believe that a partnership with the characteristics of a No Look-Through Partnership is likely to engage in transactions to manipulate the holding period of its assets for the benefit of an API taxpayer who only indirectly holds an interest in such partnership, and the nature of such partnership would make compliance with the rule impractical. Moreover, a partnership that is a portfolio investment of the fund issuing the API and that is conducting an operating business does not appear to be within the intended scope of section 1061, or stated differently, it should not make a difference for this purpose whether such a portfolio company is organized as a corporation or as a partnership.

If the intended purpose of the term "acquired" is broader, for example, if it is intended to police any indirect material change in economic exposure, we suggest that the benefits of achieving that purpose be reconsidered in light of the challenges of crafting such a rule and its collateral consequences. For example, devising such a rule could require looking through C corporations to test their asset acquisitions. In addition, for the rule to be applied symmetrically and uniformly, it would need to treat transactions (or the portion of transaction) involving no economic change as not "acquisitions" for this purpose. For example, if a portfolio corporation is the target of a tax-free reorganization by an acquirer of equal size, only half of the resulting value should be treated as "acquired" since only half represents an economic change. In any case, if the term "acquired" is retained as the trigger for starting the requisite five-year holding period under section 1061, we ask that consideration be given to at least treating a tax-free transaction involving no economic change as not an acquisition for this purpose.

ii. Scope of Exception's Tiered-Partnership Prong

Under the third prong (i.e., tiered-partnership prong) of the holding period exception, the first two prongs of the exception would apply to each partnership interest held directly or indirectly by the partnership in respect of which the API is held. The date for satisfying this third prong would be the most recent date on which, in the case of any of such underlying partnerships, substantially all of the interest held in such partnership was acquired and such partnership acquired substantially all of its assets. The application of the third prong appears not to be limited to gain recognized in respect of the lower-tier partnership being tested under the prong, since the prong itself makes no reference to the gain being tested.

If the third prong is interpreted in that manner, because these underlying partnership interests would not be looked at in relationship to each other or any other asset, the failure to acquire substantially all of the relevant interest and assets with respect to a single underlying partnership, no matter how small in relationship to any other partnership or other investment held indirectly through the directly held API, would delay the start of the requisite five-year holding period for the entire amount of gain recognized with respect to the directly held API. Under this interpretation, this result would occur even when such underlying partnership interest is unrelated to the gain recognized with respect to such directly held API, and even if all assets held by the direct partnership, including the interest in the underlying partnership interest, and all assets held indirectly through other underlying partnerships, have been held for longer than five years.

Additionally, by requiring in the case of a chain of partnerships that each partnership interest in the chain must be tested separately under clauses (i) and (ii) of section 1061(b)(2)(A) based on

when it was acquired, the third prong would subject to section 1061(a) all gain realized within five years after tax-free internal restructurings of entities conducting a single ATB as well as all assets held by such partnerships. That result does not appear to be appropriate.

We also note that collecting all relevant information, through chains of partnership interests, to determine when the third prong would be satisfied could be administratively burdensome. In our Prior 1061 Report we recommended against adopting broad look-through rules for testing the holding period of an API because we thought such a rule would not be workable, especially given how commonly API holders would lack access to the relevant information from underlying partnerships managed by third parties. Our concern is equally relevant for this proposal.

We understand that providing for this tiered-partnership rule is perhaps also intended to prevent an API holder from benefiting from another taxpayer's holding period in assets contributed by the other taxpayer to a partnership held directly or indirectly by the API holder. Again, we suggest consideration be given to addressing this concern in a more targeted manner, as outlined above.

The utility of the third prong is closely related to whether or how the "substantially all" aspect of the holding period exception is applied. For the reasons discussed below, we recommend that the "substantially all" aspect of the holding period exception be eliminated. We recognize, however, that even if that recommendation is adopted, some look-through of indirectly held partnership interest is appropriate when testing gain from a lower-tier partnership interest, including gain on the sale of partnership interest if the holding period of the partnership is longer than the holding period of the assets underlying the partnership interest.

To address that circumstance, in connection with the elimination of the "substantially all" aspect of the holding period exception, we suggest that the Look-Through Rule be adopted. Under this approach, in the case of gain realized by an API taxpayer in respect of a partnership interest held indirectly by the API taxpayer (i.e., through one or more other partnerships), the holding period requirements contained in clauses (i) and (ii) of section 1061(b)(2)(A) will be applied in a manner that results in the API taxpayer realizing long-term capital gain only if and to the extent the API taxpayer's indirect holding period in the assets to which such gain is attributable is longer than five years.

If this approach is adopted, we suggest that it not apply to No Look-Through Partnerships, subject to appropriate regulatory exceptions.[32] As noted, these partnerships are unlikely to engage in transactions to manipulate the holding period of their assets for the benefit of an API taxpayer, the nature of such partnership would make compliance with the look-through rule impractical, and a partnership that is a portfolio investment of the fund issuing the API and that is conducting an operating business does not appear to be within the intended scope of section 1061. This qualification is especially important to for investment funds that have an investment strategy of investing in other partnerships (so-called "fund of funds").

[32] The exclusion of No Look-Through Partnerships addresses, we believe, the concern we expressed regarding the administrative burdens of adopting a broad look-through rule, provided that the Look-Through Rule is generally limited, as a result of the exclusion of No Look-Through Partnerships, to partnerships that are engaged in the same ATB.

Unless modified as we have recommended, the third prong of the holding period exception would be especially punitive for an API held in fund of funds. Many funds are structured in that manner, particularly for investors unable or unwilling the meet the minimum investment requirements of the underlying investment funds (though these investors typically must meet income or wealth standards under the securities laws).

iii. Ambiguity in the Measure of "Substantially All"

The holding period exception is also unclear in other respects. These ambiguities generally relate to how "substantially all," whether with respect to an API or partnership assets, should be determined. If our recommendation to eliminate the "substantially all" aspect of the holding period exception is not adopted, we suggest the legislative history accompanying these changes include guidance as to what principles should apply when resolving these ambiguities, which would presumably be done in regulations.

Under the first prong of the holding period exception, it is unclear whether (and if so, when) a partnership interest might consist of more than a single API or when all or a portion of an API is treated as acquired. While the holding period exception itself confirms the possibility that a portion of a single API can be acquired separately from other portions, and though the holding period rules for partnership interests contemplate the possibility of separate profits interests for purposes of determining the mixed holding period treatment of a partnership interest,[33] none of the rules under section 1061 addresses when an increase in profit sharing (or in capital) is a constituent part of a preexisting API (and thus not an acquisition), or when the increase is an acquisition of either a portion of an API or an entirely new API.

The first prong of the holding period exception is also unclear in how and when total API and partial API are measured for purposes of determining when substantially all of an API is acquired. As to how the amount of an API acquired should be measured, possible alternatives might be (i) relative profit or capital participation, (ii) fair market value, (iii) the amount that would be received based on a hypothetical liquidation of the partnership based on the fair market value of the partnership's assets, (iv) the capital account balance, as determined under section 704(b), associated with the API or (v) acquisition cost. As to when those amounts should be valued, possible alternatives might be (i) as of the time of the latest acquisition and at the valuation of each partial acquisition at that time, (ii) as of the latest acquisition and at the valuation of each partial acquisition at the time of the relevant gain recognition or (iii) as of each partial acquisition at the valuations at the time of such acquisition and summing them together to obtain the total amount of an API acquired.[34]

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[33] Under the final regulations for determining the holding period of a profits interest, a partner's profits interests in a single partnership can be treated as having been acquired on different dates, resulting in a divided holding period that is determined based on the relative values of each at the time of realization as opposed to the time of acquisition. Treas. Reg. § 1.1223-3(b)(5).

[34] For example suppose that, in exchange for services, an individual is granted in year one a partnership interest in 5% of the profits from asset X with a right to share in 5% of profits in asset Y if the other holders of profits interests in asset Y quit working. At the time of grant, the liquidation value of the profits interest is zero. Now suppose that two years later the other holders quit, causing the individual to be entitled to 5% of the profits in asset Y, at which point the liquidation value of the profits interest in respect of asset X is $100 and in respect of asset Y it is $5. Assume that five years after the first grant, the individual is allocated long-term capital gain of $10 in respect of

Under the second prong of the holding period exception, it is unclear what assets should be included in the "assets held by such partnership" or as of when and how they should be valued when determining when substantially all of such assets are treated as acquired. As to which assets to consider, possible alternatives are (i) only assets held at the time that the gain with respect to the API is recognized[35] or (ii) all assets ever held by the partnership, which we view as the less natural reading of the two, since it would allow the possibility for the holding period exception to be met without any asset being held for longer than five years. On the question of what asset valuation should be used, the possibilities are: (i) the asset values at the time of the latest acquisition, (ii) the asset values at the time of the gain recognized, either by the API holder or the partnership, or (iii) the acquisition cost of each asset and summing those together to obtain the total amount of assets acquired.

When applying the second prong, we assume that the amount of capital that investors have committed to a partnership is irrelevant when determining when the partnership acquired substantially all of its assets. We also assume no categories of assets are excluded from this measure, such as cash (which would be treated as acquired when it is acquired, if the concept of "acquired" is retained, and would have no holding period, if the "holding period" concept is adopted), and that the amount of unrealized gain is irrelevant to the measure. If these assumptions are incorrect, we ask that they be clarified.

iv. Collateral Consequences of the Substantially All Requirement and Alternative Approaches

We believe that it is important to recognize that, if our recommendations for modifying the holding period exception are not adopted (or if only our recommendation for the how "acquired" should be interpreted is adopted), for APIs in the vast majority of investment funds, it is likely that the holding period exception would not be met for any gain until the end of the partnership's life, after the sale of its last few assets, even when all of its assets are held for longer than five years. That is because investment partnerships typically acquire assets at different times (and over time) and tend to hold their assets for overlapping periods. In other words, at any given point in time, before a typical fund has sold all but its last few assets, it would not have acquired substantially all of its assets longer ago than five years from when the gain on any asset would have been recognized, even if all gain is from only assets held for longer than five years. For evergreen funds, such as hedge funds, which typically reinvest realized investments, the holding

asset X and $10 in respect of asset Y, when the liquidation value of the interest in respect of asset X is $1000 and in respect of asset Y it is $10. It is unclear whether the $20 is recognized in respect of (i) one API all of which was acquired in year one, (ii) one API partially acquired in year one and partially in year three or (iii) two separate APIs acquired in years one and three. If there were two partial acquisitions of an API, it is unclear whether the first prong is satisfied for the entire $20 because substantially all the value of the API is attributable to the first acquisition at the time the gain is recognized or whether the first prong is not satisfied because the second partial acquisition represented a substantial portion of either profits or value at the time of acquisition. If there were two separate acquisitions of an API, $10 would be protected under the first prong of the holding company exception and $10 would fail to satisfy it.

[35] We note that, for partnership level gain, this answer raises the further question of whether the applicable measurement time is when the gain is allocated at the end of the partnership's tax year or when the partnership recognizes the gain.

period exception would likely never be met regardless of how long the assets are held because the funds tend to continuously buy assets.

It is not clear to us whether this consequence of the exception's scope is intended. The consequence results entirely from the exception requiring that a holding period test be met not in respect of the asset generating the gain but instead in respect of "substantially all" of the relevant API and partnership assets.[36] We understand that this "substantially all" aspect of the exception was included in the exception to curtail the use of special allocation arrangements that have the result of effectively avoiding recharacterization of income under section 1061.

If this consequence of the exception is not intended, except insofar as it discourages special allocation arrangements, we suggest consideration be given to eliminating the "substantially all" aspect of the holding period exception (i.e., look at only the holding period of the API and underlying asset generating the gain, if gain is not on the API)[37] and use a more tailored approach to curtail the use of special allocation arrangements. As part of this more tailored approach, for purposes of determining the relevant holding period of the API, we suggest that if portions of an API were acquired at different times and represent interests in different direct or indirect assets of the partnership, clause (i) of section 1061(b)(2)(A) should be applied to gain recognized in respect of an asset by reference to the holding period of the portion of API related to that asset.[38]

At their core, the special allocation arrangements operate to reduce or eliminate an API holder's economic profit participation in non-1061 Exempt Gain and increase the holder's participation by a corresponding amount in 1061 Exempt Gain (capped at the amount of available 1061 Exempt Gain).[39] In other words, the amount of an API holder's participation in 1061 Exempt Gain is determined in part by reference to what the holder's participation in non-1061 Exempt Gain would have been if it were 1061 Exempt Gain. The arrangement thus in effect shifts the

[36] We recognize that the substantially all aspect of the holding period exception also allows for the possibility that gain on assets with a holding period longer than a year and five years or less could avoid recast under section 1061, but this aspect of the rule would not change the result outlined above for funds with meaningful holding period overlap among investments.

[37] A simple formulation of this approach might be to except from NAPG gain in respect of an API if (i) the portion of the API in respect of which the gain is allocated satisfies the requisite holding period and (ii) the underlying asset generating the gain satisfies the requisite holding period. For example, if gain is allocated from an asset with a five-year holding period with respect to an API that under the normal holding period rules (as modified with respect to carry waivers to discussed below) has a five-year holding period with respect to only a portion of its fair market value at the time of the allocation, then under our recommendation, the holding period exception would apply only for the gain allocated with respect to the portion of the API with the five-year holding period.

[38] For example, if an individual is granted an API in respect of partnership asset A in one year and is granted an additional API in respect of partnership asset B in a later year, gain from the sale of asset A would be tested under clause (i) of section 1061(b)(2) based on only the period that the first portion of the API is held and without regard to the holding period of the second portion. This modification should apply to both APIs that are profits interests described in Treas. Reg. § 1.1223-3(b)(5) and APIs that are capital interests described in Treas. Reg. § 1.1223-3(b)(1). The application of this concept in respect of partnership interests that are not APIs is beyond the scope of this Report.

[39] These waiver arrangements are designed in a manner intended to satisfy the substantiality standard contained in regulations under section 704(b).

character of gain that the API holder would otherwise recognize from non-1061 Exempt Gain to 1061 Exempt Gain.

We believe that a more straight-forward way to prevent that this type of character shifting would be to override the holding period rules for the asset generating the 1061 Exempt Gain to the extent that the amount of the 1061 Exempt Gain allocated in respect of an API is determined by reference to the amount of non-1061 Exempt Gain that would have been allocated in respect of the API had it been 1061 Exempt Gain. More specifically, this new rule would require that, for purposes of the holding period exception, if the amount of gain allocated in respect of an API is determined for purposes of section 704(b) in whole or part by reference to the amount of gain recognized on an asset other than the asset generating the gain being allocated, the holding period used for determining the character of such gain so allocated, to the extent the amount of such gain allocated is determined by reference to the gain on the other asset, would be the shorter of the holding period of the asset generating the gain or the holding period of the asset in respect of which the amount of allocated gain is determined (and as of the time such other gain was recognized).[40] The holding period for the API could similarly be based on the holding period of the API at the time such other gain was recognized.

In our view, this alternative approach to curbing special allocation arrangements would be more effective than relying on the "substantially all" aspect of the holding period exception to achieve that aim. Notwithstanding the scope of the holding period exception as currently proposed, the exception would not in fact limit the ability of taxpayers to utilize special allocation arrangements to tie their economic rights in a partnership to only gains not subject to section 1061 recast. The holding period exception, as proposed, would blunt this incentive only to the extent that its application would result in a large enough portion of funds' expected gain being likely ineligible for the exception so that API holders would be unwilling to take on the commercial risk of receiving less than the amount of carry they would have absent the waiver arrangement.[41] In other words, we do not believe the "substantially all" aspect of the proposed holding period exception is an effective means of curbing special allocation arrangements, though we recognize that for most investment funds it likely makes such arrangements irrelevant by making the exception unavailable except in very limited circumstances.

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[40] Note that this rule would not apply to disproportionate allocations that are made to one partner by reason of the amount of allocations made to another partner, if the amount of such allocations are not measured by reference to the gain recognized on an asset other than the asset generating the gain being allocated. An example of this type of allocation, which would not be affected by the rule, is a so-called "catch up" allocation that is commonly made to an API holder such that, after the allocation, the holder will have been allocated an amount that is measured by reference to the amount allocated to other investors.

[41] More specifically, because waiver arrangements that are structured as Hard Wired Participations would not result in additional acquisitions of APIs under the current Proposals, gain with respect to these arrangements would satisfy the first prong after five years. For the gain to satisfy the second and third prongs, the Floating Participation could be drafted to allocate and distribute to API holders only gain after those prongs are satisfied. Provided the amount of such gain, likely from only the fund's last few assets, is sufficient to make up for the foregone gain from the assets previously sold, gain from these Floating Participations would completely avoid section 1061, without reducing the amount of carry that would have been received in its absence. If utilized, the Elective Participation would be structured similarly, the only difference being that affirmative waivers would trigger new acquisitions of APIs, delaying the satisfaction of the first prong, which would be a deterrent to using Elective Participations when that delay would extend beyond when the second prong of the exception would be expected to be met.

If this approach is adopted, we suggest that it not apply to No Look-Through Partnerships, subject to appropriate regulatory exceptions. As noted, they are unlikely to engage in transactions to manipulate the holding period of their assets for the benefit of an API taxpayer, and the nature of such partnership would make compliance with the look-through rule impractical.

We also understand that the proposed changes to section 1061 are motivated by a concern that distributions in kind are being used to avoid the provision's applicability, mostly by means of character shifting transactions similar to the intended effect of carry waivers.[42] However, the proposed changes to section 1061 do not explicitly address how or whether the holding period exception would apply to gain on property distributed in kind with respect to an API. By directing Treasury to issue regulations to prevent the distributions in kind from being used to avoid the purpose of section 1061, the proposed changes suggest there are circumstances absent the regulations in which gain from the distributed assets could qualify for the holding period exception (or otherwise avoid the application of section 1061), but how the three prongs of the exception would apply is not obvious or intuitive.[43]

We suggest that, consistent with the current law treatment of distributions in kind, the holding period exception be clarified to provide that property distributed in respect of an API to an API taxpayer would not meet the exception until the distributed property is treated as held for five years and for this purpose its holding period would start on the later of (i) the start of the holding period for such property in the hands of the distributing partnership, as determined with respect to the API taxpayer, immediately before the distribution or (ii) the start of the holding period for the various portions of the API in respect of which the property is distributed. In addition, this rule would require that, if as a result of a distribution of property in kind with respect to an API, the value of the property received by the holder exceeds the holder's share of such property before the distribution, such excess portion of the distributed property will have a holding period (or mixed holding period) that is determined in a manner consistent with the No Tacking Rule with respect to such property immediately before the distribution.[44] Inversely, the rule would also provide that, if an API holder's indirect interest in a partnership asset is reduced by reason

[42] Under current law, distributions of property with respect to an API retain their holding period and gain from them is subject to recast under section 1061 only if property's holding period is three years or less when the gain is recognized. This rule presents a variety of tax planning opportunities, the essence of which can be illustrated as follows. Assume that an investment partnership with the same commercial terms as in footnote 23 has two assets, each purchased for $50, one with a one-year holding period that appreciates by $10 and the other with a four-year holding period that appreciates by $5, entitling the GP to a total of $3 of value. To avoid 1061 recast on its share of gain from asset one, before the partnership sells asset one, the GP could be distributed its $2 share of asset one in-kind and hold it for two more years, after which time gain from asset one would no long be subject to recast under section 1061. Alternatively, the partnership could distribute both assets to its partners, but distribute $3 from asset two to the GP and the balance of its assets to the limited partners, allowing the GP to immediately sell asset two without subjecting the gain to recast under the section 1061.

[43] For example, if the holding period exception is adopted, it is unclear whether gain on the distributed property, if distributed before the three prongs of the exception are met, would meet the exception only if the both the distributed asset satisfies a five-year holding period and the three prongs are met with respect to any retained API or whether the three prongs are irrelevant if at the time the gain is recognized no API is then held.

[44] In other words, depending on which version of the No Tacking Rule that is adopted, the holding period of the distributed property in the hands of the API taxpayer, to the extent of such excess portion, either would be reset to start on the distribution date or would be the shorter of the holding period of the asset distributed or the partnership's holding period of the assets in respect of which the holder's interest decreased as a result of the distribution.

of a distribution of that asset and as a result of the distribution the holder's indirect interest in another asset with a longer holding period than the period of the distributed asset is increased, the holding period with respect to the API holder in the assets in respect of which the holder's indirect interest increased, to the extent of such increase, would be determined consistent with the No Tacking Rule.[45] We recommend, however, that these modifications not apply to No Look-Through Partnerships for the reasons noted, subject to appropriate regulatory exceptions.

Whether or not this holding period override rule is adopted, if any change to the current section 1061 holding period requirement is adopted, we ask that the changed rule be drafted so as to make clear how it would apply to gain from property distributed in respect of an API when that gain is recognized after the distribution. We also suggest that consideration be given to whether a different rule for such gain should apply based on whether the distribution occurred prior to or after the effective date of such change to section 1061 (e.g., in the case of distributions prior to the effective date, whether the new or old holding period rules should apply to determine the character of such gain), assuming that such distributions are not treated as "transfers" of APIs under the proposed changes to section 1061(d), for the reasons discussed below.

We have no comment on the proposed three-year holding period exception for taxpayers with modified adjusted gross income of less than $400,000 but note that it would not protect those taxpayers from an increase in taxes. That is because the proposed three-year holding period exception applicable to these taxpayers would impose a longer holding period requirement than applies under current law, since the three-year holding period for these taxpayers would start when the five-year period starts for other taxpayers, and determining that start date suffers from the all the ambiguities outlined above.

4. Required Gain Recognition on Transfers of APIs

Section 1061(d) currently provides that, if a taxpayer transfers an API directly or indirectly to a related person, the taxpayer must include in gross income as short-term capital gain the excess, if any, of (i) so much of the taxpayer's long-term gain with respect to such interest attributable to the sale or exchange of any asset held for not more than three years as is allocable to such interest over (ii) the amount otherwise treated as short-term gain with respect to such transfer under section 1061. As discussed in our Prior 1061 Report, neither the purpose nor scope of this statutory provision is clear. The final regulations under section 1061 generally limit its application to transfers treated as sales or exchanges in which gain is recognized. Very generally, it thus currently operates to recast as short-term any gain otherwise treated as long-term to the extent that gain from assets held for three years or less would have been allocated in respect of the transferred API if the partnership sold its assets for fair market value.

[45] Again, depending on which version of the No Tacking Rule that is adopted, the holding period with respect to API holder's indirect interest in the remaining partnership assets, to the extent of the increase in such indirect interest as a result of the distribution, either would be reset to start on the distribution date or would be the shorter of the holding period of the asset distributed or the holding period of the assets in respect of which the holder's indirect interest increased as a result of the distribution.

The Proposals would amend section 1061(d) to provide that, if a taxpayer transfers any API, gain is recognized notwithstanding any other provision. However, the purpose and intended scope of this provision is also unclear.

First, the provision appears to trigger gain without regard to whether the holding period exception would apply to protect the gain from being recast as short-term. In other words, the holding period exception appears not to protect API holders from gain acceleration on transfers of their API. We assume that this is an oversight, since whatever tax policy justifies protecting gain from section 1061 recast under the holding period exception should also protect such gain from being accelerated by reason of a transfer of the API in respect of which it would be recognized under proposed section 1061(d).[46]

Second, while unstated in the Reports accompanying the Proposals, we infer that the purpose of the proposed change to section 1061(d) might be to treat APIs similarly to how the assignment of income doctrine taxes services income that is legally transferred to another taxpayer. In short, the changes may be intended to ensure that a transfer of an API does not shift its taxation to a different taxpayer or change its character.

If this is the intention, we recommend modifying the provision so that it accelerates gain recognition only if and to the extent that the transfer would result in a reduction in the amount of gain recognized or recharacterized under section 1061 in the hands of the transferring API holder. For example, if an API is transferred in an otherwise nonrecognition transaction and the transferor's tax position with respect to the API is unchanged, perhaps because the transferee is a wholly owned S corporation, triggering gain seems inappropriate. If an API is exchanged for an API of equal value in a transaction that otherwise qualified for nonrecognition, we also question whether the transfer should accelerate the recognition of gain. If the concern is that the new API might be closer to satisfying the holding period exception by reason of the holding period of assets held indirectly through the new API, consideration should be given to requiring the API holder to either recognize the gain on the transfer or reset the start dates of the relevant holding periods of the new API to match those of the exchanged API.[47]

We note that, as drafted, the proposed changes to section 1061(d) would clearly cover any transaction treated as a sale or exchange (whether or not otherwise tax-free), and it would also seem to cover a gift or charitable contribution, and perhaps a transfer by reason of death (though query whether before or after the basis step up resulting from death). It is less clear whether it would cover a transaction disregarded for income tax purposes, such as a transfer to a grantor trust or other type of disregarded entity by its sole owner, or a transfer to a spouse. It would seem to exclude intentionally a transaction not legally treated as transfer but that has the economic effect of a transfer, such as the dilution or accretion that results from an issuance or redemptions of an API, since the Proposals would remove the existing statutory inclusion of "indirect" transfers. For example, we believe that applying the Proposals to partnership

[46] S.Con.Res.14—117th Congress (2021-2022) § 138149(c).

[47] We acknowledge that this rule would not prevent an API holder from exchanging tax-free an API that the holder would otherwise sell before the holding period exception is satisfied for other APIs that the holder intends to retain until after the holding period exception is satisfied, though if our suggested changes with respect to the term "acquired" are not adopted, the exchange would restart the holding period for the new API.

distributions of property (not an API) with respect to an API would be an unnatural reading.[48] If the Proposals were intended to apply to such cases, the Proposals should be clarified.

In our experience, transfers of APIs are not typically motivated by the avoidance of section 1061, since an API transferred in nonrecognition transactions retains its character as an API in the hands of the transferee, unless an exception to API treatment applies. For this reason, a majority of us recommend that proposed section 1061(d) be revised so that it does not trigger gain in a transaction otherwise qualifying for nonrecognition if the transferred API retains its character as API, though a significant minority of us recommend that gain be triggered in that case, unless the transferor would continue to recognize gain on the API when the gain is ultimately recognized.

In the cases of tax-free transfers in which an API does not retain its character as an API in the hands of the transferee, for example, when the transferee is a C corporation or tax-exempt entity, the transfer generally does not result in a net reduction of taxes. The gain subsequently recognized by a taxable corporate transferee would be subject to two-tiers of tax (subject to the corporation being able to shelter the gain with losses).[49] To the extent that gain from an API would not fit within the holding period exception, the charitable deduction for transfers to tax-exempt entities would be limited to the basis of the API.[50] While in those transactions the API holder would never recognize the income, as would be required under the assignment of income doctrine, such transfers are generally not made to reduce the amount of taxes paid. Moreover, when deciding whether these transfers should trigger gain, it is perhaps worth considering the tax policies that would otherwise encourage charitable contributions and the incorporation of appreciated assets.

A majority of us believe, nonetheless, that assuming that proposed section 1061(d) reflects Congress' judgment that an API should be treated as compensation income,[51] that principle should outweigh those arguments and that gain should be triggered in transactions in which the transferred API does not retain its character as API. A significant minority of us disagree and believe that these transactions should not trigger gain.

However, as noted above, we do not have confidence in our understanding of the policies motivating proposed section 1061(d). The divergence of views among our members described above reflects, we believe, our lack of consensus about those policies as well as divergent opinions on the relevance of other considerations.

Finally, if the proposed changes to section 1061 are retained, we note without comment that taxpayers earning less than $400,000 of modified adjusted gross income would not be exempt

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[48] This interpretation is also supported by the reference to "distributions of property" in proposed section 1061(e)(1), which implies that, absent regulations, distributions of property in respect of an API would not be treated as a transfer of an API for purposes of proposed section 1061(d), since no regulations would be needed for such distributions if they triggered gain under proposed section 1061(d).

[49] Under our recommendations, this would not be the case where the transferee is a corporation taxed under subchapter M.

[50] We acknowledge that the rule that limits the deduction to cost basis would not preclude a contribution of an API from avoiding the caps on charitable deductions based on the contributor's adjusted gross income, unless the gain is required to be recognized.

[51] We note that there is arguably a tension with sections 1061(a) and (b), which do not tax an API as ordinary income but instead treat it as short-term capital gain unless the holding period exception applies.

from the acceleration rule. They would recognize gain on transfers of an API just like other taxpayers.

5. Other Considerations

We also suggest that consideration be given to modifying two aspects of current section 1061 that, in our view, result in current section 1061 applying materially beyond what we understand to be its intended scope. We have raised this concern in this Report because the proposed changes to section 1061 would magnify the consequences of that unintended result.

a) Clarification of Capital Interest Exception

The final regulations under section 1061 interpret narrowly the scope of the capital interest exception to API treatment. As a result, there are many circumstances in which gain attributable solely to capital invested by holders of APIs is recharacterized under section 1061.

Under these regulations, for a partnership interest to be exempted from treatment as an API under the capital interest exception, the interest must be in a partnership that has material unrelated third-party investors or is directly or indirectly invested in a partnership with such investors. It is common, however, for investment professionals to pool their capital in partnerships that invest side-by-side with (rather than in) their investment funds (or invest in other assets unrelated to their funds) and to participate in the profits and losses from these investments generally pro rata to capital invested, just as would a third-party investor share in those profits and losses. Nevertheless, because these arrangements lack third-party capital, section 1061 currently treats these partnership interests as APIs and subject to recharacterization unless the requisite holding period is met. This result seems contrary to the purpose of section 1061.

Avoiding this result would require simply that the capital interest exception be clarified to apply to allocations made by partnerships without third-party investors if those allocations are made commensurate with capital. The final regulations already take this approach in the tiered partnership context (provided the lower-tier partnership has third-party investors) by treating as a "capital interest allocation" the allocation of a "capital interest allocation" from a lower tier partnership if it is "properly allocated to the upper-tier partnership's partners with respect to their capital interests in a manner that is respected under 704(b) (taking into account the principles of section 704(c))." In other words, allocations of lower-tier gain that qualifies for the capital interest exception can also qualify for the exception when allocated by the upper-tier partnership whether or not the upper-tier partnership has third-party capital, so long as the upper-tier allocation is respected under section 704(b) (taking into account the principles of section 704(c)) and is made in respect of capital interests in the upper-tier partnership. We do not believe that extending this relief to allocations made in the prescribed manner by stand alone partnerships would present greater opportunities for tax avoidance than does the current tiered-partnership rule.

b) Tax Parity for Taxation of Goodwill and Enterprise Value

The final regulations under section 1061 do not protect from recharacterization gain attributable to the goodwill or enterprise value of an investment management business.[52] As a result, such goodwill and enterprise value would be taxed less favorably than gain from goodwill and enterprise value of other types of service businesses. Section 1061(b) authorizes regulations to be issued that could treat this goodwill similarly to that of other services businesses, and in our Prior 1061 Report we recommended that such regulations be issued. However, to date, Treasury has not done so.

In light of the potential breath of the proposed changes to section 1061 and the consequent expansion of the provision's applicability, we believe that affirmative statutory protection for gain attributable to this goodwill and enterprise value should be considered. As noted, the narrowness of the proposed holding period exception would provide little protection from gain being recast under section 1061, and (if not modified as recommended in this Report) the gain acceleration rule contained in proposed section 1061(d) [53] would apply to many common transfers of partnership interests that have no relationship to carry or profits interests in an investment partnership. Therefore, consistent with our Prior 1061 Report, and consistent with the principle of tax parity underlying the purpose of section 1061, we suggest that consideration be given to modifying section 1061 (effective as of the original effective date of that provision) so that gain attributable to goodwill and enterprise value from an investment management business will be taxed in the same manner as gain attributable to goodwill and enterprise value from other types of service business (subject to a regulatory override to prevent tax avoidance).

III. Selected Other Proposals Related to the Taxation of Partnerships and their Partners

A. Application of Section 163(j) Interest Limitations at Partner Level

Section 163(j) generally limits a taxpayer's deduction of net business interest expense to 30% of its adjusted taxable income. In the case of partnerships and S corporation, current law applies this limitation at the entity level, rather than the partner or shareholder level, and permits excess net business interest expense to be carried forward indefinitely. The Proposals would amend section 163(j)(4) to apply the limitation at the partner or S corporation shareholder level and limit the carryover period to five years, effective for interest that is paid or accrued in a taxable year beginning after December 31, 2021.

Consistent with our recommendations in a prior report,[54] we support the Proposals' proposed application of the section 163(j) limitation at the partner or S corporation shareholder level, rather than the entity level. This change would dramatically simplify the application of the limitation.

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[52] The preamble to these regulations states that Treasury and the Internal Revenue Service continue to study whether section 1061(a) applies to recharacterize gain attributable to enterprise value. The capital interest exception would rarely protect the value of an API that is attributable to goodwill and enterprise value.

[53] S.Con.Res.14—117th Congress (2021-2022) § 138149(c).

[54] New York State Bar Association Tax Section, Report No. 1412, *Report of Proposed Section 163(j) Regulations* (Feb. 26, 2019).

B. Temporary Tax-Free Conversion of Certain S Corporations into Partnerships

Under current law, an S corporation's conversion to a partnership is treated as a liquidation of the corporation under section 331 followed by a transfer of the assets by the corporation's shareholders to the partnership. As a result, the conversion (treated as a liquidation) results in each shareholder recognizing taxable gain or loss on its shares, as well as the S corporation recognizing gain (or loss) under section 336(a) on its appreciated (or depreciated) assets (which is then taken into account by its shareholders in their taxable income). The S corporation also pays a "section 1374 tax" on any built-in gain in assets acquired in the prior five years from a C corporation pursuant to a conversion, merger, or other carryover basis transaction (any such gain, "section 1374 built-in gain", and any such carryover basis assets, regardless of when the carryover basis transaction occurred, "C corporation carryover basis assets").

The Proposals would allow an "eligible S corporation" to elect to treat a "qualified liquidation" in the same manner as if the liquidation were governed by section 332(b) and the partnership to which its assets are transferred were a corporation that is a distributee within the meaning of section 337(c). As a result, the qualified liquidation is tax-free for the eligible S corporation and its shareholders under sections 337(a) and 332(a), respectively, and the partnership has a carryover tax basis in the former S corporation's assets under section 334(b).[55] There is little precedent for such treatment and therefore guidance about how it should operate is lacking. Accordingly, our comments below are not intended to be comprehensive, but rather are only intended to address certain aspects of the qualified liquidation rule.

An eligible S corporation is any corporation (including any predecessor) that was an S corporation on May 13, 1996 (the "cut-off date") and at all times thereafter through the completion of the qualified liquidation. A qualified liquidation is one or more transactions occurring in 2022 or 2023 if they result in (i) the S corporation's complete liquidation and (ii) the transfer of substantially all the assets and liabilities of the S corporation to a domestic partnership. The domestic partnership after the qualified liquidation is generally not permitted to make a subchapter S election for five taxable years under section 1362(g).

The qualified liquidation rule, which is a non-Code provision, provides that its terms that are also used in the Code have the same meaning as when used in the Code. Numerous Code provisions use the term "predecessor," and it is not clear which definition should be used for the qualified liquidation rule. For comparison, section 1374(c)(1) uses the term "predecessor" that is broadly defined in Treasury Regulation section 1.1374-1(e) as follows: "For purposes of section 1374(c)(1), if the basis of an asset of the S corporation is determined (in whole or in part) by reference to the basis of the asset (or any other property) in the hands of another corporation, the other corporation is a predecessor corporation of the S corporation" (the "Sub S definition").

The impact of applying the Sub S definition in the context of the qualified liquidation rule can be illustrated by the following examples:

> Example 1: A C corporation converts into an S corporation in 1995 in a transaction in which the S corporation takes a carryover basis in the C corporation's assets. The S

[55] Presumably tax-free treatment does not apply to a qualified liquidation of an eligible S corporation that is insolvent. Cf. Rev. Rul. 2003-125, 2003-2 C.B. 1243.

corporation still has some of those assets on September 13, 2021. The S corporation is an eligible S corporation under the Sub S definition because, although the C corporation is a predecessor of the S corporation, the corporation has been an S corporation since the cut-off date.

Example 2: An S corporation was formed in 1993. In 1995, the S corporation acquires a small C corporation by merger in a carryover basis transaction, and the S corporation still owns some of the former C corporation's assets on September 13, 2021. The S corporation is an eligible S corporation for the reasons set forth above.

Example 3: An S corporation was formed in 1993. In 1998, the S corporation acquires a small C corporation by merger in a carryover basis transaction, and the S corporation still owns some of the former C corporation's assets on September 13, 2021. The S corporation is not an eligible S corporation, because the former C corporation is a predecessor that has not been an S corporation since the cut-off date.

Example 4: A small S corporation ("Minnow Corp.") was formed in 1995. A large S corporation ("Whale Corp.") was formed in 2015 and would not otherwise qualify as an eligible Sub S corporation. Whale Corp. merges into Minnow Corp. in 2020 (or 2022), with Minnow Corp. as the surviving entity. Minnow Corp. is not an eligible S corporation because Whale Corp. was not an S corporation on the cut-off date.

In other words, so long as the S corporation or its predecessors were S corporations at all times after the cut-off date and have no had no tax-free acquisition of non-pedigreed assets (any C corporation carryover basis assets or non-pedigreed S corporation carryover basis assets) since the cut-off date, the S corporation is an eligible S corporation under the Sub S definition. It should be noted that the cut-off date is more than a quarter century ago. For comparison, prior Congressional proposals permitted tax-free liquidations by S corporations as long as they were formed more than around 10 years before the legislation's effective date,[56] which coincided with the section 1374 built-in gains recognition period at the time of 10 years (now shortened to five years).

If the Sub S definition is the intended definition of predecessor, then the impact of the predecessor rule is fairly clear, and the Proposal would seemingly not permit an S corporation to convert to a partnership while avoiding any section 1374 tax.[57] However, House Report 117-130, at 1351, notes the following: "An eligible S corporation does not, however, include an S corporation that, during the period beginning on September 13, 2021, and ending with the date the qualified liquidation is completed holds, acquires or transfers any asset for which the S corporation's basis is determined (in whole or part) by reference to the basis of such asset (or other property) in the hands of a C corporation. Thus, for example, if there is a merger or other transaction between a C corporation and an otherwise eligible S corporation that results in the S corporation holding carryover-basis property of the C corporation, then the S corporation is not

[56] See S. 1904, introduced in the Senate in 1999 by Senators Craig Thomas and Michael B. Enzi; H.R. 3851, introduced in the House of Representatives in 2000 by Representative Barbara Cubin; and H.R. 2337, introduced in the House of Representatives in 2001 by Representatives Barbara Cubin and Scott McInnis.

[57] We assume that the phrase "any corporation (including any predecessor)" means all such corporations rather than any one of such corporations.

treated as an eligible S corporation under this provision." In a footnote to this statement (the "C Corp Rule"), the report states, "A technical correction may be necessary to reflect this intent." It is not clear how if at all the C Corp Rule is intended to interact with the definition of predecessor.

The intent of the C Corp Rule appears to be to address the potential for avoidance of section 1374 tax, but, as discussed above, if the Sub S definition of predecessor was intended, then there would be no section 1374 tax avoided. As such, the House Report suggests that the Sub S definition was not sufficient and perhaps the C Corp Rule is a supplemental overlay. In that case, the application of the C Corp Rule would appear to be limited to transactions which occurred prior to the cut-off date. For example, the C Corp Rule would reverse the results in Examples 1 and 2 above:

> Example 1A: A C corporation converts into an S corporation in 1995 in a transaction in which the S corporation takes a carryover basis in the C corporation's assets. The S corporation still has some of those assets on September 13, 2021. The S corporation is not an eligible S corporation due to the C Corp Rule because it owns C corporation carryover basis assets.
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> Example 2A: An S corporation was formed in 1993. In 1995, the S corporation acquires a small C corporation by merger in a carryover basis transaction, and the S corporation still owns some of the former C corporation's assets on September 13, 2021. The S corporation is not an eligible S corporation due to the C Corp Rule.

These results would occur because as described in the House Report, there does not appear to be any time limit on when the C corporation carryover basis assets were acquired by an S corporation and subject to the C Corp Rule. In Example 3, even if the S corporation were otherwise an eligible S corporation under the applicable predecessor rule, the S corporation cannot become an eligible S corporation under the C Corp Rule by selling all of its carryover basis assets on or after September 13, 2021 in fully taxable transactions.

The House Report does not state, however, that the scope and purpose of the C Corp Rule is limited to transactions before the cut-off date and in fact specifically excludes "an S corporation that, during the period beginning on September 13, 2021, and ending with the date the qualified liquidation is completed holds, acquires or transfers any asset for which the S corporation's basis is determined (in whole or part) by reference to the basis of such asset (or other property) in the hands of a C corporation" (emphasis added). If the Sub S definition were intended, the underscored language would be unnecessary. This could imply that the Sub S definition was not intended to be used for the definition of 'predecessor,' and that some other definition was intended.

If it is correct that the Sub S definition is not applicable and the C Corp rule is intended to serve some purpose other than as a supplement to the Sub S definition, it could affect the results in the above examples. In Examples 1A and 2A, the S corporation would still be an eligible S corporation if the S corporation had sold all of its C corporation carryover basis assets before September 13, 2021. In Example 4, Minnow Corp. may be an eligible S corporation under this interpretation because it is an S corporation on May 13, 1996 and at all times thereafter, even if

some or most of its assets are acquired in a carryover basis transaction from an ineligible S corporation, and even if they were acquired after September 13, 2021. Guidance is needed as to whether the definition of 'predecessor' is intended to use the Sub S definition or another definition, how the C Corp Rule should be interpreted, and how the two rules should interact.

Regardless of the proper interpretation of the predecessor rule and the C Corp Rule, as presently drafted, an S corporation can be disqualified as an eligible S corporation for owning any amount of C corporation carryover basis assets, and even if the section 1374 built-in gains recognition period expired long ago. The S corporation is worse off than if it had sold all of its C corporation carryover basis assets in fully taxable transactions before the cut-off date, or if it had always held the C corporation carryover basis assets in a subsidiary C corporation instead. If this result was not intended, Congress might consider, for example, providing that an S corporation is an eligible S corporation as long as the S corporation pays any applicable section 1374 tax on its C corporation carryover basis assets as of the date of the completion of the qualified liquidation (without regard to any taxable income limitations in section 1374(d)(2)) or has sold all of its C corporation carryover basis assets as of such date.

In addition, an S corporation may have C corporation accumulated earnings and profits ("E&P"). As we read the relevant proposed provisions, the existence of such accumulated E&P does not prevent the S corporation from being an eligible S corporation or engaging in a qualified liquidation. If this result was intended, Congress might nonetheless wish to consider whether the S corporation should be required to distribute its accumulated E&P as taxable dividends to its shareholders before the completion of the qualified liquidation. If so, the S corporation might be permitted to make an election to be deemed to distribute its accumulated E&P to its shareholders, similar to a combined section 565 consent dividend election and section 1368(e)(3) election. Moreover, if the C corporation carryover basis rules are adjusted to require recognition of gain with respect to any section 1374 built-in gain in the assets rather than disqualifying the S corporation from making a qualified liquidation, the accumulated E&P might be adjusted to include the after-tax section 1374 built-in gain that is recognized upon the completion of the qualified liquidation.[58]

We note that, because a qualified liquidation requires that the transferee entity be a domestic partnership, which would require two or more partners, it appears that, to participate in a qualified liquidation, an eligible S corporation otherwise wholly owned by a single shareholder must change its ownership, either by introducing a new shareholder or transferring its assets to a new or existing domestic partnership with at least one partner in addition to the shareholder. We question whether this result was intended.

Lastly, an S corporation may have accumulated post-1986 deferred foreign income under section 965 from its controlled foreign corporation subsidiaries in 2017 or 2018. Section 965(i) permits the S corporation's shareholders to elect to defer their section 965(i) tax liability until the

[58] Although there may not be an existing statutory provision addressing this outcome, it may be conceptualized as if the S corporation owned all of its C corporation carryover basis assets in a notional wholly owned domestic C corporation subsidiary, the deemed C corporation disposed of all of its assets in a taxable transaction, and the deemed C corporation is liquidated into the S corporation under section 332 such that the S corporation inherits all of the C corporation's accumulated E&P (equal to the recognized built-in gains minus the corporate-level income tax).

occurrence of certain triggering events, such as a liquidation of the S corporation or the cessation of its S election. Congress may want to consider clarifying whether a qualified liquidation is a triggering event under section 965(i)(2) in light of the policy goals of section 965(i) and the qualified liquidation rule.

C. Expansion of Section 165(g) to Cover Partnership Indebtedness and Conformity for Worthless Partnership Interests

Under case law, whether a loss from the worthlessness or abandonment of partnership equity or debt is treated as capital or ordinary depends on how the loss is recognized and, in the case of partnership equity, whether the partner is allocated partnership liabilities. These rules permit taxpayer electivity.[59] In the case of stock or securities of a corporation, such losses are treated as capital.

The Proposals would expand the definition of "security" under section 165(g) to include indebtedness issued by partnerships. In addition, the Proposals would add a new section 165(m), which provides that any loss from a partnership interest becoming worthless, regardless of whether the partner is allocated partnership liabilities, would be treated as a capital loss.

We support this proposal, as it would reduce taxpayer electivity and treat losses from partnership and corporate debt and equity more similarly.

D. Expansion of Net Investment Income Tax to Active Limited Partners of a Limited Partnership

Under current law, section 1411 generally imposes a 3.8% tax on the "net investment income" of a taxpayer (such tax, the "NIIT"). Net investment income generally includes (1) gross income from interest, dividends, rents, royalties, substitute dividends and substitute interest, but excluding income from an ordinary trade or business that is not a passive activity (defined by reference to section 469) and that does not relate to trading in financial instruments or commodities (a "Section 1411 Trade or Business"), as well as (2) other gross income attributable to a Section 1411 Trade or Business.

As we have noted in a prior report,[60] under current law, the NIIT is not imposed on certain income (such as fees) attributable to a trade or business so long as the taxpayer materially participates in the trade or business and such trade or business is therefore not passive under section 469. A limited partner is also exempt from self-employment tax on its distributive share of income or loss, except with respect to income received for guaranteed payments for services.[61] Consequently, and as noted in a prior report, certain gain from a trade or business conducted by a partnership is not subject to any of the Federal Insurance Contribution Act ("FICA") or the Self-

[59] For example, if any of the partnership's liabilities are allocated to a taxpayer, the taxpayer can avoid capital treatment on the loss by paying off the debt before recognizing loss.
[60] New York State Bar Association Tax Section, Report No. 1284, *Report on the Proposed Regulations under Section 1411* (May 15, 2013).
[61] Section 1402(a)(13).

Employment Contributions Act ("SECA") regimes or the NIIT. Likewise, a shareholder of an S corporation is not subject to FICA, SECA, or the NIIT on profits of the S corporation.

The Proposals would subject all individuals with taxable income above a certain threshold to the 3.8% net investment income tax on all income from a trade or business, regardless of whether the person participates in the trade or business, unless the income is subject to FICA or SECA. For such taxpayers with taxable income over a certain threshold, the NIIT is imposed on the higher of "net investment income" and "specified net income". "Specified net income" is defined as "net investment income" but without regard to the exceptions for income from a Section 1411 Trade or Business, with a clarification that wages subject to FICA are not included in specified net income.

Section 164(f) allows an individual taxpayer to take an above-the-line deduction for one half of the self-employment tax.[62] The purpose of the deduction is to equalize, for federal income tax purposes, the treatment of employees and employers on the one hand, and self-employed individuals on the other, because employees do not include in gross income the FICA taxes paid by the employer and the employers may deduct such FICA taxes. There is no corresponding provision in section 164 for NIIT.

We support this proposal and suggest that consideration be given to expanding section 164(f) to allow a deduction of half the NIIT assessed on trade or business income to equalize the treatment of individuals subject to self-employment tax, on the one hand, and individuals subject to NIIT on trade or business income, on the other.[63]

[62] For self-employment income generated after December 31, 2012, in tax years beginning after that date, the deduction does not include the additional hospital insurance tax imposed by section 3101(b)(2) on income generated after such date.

[63] The self-employment tax subject to Section 164(f) has two components, a 12.4% Social Security tax on earnings up the social security cap for employees, and a 2.9% Medicare tax on all self-employment earnings. Half of those taxes are considered the employer portion eligible for the deduction. There is an additional .9% Medicare tax on income in excess of a threshold, but this tax is imposed on employees rather than the employer, and no part of it is deductible to the self-employed under Section 164(f).