



Section of Taxation

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March 22, 2019

Hon. Charles P. Rettig
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Comments on the Treatment of Applicable Partnership Interests Under Section 1061

Dear Commissioner Rettig:

Enclosed please find comments on the treatment of applicable partnership interests under section 1061 of the Internal Revenue Code. These comments are submitted on behalf of the Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

The Section of Taxation would be pleased to discuss these comments with you or your staff.

Sincerely,

Eric Solomon
Chair, Section of Taxation

Enclosure

cc: Hon. David Kautter, Assistant Secretary (Tax Policy), Department of the Treasury
Krishna P. Vallabhaneni, Acting Tax Legislative Counsel, Department of the Treasury
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**AMERICAN BAR ASSOCIATION
SECTION OF TAXATION**

**Comments on the Treatment of Applicable
Partnership Interests Under Section 1061**

These comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Ben Applestein, Sean Austin, Rachel Cantor, David Franklin, Todd Golub, Matthew Lay, Todd McArthur, and Michael Scaramella. Substantial contributions were made by Jennifer Alexander and Risa Trump. These Comments were reviewed by Adam M. Cohen, Council Director for the Partnerships & LLCs Committee and the Real Estate Committee, Jeanne Sullivan of the Committee on Government Submissions, and Eric B. Sloan, Vice-Chair for Government Relations for the Tax Section.

Although the members of the Section of Taxation may have clients who might be affected by the federal tax principles addressed by these Comments, no member who has been engaged by a client (or who is a member of a firm or other organization that has been engaged by a client) to make a government submission with respect to, or otherwise to influence the development or outcome of one or more specific issues addressed by, these Comments has participated in the preparation of the portion (or portions) of these Comments addressing those issues. Additionally, while the Section’s diverse membership includes government officials, no such official was involved in any part of the drafting or review of these Comments.

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Date: March 22, 2019

Table of Contents

I.	Executive Summary	3
II.	Background	5
III.	Discussion	8
A.	Confirm that, except for related party transfers to which section 1061(d) applies, the relevant holding period for purposes of section 1061(a) is the holding period of the capital asset sold (<i>i.e.</i> , the API or a capital asset owned by a partnership in which the taxpayer holds an API)..	8
B.	Confirm that the excess, if any, of net long-term capital gain as determined under section 1061(a)(1) over net long-term capital gain as determined under section 1061(a)(2) is based on gain or loss recognized with respect to all APIs held by the taxpayer during the taxable year	15
C.	Definition of “taxpayer” for purposes of section 1061.....	15
D.	Consideration of certain types of income, gain, or loss.....	23
E.	Treasury and the Service should exercise their authority under section 1061(b) to exclude from section 1061(a) income or gain attributable to any asset not held for portfolio investment on behalf of third-party investors	27
F.	Confirm that capital interests and profits interests owned by the same persons can be bifurcated for purposes of section 1061(a), and provide guidance on how each of those interests is determined.....	28
G.	Suspend the application of section 1061(d) until Congress amends the provision to clarify its application.....	30

I. Executive Summary

Section 1061¹ generally provides for a three-year holding period for long-term capital gain with respect to certain partnership interests to retain its character as long-term capital gain. If the three-year holding period is not satisfied, such long-term capital gain may be recast as short-term capital gain. Section 1061 applies to any applicable partnership interests (“APIs”) held by a taxpayer during the taxable year.

More specifically, section 1061 treats as short-term capital gain, taxed at ordinary income rates, the amount of a taxpayer’s net long-term capital gain with respect to an API for the taxable year that exceeds the amount of that gain calculated as if a three-year (rather than one-year) holding period applies. An API generally means any interest in a partnership that, directly or indirectly, is transferred to (or is held by) the taxpayer in connection with the performance of substantial services by the taxpayer, or any other related person, in any “applicable trade or business” (“ATB”). There are several exceptions to the general definition of an API and, to the extent provided by the Secretary, section 1061(a) does not apply to “income or gain attributable to any asset not held for portfolio investment on behalf of third party investors.” In addition, if a taxpayer transfers an API, directly or indirectly, to a related person, then the taxpayer includes in gross income as short-term capital gain so much of the taxpayer’s net long-term capital gain attributable to the sale or exchange of an asset held for not more than three years as is allocable to the interest. The amount included as short-term capital gain on the related party transfer is reduced by the amount treated as short-term capital gain on the transfer for the taxable year under section 1061 so that amounts are not double counted.

Section 1061 was enacted by Public Law 115-97 (the “Act”) on December 22, 2017² and is effective for taxable years beginning after December 31, 2017.³ These Comments address the treatment of capital gain with respect to APIs under section 1061.

Below is a summary of our recommendations.⁴ Section II of these Comments provides certain background information on the enactment of section 1061, and Section III provides a more detailed discussion of our recommendations.

We respectfully recommend that the Department of the Treasury (“Treasury”) and the Internal Revenue Service (the “Service”) issue proposed regulations that:

¹ Unless otherwise indicated, all “section” references are to the Internal Revenue Code of 1986, as amended (the “Code”), and all “Regulation §” references are to the Treasury regulations promulgated under the Code, all as in effect on the date of these Comments.

² An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018, Pub. L. No. 115-97, 131 Stat. 2054 (also known as the “Tax Cuts and Jobs Act”).

³ Section 13309(c) of the Act. It is unclear the extent to which section 1061(a) applies to sales or exchanges of property by a fiscal year partnership with a taxable year beginning before January 1, 2018, and ending after December 31, 2017, if a partner’s distributive share of capital gain or loss from those sales or exchanges is reported on a calendar year 2018 return.

⁴ Our recommendations focus on a number of fundamental considerations regarding the application and scope of section 1061. We expect to submit additional comments after proposed regulations are issued.

1. Confirm that, except for related party transfers to which section 1061(d) applies, the relevant holding period for purposes of section 1061(a) is the holding period of the property sold (*i.e.*, the API or an asset owned by a partnership in which the taxpayer holds an API).
2. Confirm that the excess, if any, of net long-term capital gain as determined under section 1061(a)(1) over net long-term capital gain as determined under section 1061(a)(2) is based on gain or loss recognized with respect to all APIs held by the taxpayer during the taxable year.
3. Provide guidance regarding the application of section 1061 in tiered partnership structures, including the extent to which net long-term capital gain is recharacterized under section 1061(a) if a partnership owns an API.
4. Regarding the application of section 1061(a) to certain types of income, gain, or loss:
 - a. Confirm that section 1061(a) does not recharacterize amounts taxed as net capital gain without regard to section 1221 or 1222, such as qualified dividend income as defined in section 1(h)(11)(B);
 - b. Confirm that section 1061(a) does not recharacterize amounts treated as short-term or long-term capital gain (or loss) without regard to the holding period in section 1222(3) or (4), such as section 1231 gain or loss or similar items;
 - c. Provide that capital gain dividends, as defined in sections 852(b)(3)(C) and 857(b)(3)(B), should be treated as greater-than-three-year capital gains for purposes of applying section 1061(a) to the extent the capital asset (or assets) giving rise to the capital gain dividends had been held for longer than three years; and
 - d. Provide guidance regarding the potential application of section 1061(a) to inclusions resulting from the sale of capital assets by a passive foreign investment company for which the taxpayer made a qualified electing fund election.
5. Confirm that, under section 1061(b), section 1061(a) does not apply to recharacterize income or gain attributable to the enterprise value of an applicable trade or business.
6. Confirm that, for purposes of section 1061(c)(4)(B), capital interests and profits interests owned by the same persons can be bifurcated for purposes of section 1061(a), and provide guidance on how each of those interests is determined.
7. Suspend the application of section 1061(d) until Congress amends the provision to clarify its application.

II. Background

Section 1061(a) provides that if one or more applicable partnership interests (APIs) are held by a taxpayer at any time during the taxable year, the excess (if any) of (1) the taxpayer's net long-term capital gain with respect to such interests for such taxable year, over (2) the taxpayer's net long-term capital gain with respect to such interests for that taxable year computed by applying paragraphs (3) and (4) of section 1222 by substituting "3 years" for "1 year," must be treated as short-term capital gain, notwithstanding section 83 or any election in effect under section 83(b).⁵ Thus, the provision treats as short-term capital gain, taxed at ordinary income rates, the amount of the taxpayer's net long-term capital gain with respect to an API for the taxable year that exceeds the amount of that gain calculated as if a three-year (rather than one-year) holding period applies.

Section 1061(b) provides that, to the extent provided by the Secretary, section 1061(a) does not apply to "income or gain attributable to any asset not held for portfolio investment on behalf of third party investors." For this purpose, the term "third party investor" means a person who (A) holds an interest in the partnership that does not constitute property held in connection with an applicable trade or business (ATB); and (B) is not (and has not been) actively engaged, and is (and was) not related to a person so engaged, in (directly or indirectly) providing substantial services described in section 1061(c)(1) for that partnership or any ATB.⁶

Under section 1061(c)(1), an API generally means any interest in a partnership that, directly or indirectly, is transferred to (or is held by) the taxpayer in connection with the performance of substantial services by the taxpayer, or any other related person, in any ATB. Section 1061 does not define the term "related person" for this purpose. The Joint Committee on Taxation has indicated that "it is intended that for this purpose a related person means a related person within the meaning of section 267(b) or 707(b)."⁷

Under section 1061(c)(2), an ATB means any activity conducted on a regular, continuous, and substantial basis that, regardless of whether the activity is conducted in one or more entities, consists, in whole or in part, of (A) raising or returning capital, and (B) either (i) investing in (or disposing of) specified assets (or identifying specified assets for such investing or disposition), or (ii) developing specified assets.⁸

⁵ Section 1222(3) provides that the term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than one year, and section 1222(4) provides that the term "long-term capital loss" means loss from the sale or exchange of a capital asset held for more than one year. The excess, if any, of a taxpayer's long-term capital gains for the taxable year over the taxpayer's long-term capital losses for the taxable year is the taxpayer's "net long-term capital gain" under section 1222(7), which may be subject to preferential tax rates.

⁶ I.R.C. § 1061(c)(5).

⁷ JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF PUBLIC LAW 115-97, JCS-1-18, at 201 (2017) (the "Blue Book"). The Blue Book states that a technical correction may be needed to carry out this intent. *Id.* Section 1061(c)(5) also refers to a "related" person without defining the relationship for which the provision is testing.

⁸ The Blue Book states the following with respect to the development of specified assets.

Under section 1061(c)(3), the term “specified asset” means securities (as defined in section 475(c)(2) without regard to the last sentence thereof), commodities (as defined in section 475(e)(2)), real estate held for rental or investment, cash or cash equivalents, options or derivative contracts with respect to any of the foregoing, and an interest in a partnership to the extent of the partnership’s proportionate interest in any of the foregoing. For example, if a hedge fund acquires “an interest in a partnership that is neither publicly traded nor widely held and whose assets consist of stocks, bonds, positions that are clearly identified hedges with respect to securities, and commodities,” the partnership interest is a specified asset.⁹

There are three statutory exceptions to the general definition of an API. First, the term “API” does not include an interest held by a person who is employed by another entity that is conducting a trade or business (other than an ATB) and who only provides services to that other entity.¹⁰ Second, the term “API” does not include any interest in a partnership directly or indirectly held by a corporation (the “Corporate Exception”).¹¹ Third, the term “API” does not include any capital interest in the partnership that provides the taxpayer with a right to share in partnership capital commensurate with (i) the amount of capital contributed (determined at the time of receipt of such partnership interest), or (ii) the value of that interest subject to tax under section 83 upon the receipt or vesting of that interest.¹²

Developing specified assets takes place, for example, if it is represented to investors, lenders, regulators, or others that the value, price, or yield of a portfolio business may be enhanced or increased in connection with choices or actions of a service provider or of others acting in concert with or at the direction of a service provider. Services performed as an employee of an applicable trade or business are treated as performed in an applicable trade or business for purposes of this rule. Merely voting shares owned or exercising the right to vote with respect to shares owned does not amount to development; for example, a mutual fund that merely votes proxies received with respect to shares of stock it holds is not engaged in development.

Blue Book at 202. Similar language was contained in H.R. REP. NO. 115-466, at 267 (2017) (Conf. Rep.) (the “Conference Report”) and H.R. Rep. No. 115-409, at 195 (2017) (the “House Report”). The Conference Report and the House Report together with the Blue Book are collectively referred to below as the “Reports.”

⁹ Blue Book at 203. In contrast, the House Report and the Conference Report indicated that a hedge fund that acquired an interest in an operating business conducted in the form of a non-publicly traded partnership that is not widely held would be treated as a specified asset. House Report at 280; Conference Report at 421-22. This language contradicts the language of the statute and was not repeated in the Blue Book.

¹⁰ I.R.C. § 1061(c)(1).

¹¹ I.R.C. § 1061(c)(4)(A). For example, if two corporations form a partnership to conduct a joint venture for developing and marketing a pharmaceutical product, the partnership interests held by the two corporations are not APIs. Blue Book at 201. In Notice 2018-18, 2018-2 I.R.B. 443, Treasury and the Service announced that they intend to issue regulations providing that the term “corporation” for this purpose does not include an S corporation. *See also* Blue Book at 201 (“The term ‘corporation’ for purposes of section 1061(c)(4)(A) does not include an S corporation, so a partnership interest held by an S corporation is not excluded from the term ‘applicable partnership interest.’”)

¹² I.R.C. § 1061(c)(4)(B). The Reports explain this rule as follows:

For example, in the case of a partner who holds a capital interest in the partnership with respect to capital he or she contributed to the partnership, if the partnership agreement provides that the partner’s share of partnership capital is commensurate with the amount of capital he or she

Section 1061(d) provides:

(1) In general. If a taxpayer transfers any API, directly or indirectly, to a person related to the taxpayer, the taxpayer shall include in gross income (as short-term capital gain) the excess (if any) of –

(A) so much of the taxpayer’s long-term capital gains with respect to such interest for such taxable year attributable to the sale or exchange of any asset held for not more than 3 years as is allocable to such interest, over

(B) any amount treated as short-term capital gain under subsection (a) with respect to the transfer of such interest.

(2) Related person. For this purpose, a person is related to the taxpayer if –

(A) the person is a member of the taxpayer’s family within the meaning of section 318(a)(1), or

(B) the person performed a service within the current calendar year or the preceding three calendar years in any applicable trade or business in which or for which the taxpayer performed a service.

Section 1061(e) directs the Secretary to require such reporting (at the time and in the manner prescribed by the Secretary) as is necessary to carry out the purposes of section 1061. Section 1061(f) directs the Secretary to issue regulations or other guidance as is necessary or appropriate to carry out the purposes of section 1061. The Reports explain that this “guidance is to address prevention of the abuse of the purposes of the provision, including through the allocation of income to tax-indifferent parties . . . [and] to provide for the application of the provision in the case of tiered structures of entities.”¹³

contributed (as of the time the partnership interest was received) compared to total partnership capital, the partnership interest is not an applicable partnership interest to that extent.

House Report at 278; Conference Report at 420-21; Blue Book at 201-2. The Reports also explain, however, that “partnership interests shall not fail to be treated as transferred or held in connection with the performance of services merely because the taxpayer also made contributions to the partnership, and the Treasury Department is directed to provide guidance implementing this intent.” House Report at 278; Conference Report at 420; Blue Book at 201.

¹³ House Report at 280; Conference Report at 422; Blue Book at 203.

III. Discussion

A. Confirm that, except for related party transfers to which section 1061(d) applies, the relevant holding period for purposes of section 1061(a) is the holding period of the capital asset sold (i.e., the API or a capital asset owned by a partnership in which the taxpayer holds an API)¹⁴

We believe the relevant holding period for purposes of section 1061(a) should be the holding period of the capital asset sold.¹⁵

As discussed above, section 1061(a) provides that if one or more APIs are held by a taxpayer at any time during the taxable year, the excess (if any) of (1) the taxpayer's net long-term capital gain with respect to such interests for such taxable year, over (2) the taxpayer's net long-term capital gain with respect to such interests for that taxable year computed by applying paragraphs (3) and (4) of sections 1222 by substituting "3 years" for "1 year," must be treated as short-term capital gain, notwithstanding section 83 or any election in effect under section 83(b). The House Report explains that section 1061 "imposes a three-year holding period (not the generally applicable one-year holding period) in the case of long-term capital gain from applicable partnership interests."¹⁶ Neither section 1061 nor the Reports, however, explicitly provides what the relevant holding period is for purposes of section 1061(a).¹⁷

There are several possible approaches to measure the relevant holding period for determining whether capital gain with respect to an API meets the three-year holding period requirement under section 1061(a).

- 1) The relevant holding period is the partner or partnership's holding period in the capital asset that gives rise to gain in the asset disposition, whether the asset disposed of, respectively, is the API itself or is an underlying capital asset held by the partnership (the "68-79 Approach").

¹⁴ For transfers of APIs to which section 1061(d) applies, it may be necessary to look not only to the holding period of the API being sold but also to the holding period of assets of the partnership (and lower-tier partnerships) that are attributable to the transferred API.

¹⁵ In the case of gain recognized under section 731(a)(1), the relevant holding period would be the holding period of the partnership interest with respect to which the distribution was made.

¹⁶ House Report at 277.

¹⁷ Consistent with the legislative history and IRS Publication 541, these Comments assume that net long-term capital gain "with respect to" an API is intended to include capital gain or loss on the disposition of the API as well as the distributive share of partnership capital gains and losses allocated in respect of the API. House Report at 277 ("If the holder of an applicable partnership interest is *allocated gain from the sale of property held for less than three years*, that gain is treated as short-term capital gain and is subject to tax at the rates applicable to ordinary income." Emphasis added); IRS Publication 541 at 3 (section 1061 "applies to: 1. Capital gains recognized by a partner from the sale or exchange of an applicable partnership interest under Internal Revenue Code sections 741(a) and 731(a); and 2. Capital gains recognized by a partnership, allocated to a partner with respect to an applicable partnership interest.")

- 2) The relevant holding period is the partner's holding period in its API, regardless of whether the partnership sells a capital asset (or assets) or the partner sells an API (the "Interest Approach").
- 3) The relevant holding period is the partnership's holding period in the capital asset (or assets) held by the partnership, regardless of whether the partnership sells a capital asset (or assets) or the partner sells an API (the "Underlying Asset Approach").
- 4) The relevant holding period is both the partnership's holding period in the capital asset (or assets) and the partner's holding period in the API itself (or portion thereof), regardless of whether the partnership sells a capital asset (or assets) or the partner sells an API (the "Dual Level Approach").

We discuss each approach below.

1. 68-79 Approach

The 68-79 Approach looks to the holding period in the capital asset giving rise to gain in a disposition. For example, if a partnership that has issued an API sells a capital asset and allocates some or all of the gain to the holder of an API, the partnership's holding period in the sold capital asset is the relevant holding period. Alternatively, if an API is sold, the partner's holding period in that API is the relevant holding period. As discussed below, the 68-79 Approach is based on applying long-standing principles of the taxation of partnerships and their partners to account for the extended holding period imposed by section 1061(a).¹⁸

In determining its income tax liability, each partner takes into account separately the partner's distributive share of the partnership's items of income, gain, loss, deduction, and credit, including capital gains and losses recognized by the partnership.¹⁹ For gains and losses from sales or exchanges of capital assets by the partnership, the character is determined as if the gain or loss were realized directly from the source from which realized by the partnership.²⁰

¹⁸ Subchapter K of Chapter 1 of Subtitle A of the Code ("Subchapter K") governs the taxation of partnerships and their partners. For an overview of the general principles relevant to this discussion, *see generally* Rev. Rul. 68-79, 1968-1 C.B. 310, section 702, and section 741.

¹⁹ I.R.C. § 702.

²⁰ I.R.C. § 702(b) and Reg. § 1.702-1(b). Reg. § 1.702-1(b) illustrates these principles in the following examples.

For example, a partner's distributive share of gain from the sale of depreciable property used in the trade or business of the partnership shall be considered as gain from the sale of such depreciable property in the hands of the partner. Similarly, a partner's distributive share of partnership "hobby losses" (section 270) or his distributive share of partnership charitable contributions to organizations qualifying under section 170(b)(1)(A) retains such character in the hands of the partner.

In Rev. Rul. 68-79,²¹ the Service held that the relevant holding period for obtaining long-term capital gain on the sale of a capital asset by the partnership is the partnership's holding period in the asset sold. In that ruling, three equal partners owned a partnership that acquired stock in a corporation. Eight months later, one of the partners sold its interest in the partnership to a new partner. Three months after the sale of the partnership interest to the new partner, the partnership sold the stock. The ruling concluded that the new partner's distributive share of gain from the sale of the stock by the partnership was long-term gain because the stock had been held by the partnership for more than six months,²² even though the partner receiving an allocation of that gain had held his partnership interest for less than six months at the time of the sale.

If a partner recognizes capital gain or loss on the sale or exchange of its partnership interest, however, the relevant holding period is the partner's holding period in the partnership interest sold or exchanged. Section 741 provides that gain or loss on the sale of a partnership interest is considered as gain or loss from the sale or exchange of a capital asset (the partnership interest), except as otherwise provided in section 751 (relating to unrealized receivables and inventory items held by the partnership).²³ Regulation section 1.1223-3 provides detailed rules

See also Davis v. Comm'r, 74 T.C. 881, 895 (1980) (noting that section 702(b) "has been consistently interpreted to mean that the character of partnership income is determined at the partnership level"), *aff'd*, 746 F.2d 357 (6th Cir. 1984); *Goodwin v. Comm'r*, 75 T.C. 424 (1980) (noting that Reg. § 1.702-1(b) "has been held to require that the character of the items comprising the partnership income or loss be determined at the partnership level."); *Miller v. Comm'r*, 70 T.C. 448, 455-56 (providing that the partnership's motives should be examined in determining the character of interest expense); *Podell v. Comm'r*, 55 T.C. 429, 432-34 (1970) (noting that "for the purpose of determining the nature of an item of income, gain, loss, deduction, or credit in the hands of the partnership before distribution or a partner....after distribution, the partnership is to be viewed as an entity and such items are to be characterized from the viewpoint of the partnership rather than from the viewpoint of an individual partner."); *Grove v. Comm'r*, 54 T.C. 799, 803-5 (providing that "Since the petitioner in this case intended to and did enter into a joint venture, it is the character of the profits in the hands of the joint venture or partnership that determines whether the income constitutes capital gain or ordinary income to petitioner."); *Barham v. United States*, 301 F. Supp. 43, 44-7 ("an item of income, deduction, gain, loss or credit ... are to be viewed from the standpoint of the partnership (or joint venture) rather than from the standpoint of each individual member."), *aff'd per curiam*, 429 F.2d (5th Cir. 1970).

²¹ 1968-1 C.B. 310.

²² At the time the ruling was issued, the necessary holding period to obtain long-term capital gain was more than six months (rather than more than one year or more than three years).

²³ I.R.C. § 741 and Reg. § 1.741-1(a). Section 751(a) can recharacterize as ordinary income or loss the gain or loss recognized on the sale or exchange of a partnership interest. It might be argued that the inclusion of "with respect to such interests" in section 1061(a) creates (or evidences the desire to implement) a requirement to characterize the gain or loss from the sale of a partnership interest as short-term if the holding period of either the API or the partnership assets attributable to the API is not more than three years, similar to how section 751(a) recharacterizes those amounts as ordinary income or loss based on the non-capital nature of certain partnership assets attributable to the transferred interest. As noted below, however, there is no clear evidence that Congress intended to change the long-standing principles discussed above. Indeed, the presence of section 751(a) demonstrates that Congress knows how to "look through" partnership interests. *See also* Regulation section 1.1(h)-1, which applies a look-through approach for collectibles gain and unrecaptured section 1250 gain upon the sale or exchange of a partnership interest, and section 864(c)(8), which was enacted by the Act and uses a look-through concept for a non-U.S. person selling a partnership interest. Section 864(c)(8) generally provides that gain or loss from the sale or exchange of a partnership interest is effectively connected with a U.S. trade or business to the extent that the transferor would have had "effectively connected" gain or loss had the partnership sold all of its assets at fair market value as of the date of the sale or exchange.

for determining a partner's holding period in a partnership interest, which, in turn, determines whether any capital gain or loss recognized on the sale or exchange of the interest are long-term or short-term.²⁴

The application of the 68-79 Approach (and the other approaches discussed below) may be illustrated in the following examples:

Example 1: A and B are equal partners in Partnership AB. On June 1, 2016, Partnership AB acquires all the stock of company X, a capital asset in the hands of Partnership AB. On January 1, 2018, Partnership AB issues an API to C. On February 1, 2020, Partnership AB sells its X stock and allocates the capital gain to A, B, and C. C has no source of income, gain, loss, or deduction other than C's API in Partnership AB.

In applying the 68-79 Approach to Example 1, the relevant holding period for the application of section 1061(a) to C's distributive share of capital gain with respect to C's API is Partnership AB's holding period in the X stock (*i.e.*, the asset the sale or exchange of which gave rise to the capital gain). Here, Partnership AB has met the three-year holding period requirement in the X stock it sold. Thus, C's distributive share of that capital gain remains long-term capital gain under section 1061(a).

Example 2: The facts are the same as in Example 1, except that on February 1, 2020, instead of Partnership AB selling its X stock, C sells its API in Partnership AB to D, an unrelated person.

In applying the 68-79 Approach to Example 2, the relevant holding period for the application of section 1061(a) for the sale of the API is C's holding period in its API (*i.e.*, the asset the sale or exchange of which gave rise to the capital gain). Here, C has not meet the three-year holding period requirement in the API it sold. Thus, C's capital gain from the sale of the API is treated as short-term capital gain under section 1061(a).

2. Interest Approach

The Interest Approach looks solely to the holding period in the API, regardless of whether the partnership sells a capital asset, or the partner sells its API. In applying the Interest Approach to Example 1 above, the relevant holding period for the application of section 1061(a) to C's distributive share of capital gain with respect to C's API is C's holding period in its API. Here, C's holding period in its API does not meet the three-year holding period requirement (even though Partnership AB's holding period in the X stock, the asset that gave rise to the gain, met the three-year holding period). Thus, C's distributive share of that capital gain is treated as short-term capital gain under section 1061(a).

In applying the Interest Approach to Example 2, the result is the same as under the 68-79 Approach because the relevant holding period is C's holding period in the API that it sold. Thus,

²⁴ In effect, the 68-79 Approach modifies these long-standing principles by changing the applicable holding period in the analysis from "more than one year" to "more than three years."

C's capital gain from the sale of the API is treated as short-term capital gain under section 1061(a).

3. Underlying Asset Approach

The Underlying Asset Approach looks solely to the holding period in the underlying asset (or assets) of the partnership, regardless of whether the underlying asset is sold by the partnership or the API is sold by its owner. In general, the value of a partnership interest is derived from the underlying partnership assets. Thus, there may be conceptual appeal in using the Underlying Asset Approach and to base the relevant holding period for purposes of section 1061(a) on the assets of the partnership. This result is consistent with the text of the Code if the phrase “with respect to such interests” is properly interpreted to mean the gain inherent in the underlying assets from which the API derives its value.²⁵

In applying the Underlying Asset Approach to Example 1 above, the result is the same as under the 68-79 Approach because the relevant holding period on a sale of the stock is Partnership AB's holding period in the asset (the stock) that gave rise to the capital gain. Thus, C's distributive share of that capital gain remains long-term capital gain under section 1061(a).

In applying the Underlying Asset Approach to Example 2, even in a sale of the API, the relevant holding period for the application of section 1061(a) is Partnership AB's holding period in the X stock, which has been held for more than three years. As such, even though the asset being sold (the API) has not been held for three years, C's gain from the sale of the API is treated as long-term capital gain because the underlying capital asset (the X stock) has been held for more than three years.

4. Dual Level Approach

The Dual Level Approach looks to both the holding period in the underlying asset (or assets) of the partnership and the holding period in the API, regardless of whether the underlying asset is sold by the partnership or the API is sold by its owner.²⁶ Because both holding periods must meet the three-year holding period requirement, this approach increases the likelihood that net long-term capital gain will be treated as short-term capital gain under section 1061(a).

In applying the Dual Level Approach to Example 1, the relevant holding period for the application of section 1061(a) to C's distributive share of capital gain with respect to C's API is both Partnership AB's holding period in the asset that gave rise to the capital gain (the X stock) and C's holding period in the API. Here, while Partnership AB has met the three-year holding period requirement in the X stock it sold, C has not met the three-year holding period requirement in its API. Thus, C's distributive share of that capital gain is treated as short-term capital gain under section 1061(a).

²⁵ Upon the sale of an API, the Underlying Asset Approach could be difficult to apply to a partner that received several APIs at different times from a partnership that owns multiple assets.

²⁶ It has been argued that a broad reading of “with respect to such interests” in section 1061(a) necessitates a Dual Level Approach. See Walter D. Schwidetzky, *Carried Interests Under the TCJA: Progress or Regress?*, 160 TAX NOTES 1673 (Sept. 17, 2018).

In applying the Dual Level Approach to Example 2, the relevant holding period for the application of section 1061(a) to the sale of the API is both Partnership AB's holding period in the underlying asset and C's holding period in the API. Because C has not met the three-year (rather than one-year) holding period requirement in its API, there is no need to determine whether the holding period has been met with respect to the underlying asset. Thus, C's capital gain from the sale of the API is treated as short-term capital gain under section 1061(a).

5. Conclusion

We believe the 68-79 Approach is the best alternative for several reasons. First, the approach achieves the objective of imposing a three-year holding period rather than the generally applicable one-year holding period. Second, the approach is consistent with long-standing principles of Subchapter K. Third, the approach is based on a plain reading and application of section 1061, and none of the Reports contain any clear indication that Congress intended to change or depart from these long-standing principles. Finally, we believe this approach achieves the objective of Congress without requiring potentially complicated, burdensome, and uncertain rules, such as how to attribute a partner's holding period in its partnership interest to the partner's share of partnership assets (or vice versa).

Alternatively, the Interest Approach is generally inconsistent with the principles of Subchapter K discussed above and Congress's apparent intent based on the legislative history.²⁷ The Interest Approach also reaches a seemingly incorrect result in allowing taxpayers to obtain long-term capital gain treatment arising from the sale of partnership assets that are not held for the more than three years by the partnership. This result would encourage distortive behavior in investment funds, which might look to "recycle" a single investment partnership for different investors solely for tax purposes. That is, if a single investment partnership is used, the partners of that investment partnership would not be subject to section 1061 if they have owned their APIs for more than three years, irrespective of how long the investment partnership has held an asset that it sold.

Despite certain conceptual appeal of the Underlying Asset Approach, it is generally inconsistent with the principles of Subchapter K discussed above and would be difficult (and burdensome) for taxpayers to apply as it would require a determination of value for each asset of

²⁷ For example, the Interest Approach would be inconsistent with the language in the House Report:

The Committee believes that the lower rates that apply to long-term capital gain *from sales or exchanges of capital assets of partnerships* should not be available to holders of applicable partnership interests unless an extended holding period requirement has been met. Therefore, the Committee bill imposes a three-year holding period (not the generally applicable one-year holding period) in the case of long-term capital gain from applicable partnership interests. If the holder of an applicable partnership interest is *allocated gain from the sale of property held for less than three years*, that gain is treated as short-term capital gain and is subject to tax at the rates applicable to ordinary income.

House Report at 277 (emphasis added). By referring to allocations of gain from the sale of property held for less than three years, this description of the proposal clearly indicates that when a partnership's property is sold, the character of any resulting gain should be determined by reference to the holding period of that property.

the partnership every time an asset is sold.²⁸ As discussed above, there is precedent of look-through approaches being explicitly utilized in the sale of partnership interests in the Code, including in the Act, and section 1061 did not follow their guide.²⁹ Rather, section 1061(a) modifies the application of section 1222 to a transaction, and does not modify the transaction to which section 1222 applies. Moreover, the Underlying Asset Approach could enable an API holder to sell a recently issued API to an unrelated buyer shortly after receipt and not be subject to section 1061(a) provided the partnership has a sufficient holding period in its assets.³⁰ Allowing such transactions to escape section 1061(a) seems incongruous with the intent and meaning of the provision. We also do not believe the Dual Level Approach is the best approach. While the overall policy of section 1061 is not clear from the Reports, if the policy is to subject the ultimate owners of an API to more than three years of economic exposure with respect to both the partnership interest itself and to an underlying asset to obtain long-term capital gain treatment, then the Dual Level Approach would be warranted.³¹ Such an approach, however, would be a significant departure from the historic principles of Subchapter K, discussed above. We would have expected Congress to explicitly call for such a departure, as was the case in other provisions discussed above that looked through a partnership interest to apply a particular rule.³² Neither section 1061 nor the Reports, however, contain any clear indication that Congress intended to change anything other than the definitions of long-term capital gain and long-term capital loss in sections 1222(3) and (4), respectively.³³ Under these circumstances, it is difficult to interpret these definitional changes in a manner that would fundamentally change the taxation of partnerships and their partners.

²⁸ In a tiered partnership structure, it is unclear what “underlying asset” should be used to apply section 1061(a). For example, would the Underlying Asset Approach use the holding period of the upper-tier partnership in its lower-tier partnership interest or the holding period of the lower-tier partnership in its assets? Alternatively, would the Underlying Asset Approach use both the holding period in the lower-tier partnership interest and the holding period in the lower-tier partnership assets? Using any holding period other than the upper-tier partnership’s holding period in its lower-tier partnership interest could be difficult for taxpayers to apply and for the Service to enforce.

²⁹ See note 23 *supra*.

³⁰ The impact of prior guidance or authorities addressing the disposition of a profits interest (*see, e.g.*, Rev. Proc. 93-27, 1993-2 C.B. 343; *Diamond v. Comm’r*, 492 F.2d 286 (7th Cir. 1974); *Campbell v. Comm’r*, 943 F.2d 815 (8th Cir. 1991)) is beyond the scope of these Comments.

³¹ For example, the application of the Dual Level Approach could be difficult in situations in which a partner has received several APIs at different times from a partnership that owns multiple assets. In a tiered partnership structure, the Dual Level Approach may require testing the holding period of multiple intervening partnership interests. For instance, if a partnership that had issued an API acquires a lower-tier partnership interest and the lower-tier partnership has held stock for more than three years, under a Dual Level Approach, any gain allocated to the holder of the API from a sale of the lower-tier partnership’s stock would be recharacterized as short-term if the lower-tier partnership interest has not been held for three years.

³² See note 23 *supra*.

³³ Moreover, section 1061(d) (discussed below) could be interpreted to require a dual level holding period determination for purposes of section 1061 when a taxpayer transfers an API to a related person. Under that interpretation, section 1061(d) would be superfluous under the Dual Level Approach. As discussed below, such an interpretation of section 1061(d) is far from clear.

For these reasons, while each of the various approaches merits consideration, we recommend that Treasury and the Service publish guidance confirming the 68-79 Approach.

B. Confirm that the excess, if any, of net long-term capital gain as determined under section 1061(a)(1) over net long-term capital gain as determined under section 1061(a)(2) is based on gain or loss recognized with respect to all APIs held by the taxpayer during the taxable year

Section 1061(a) states that if one *or more* APIs are held by the taxpayer, the amount that is to be recharacterized as short-term capital gain is computed using the net long-term gain with respect to *such interests* in each part of the provision’s formula. Section 1061(a) does not call for a separate calculation for each API. Under a plain reading of the statute, when a taxpayer holds several APIs, the taxpayer first calculates its net long-term capital gain with respect to all of its APIs for a taxable year and then subtracts from that amount its net long-term capital gain with respect to those same APIs for the taxable year computed with the three-year (rather than one-year) holding period for such gains to determine the amount, if any, treated as short-term capital gain. The Reports state that section 1061 “provides for a three-year holding period in the case of certain net long-term capital gain with respect to *any applicable partnership interest* held by the taxpayer.”³⁴ Section 1061(a), however, is clear that when more than one interest is owned, capital gains and losses with respect to all of those interests are taken into account in computing the amount under section 1061(a)(1) and (2).

We believe that gain or loss recognized with respect to all APIs held by the taxpayer during the taxable year are considered in calculating the excess, if any, of the taxpayer’s net long-term capital gain determined under section 1061(a)(1) over the taxpayer’s net long-term capital gain determined under section 1061(a)(2).³⁵ For these reasons, we recommend that Treasury and the Service publish guidance confirming this.

C. Definition of “taxpayer” for purposes of section 1061

By its terms, section 1061(a) applies if “one or more applicable partnership interests are held by a *taxpayer* at any time during the taxable year.”³⁶ One question is whether a partnership (or an S corporation,³⁷ assuming S corporations are subject to section 1061) that receives an API in connection with the performance of services – such as a partnership that is the general partner of, and receives a carried interest in, an investment fund – is a taxpayer for purposes of section 1061(a). The resolution of this question has many potential consequences, two of which are (i) subjecting capital gains and losses to section 1061 as a result of a partnership’s ownership of an API even though the partners of that partnership do not directly own the API (“partnership-level

³⁴ House Report at 277; Conference Report at 419; Blue Book at 200.

³⁵ For example, if a taxpayer is allocated a distributive share of capital gain with respect to one API and a distributive share of capital loss with respect to another API, we believe that the taxpayer would take both the capital gain and capital loss into account when determining the excess amount, if any, under section 1061(a).

³⁶ Emphasis added.

³⁷ For convenience, the discussion below focuses on partnerships, but similar considerations apply in the case of APIs held by S corporations.

taint”), and (ii) requiring partnership-level computations to determine whether there is an excess of the amount determined under section 1061(a)(1) over the amount determined under section 1061(a)(2) (“partnership-level netting”).³⁸ These consequences can cause the results under section 1061(a) to differ depending on whether the APIs are held directly or through one or more partnerships.

As discussed below, one approach is to not treat a partnership as a taxpayer for purposes of section 1061 and, rather, apply section 1061 to the direct or indirect partners that are subject to tax on the partnership’s items of capital gain and loss, such as a partner that is an individual (the “Aggregate Approach”).³⁹ Alternative approaches would treat the partnership as a taxpayer for purposes of only the partnership-level taint (the “Partial Entity Approach”) or for purposes of both the partnership-level taint and the partnership-level netting (the “Full Entity Approach”).

Under the Partial Entity Approach, the partnership would designate its capital gains and losses with respect to APIs as subject to section 1061 but would not perform partnership-level netting. Rather, under the Partial Entity Approach, the direct or indirect partners that are subject to tax on those capital gains and losses would apply section 1061(a) to those capital gains and losses, taking into account any other capital gains and losses they have with respect to other APIs.⁴⁰ Under the Full Entity Approach, the partnership would apply section 1061(a) based on the partnership’s capital gains and losses with respect to its APIs to recharacterize an amount, if any, as short-term capital gain. If Treasury and the Service were to adopt the Full Entity Approach, however, we recommend that guidance allow, but not require, direct and indirect partners subject to tax on these amounts to determine the amount recharacterized under section 1061(a) as though there were no partnership-level netting. In other words, the guidance should allow partners to re-determine the amount recharacterized under section 1061(a) by taking into account capital gains and losses with respect to APIs that those partners have in addition to the partner’s share of the capital gains and losses with respect to the partnership’s APIs (“Partner-Level Redetermination”).⁴¹ As discussed below, the ability to re-determine the amount recharacterized will reduce the situations in which the Full Entity Approach results in more gain recharacterized under section 1061(a) than if the Aggregate Approach applied.

Below is a general discussion of the definition of a taxpayer for purposes of the Code and a detailed discussion of considerations with respect to the three approaches described above (*i.e.*, the Aggregate Approach, Partial Entity Approach, and Full Entity Approach).

³⁸ The formula of section 1061(a) is discussed in more detail in Section III.B. of these Comments.

³⁹ Regardless of whether a partnership is a “taxpayer” or owns an API, if amounts are not otherwise required to be separately stated, we believe a partnership generally should provide its partners with additional information regarding gains and losses recognized by the partnership from the sale or exchange of capital assets to enable direct and indirect partners to apply section 1061. Specifically, we believe a partnership generally should provide its partners with (i) gain or loss from the sale or exchange of a capital asset held for more than one year but not more than three years, and (ii) gain or loss from the sale or exchange of a capital asset held for more than three years (the “Additional Holding Period Information”).

⁴⁰ In the Partial Entity Approach, the partnership would have to provide its partners with the Additional Holding Period Information in a way that identified which of the gains and losses are with respect to APIs.

⁴¹ In the Full Entity Approach, the partnership would have to provide the Additional Holding Period Information in a way that allows the amounts taken into account in the section 1061 analysis to be identified.

1. Definition of taxpayer

As a general matter, a partnership is a “person” for purposes of the Code. The term taxpayer is not defined in section 1061(a) or in the Reports. Section 7701(a)(14) provides that, “[w]hen used in this title [*i.e.*, the Code], where not otherwise distinctly expressed or manifestly incompatible with the intent thereof . . . [t]he term ‘taxpayer’ means any person subject to any internal revenue tax.” Section 7701(a)(1) generally provides that the term “person” for purposes of the Code “shall be construed to mean and include an individual, a trust, estate, partnership, association, company or corporation.” Although historically not subject to U.S. federal income tax, partnerships have been subject to certain other internal revenue taxes, such as certain withholding taxes and excise taxes. For that reason, it seems clear that the term taxpayer as defined in section 7701(a)(14) is broad enough to encompass a partnership as a general matter.⁴²

In considering this question, however, it is important to note directives in section 1061(f) and the Reports. Specifically, section 1061(f) and each of the Reports directs Treasury to issue regulations or other guidance as is necessary or appropriate to carry out the purposes of section 1061. The Reports further direct that this guidance is “to provide for the application of the provision in the case of tiered structures of entities.”⁴³ The question of whether a partnership is a taxpayer for purposes of section 1061 arises only in tiered partnerships structures. Thus, these directives suggest that Treasury and the Service have discretion in determining whether, and for what purposes, a partnership is a taxpayer for purposes of section 1061.⁴⁴

2. General considerations of the three approaches

The discussion below contains some observations concerning the relative advantages and disadvantages of the three approaches (*i.e.*, the Aggregate Approach, Partial Entity Approach, and Full Entity Approach).

⁴² This is consistent with cases that have held partnerships to be taxpayers for purposes of various different provisions of the Code. *See, e.g., Hayden v. Comm’r*, 112 T.C. 115 (1999) (discussing the applicable authorities and holding that a partnership is a taxpayer for purposes of section 179(b)(3)), *aff’d*, 204 F.3d 772 (7th Cir. 2000).

⁴³ House Report at 280; Conference Report at 422; Blue Book at 203.

⁴⁴ In deciding whether a partnership is a taxpayer for purposes of certain provisions, some courts have considered the purpose of the provision at issue. *See, e.g., Elliston v. Commissioner*, 82 T.C. 747 (1984), *aff’d w/out written opinion*, 765 F.2d 1119 (5th Cir. 1985) (“Furthermore, although Congress used the broad term taxpayer in section 465(a), Congress did not intend that section 465 apply to a partnership as an entity.”); *Southern v. Commissioner*, 87 T.C. 49 (1986) (“it is clear that an entity rather than an aggregate approach is contemplated [by section 46(c)(1), relating to the investment credit under section 38].”); *Hayden v. Commissioner*, 112 T.C. 115 (1999), *aff’d*, 204 F.3d 772 (7th Cir. 2000) (“Surely petitioners would not contend that an election may not be made for property in a business conducted by a partnership. For purposes of section 179(b)(3)(A) [relating to the election by a taxpayer to deduct rather than capitalize certain expenses], a partnership is a taxpayer.”); *Clearmeadow Invs., LLC v. U.S.*, 2010 U.S. Claims Lexis 712 (Ct. Cl. 2010) (“both the statutory language and the underlying regulations indicate that the defense in section 6664 [relating to the reasonable cause exception for penalties on underpayments] is possessed only by the individual partners”).

a. Without our recommended adjustment, the Full Entity Approach may artificially increase the amount of capital gain recharacterized under section 1061(a)

By treating a partnership as a taxpayer for purposes of both the partnership-level taint and the partnership-level netting, the amount of net long-term capital gain recharacterized under section 1061(a) may be increased unless a Partner-Level Redetermination is permitted. Consider the following example.

Example 3. GP 1, GP 2, Fund 1, and Fund 2 are all partnerships. GP 1 holds an API in Fund 1 that it has held for 2 years. GP 2 holds an API in Fund 2 that it has held for 4 years. Individual X holds an API in each of GP 1 (which X has held for 2 years) and GP 2 (which X has held for 4 years). X also owns stock in corporation Z that X has held for 4 years. The Z stock is a capital asset in X's hands.

Assume that, in a given taxable year:

- Fund 1 allocates \$100 of capital gain from the sale of a capital asset held for 2 years to GP 1, and GP 1 allocates \$50 of that gain to X.
- Fund 2 allocates \$100 of capital loss from the sale of a capital asset held for 4 years to GP 2, and GP 2 allocates \$50 of that loss to X.
- X sells the Z stock for a capital gain of \$50.

If GP 1 is a taxpayer for purposes of section 1061(a), GP 1's \$100 of capital gain from Fund 1 would be recharacterized as short-term capital gain under section 1061(a) because GP 1's net long-term capital gain from APIs under the normal holding period rules is \$100, but GP 1's net long-term capital gain from APIs under the modified holding period rules in section 1061(a)(2) would be \$0. Thus, if GP 1 is a taxpayer for purposes of section 1061(a), X's \$50 distributive share of the short-term capital gain from GP 1 would be taken into account by X as short-term capital gain.

No portion of GP 2's capital loss would be characterized under section 1061(a) as short-term capital gain because GP 2 had no net long-term capital gain (and even if GP 2's capital loss was a capital gain, that gain arose from the sale of a capital asset held for more than three years by Fund 2). Accordingly, X's \$50 share of GP 2's long-term capital loss should be taken into account by X as a long-term capital loss from property held for more than three years.

Even if section 1061(a) applies at the level of GP 1 and GP 2, it appears that section 1061(a) would also need to be applied at the level of X because X is a taxpayer that holds APIs. As discussed above, X has \$50 of short-term capital gain from GP 1 and \$50 of long-term capital loss from the sale of a capital asset with a four-year holding period from GP 2. X also has \$50 of long-term capital gain from the sale of a non-API capital asset (the Z stock). If the short-term capital gain is not taken into account in X's section 1061 analysis, the short-term capital gain

would remain short-term capital gain. Also, no additional amounts would be recharacterized under section 1061(a) because X's net long-term capital gain from APIs under the normal holding period rules would be \$0, and X's net long-term capital gain from APIs under the modified holding period rules in section 1061(a)(2) also would be \$0.

Accordingly, if both the partnership-level taint and partnership-level netting apply, X would have \$50 of short-term capital gain from GP 1, \$50 of long-term capital loss from GP 2, and \$50 of long-term capital gain from the sale of the Z stock. Because long-term capital gains and losses are first netted against each other before being netted against short-term capital gains and losses, the \$50 of long-term capital gain from the stock and the \$50 of long-term capital loss from GP 2 offset each other, leaving X with \$50 of short-term capital gain as a result of the application of section 1061(a) to GP 1.

By contrast, if Partner-Level Redeterminations are allowed, X would be able to take its distributive share from GP 1 into account in its section 1061(a) analysis as a \$50 long-term capital gain from an asset held for two years. That is, if X decided to make a Partner-Level Redetermination, no amount would be recharacterized under section 1061(a) because X's net long-term capital gain from APIs under the normal holding period rules would be \$0 (*i.e.*, \$50 capital gain from GP 1 and \$50 capital loss from GP 2).⁴⁵ Because section 1061(a) would not recharacterize any of X's items as short-term capital gain, X would have \$50 of long-term capital gain from GP 1, \$50 of long-term capital loss from GP 2, and \$50 of long-term capital gain from the sale of the Z stock. After netting the loss against the gains, X would have \$50 of long-term capital gain. The same result would occur under the Partial Entity Approach and the Aggregate Approach because each of these approaches would apply the formula under section 1061(a) only at X's level, rather than to GP 1, GP 2, and X.

The discussion above illustrates that the tax consequences to the ultimate partners may differ materially depending on where the formula in section 1061(a) is applied. Given that it is individuals, trusts, and estates – as opposed to partnerships and S corporations – that ultimately pay tax on capital gains,⁴⁶ it appears to be distortive in this example to apply the formula in section 1061(a) at the partnership level without the ability to re-determine the results under that formula at the partner level (*i.e.*, the Partner-Level Redetermination). This result could be achieved under all three approaches considered by these comments.

b. Each approach will add administrative burden and complexity

In virtually all cases, section 1061 increases the administrative burden on partnerships and their partners because, at a minimum, partnerships need to provide their partners with additional information to apply section 1061 at the partner level if necessary (*i.e.*, the Additional Holding Period Information). The administrative burden is potentially increased the more times that the formula in section 1061(a) is applied. For example, the Full Entity Approach would

⁴⁵ Because the amount under section 1061(a)(1) is \$0, X cannot have an “excess” of gains determined under section 1061(a)(1) over gains determined under section 1061(a)(2).

⁴⁶ The new partnership audit rules potentially do permit an “imputed underpayment” to be collected from the partnership; however, it is not the partnership that is liable for the income tax in the first instance.

require a separate section 1061 calculation to be performed at each level at which an API is held in a tiered partnership structure. By multiplying the number of section 1061 calculations that needs to be performed, the Full Entity Approach would increase the administrative burden imposed by section 1061 on taxpayers (including partnerships and S corporations). The additional calculations also would increase the administrative burden imposed by the provision on the Service, which is tasked with auditing and enforcing the application of section 1061.

The Full Entity Approach also may add additional complexity and burden if there are direct or indirect corporate partners. As discussed above, the Corporate Exception provides that “[t]he term ‘applicable partnership interest’ shall not include (A) any interest in a partnership directly or indirectly held by a corporation.”⁴⁷ The phrase “directly or indirectly” appears to require that, if (i) long-term capital gain is treated as short-term capital gain under section 1061 at the level of a partnership that holds an API, and (ii) part of the short-term capital gain ultimately is taken into account by a direct or indirect corporate partner, that portion of the short-term capital gain must be recharacterized back to long-term capital gain. Thus, if the Full Entity Approach were applied, any short-term capital gain resulting from the application of section 1061 at the partnership level would need to be tracked separately as it is allocated to the partners. No additional tracking would be necessary under the Partial Entity Approach, however, because the formula under section 1061(a) would not be applied at the partnership level in that case. Rather, the partnership would only designate which capital gains and losses are with respect to an API, information a direct or indirect corporate partner would disregard as inapplicable to it under the Corporate Exception.

Based on the discussion above, these factors tend to support the use of the Partial Entity Approach and the Aggregate Approach.

c. The Aggregate Approach, if too broadly applied, could permit taxpayers to avoid section 1061 through the use of tiered partnership structures

Under the Aggregate Approach, taxpayers may attempt to use tiered partnership structures to achieve an unintended result under section 1061(a). Consider the following example.

Example 4. Individuals A, B, and C form partnership GP by contributing \$100 each in exchange for equal interests in GP. GP spends the \$300 of cash on deductible expenses. In connection with GP’s provision of services for Fund, Fund issues to GP a carried interest that would constitute an API for purposes of section 1061 if issued to a taxpayer. (GP contributes no capital to Fund.) Because A, B, and C all received their partnership interests in GP in exchange for proportionate contributions of capital, their interests would appear to qualify for the exception from API treatment in section 1061(c)(4)(B)(i) (*i.e.*, the exception for capital interests). However, if no part of GP’s distributive share of income from Fund is subject to section 1061 at the GP level because the Aggregate Approach is applied, and if all

⁴⁷ I.R.C. § 1061(c)(4)(A).

of A, B, and C's income from GP is exempt at the individual level under section 1061(c)(4)(B)(i), then none of the carried interest income in the structure would be subject to section 1061 at any level.

It seems unlikely that this result would be consistent with congressional intent. Under the Aggregate Approach, the risk of this result could be mitigated through the use of special rules for tiered partnership structures. Those rules are likely to further increase the complexity and uncertainty of the application of section 1061(a). The Partial Entity Approach and Full Entity Approach prevent these types of abuses, however, because both approaches preserve the "partnership-level taint" with respect to the partnership's APIs regardless of how direct and indirect partners acquired their interests.⁴⁸ We believe this strongly supports the use of the Partial Entity Approach or Full Entity Approach.

d. Whether section 1061(a) recharacterizes long-term capital gains as short-term capital gains even if the income ultimately is taken into account by a partner who provides no services

If the Partial Entity Approach or the Full Entity Approach is adopted, one consequence of the partnership-level taint would be that capital gains and losses could become subject to section 1061(a) even though they are taken into account by a direct or indirect partner that did not provide services. Consider the following example.

Example 5. A, B, C, and D form partnership GP. A, B, and C receive profits interests in connection with the provision of services to GP. D performs no services but contributes cash to GP in exchange for a capital interest in GP. Under the GP partnership agreement, each of A, B, C, and D is entitled to a 25% share of GP's profits. GP receives a carried interest from partnership Fund in connection with the performance of services for Fund. A, B, C, and GP's carried interests are all APIs. In year 3, Fund allocates to GP \$100 of capital gain from the sale of a capital asset held for 2 years. GP allocates 25% of the \$100 of capital gain to each of A, B, C, and D.

If the partnership-level taint applies, the \$25 of capital gain allocated to each of A, B, C, and D would be subject to section 1061 (*i.e.*, the capital gain would be capital gain with respect to an API) even though D does not directly own an API. In this case, assuming there are no other gains and losses with respect to APIs, section 1061(a) would recharacterize all \$100 of these capital gains because they are from the disposition of an asset held for two years (*i.e.*, not more than three years). Therefore, D would take into account short-term capital gain under section 1061(a) even though D has provided no services and does not hold an API directly.

⁴⁸ We believe Treasury and the Service have discretion to provide further exceptions and limitations to section 1061(a) and believe further consideration to these exceptions and limitations is warranted, such as whether a direct or indirect partner that provides no services in exchange for its partnership interest should be subject to section 1061 based on a partnership's activities (considered further below).

Under the Aggregate Approach, the partnership-level taint would not apply. Thus, D's income would not be subject to recharacterization under section 1061. Because the GP interests owned by A, B, and C are APIs, however, their shares of the capital gain would be subject to section 1061(a). Thus, under the Aggregate Approach, section 1061(a) would recharacterize the capital gain allocated to each of A, B, and C, as the gain is with respect to an API for those partners and the gain is from the disposition of an asset held for two years.

Whether D's share of the capital gain should be subject – as a policy matter – to section 1061(a) is unclear. It might be argued that applying section 1061 to D's share of the income is consistent with the purposes of section 1061. Specifically, D invested in a partnership that earns gains and losses on which Congress intended to impose a three year (rather than one year) holding period to obtain long-term capital gain treatment. Alternatively, it might be argued that Congress intended to impose the extended holding period only on direct and indirect partners that are subject to U.S. federal income tax on the applicable gains and losses (*e.g.*, not to upper-tier partnerships but to individuals that take into account their distributive shares from these partnerships in determining their U.S. federal income tax liabilities). On balance, we believe the Partial Entity Approach best addresses these considerations by allowing Treasury and the Service to provide a general rule that is consistent with imposing an extended holding period on all gains and losses that are received in exchange for certain types of services, while providing exceptions and limitations in warranted situations.

3. Summary of considerations

An Aggregate Approach would address adverse consequences of the partnership-level netting issue by (i) avoiding an artificial increase in the amount of capital gain to which section 1061(a) applies and (ii) significantly reducing the number of different levels at which section 1061(a) must be applied, thereby reducing the administrative burden imposed by section 1061 on taxpayers and the Service. These administrative efficiencies may be completely lost, however, by additional rules that may be necessary to mitigate the risk of tiered partnership structures being used to achieve unintended results under section 1061 as a result of there being no partnership-level taint.⁴⁹

The Partial Entity Approach incorporates the benefits of the Aggregate Approach with respect to the partnership-level netting issue and preserves the partnership-level taint, preventing gains from inappropriately escaping section 1061. The Partial Entity Approach similarly would allow Treasury and the Service to draft rules that would exempt non-service-providers in appropriate situations.

Finally, the Full Entity Approach preserves the benefits of the Partial Entity Approach with respect to the partnership-level netting issue noted above. It could, however, create additional complexity with the application of section 1061(a) at different levels and artificially

⁴⁹ For example, the proposed regulations could include anti-abuse rules to prevent an overly broad application of the Aggregate Approach. We generally believe, however, that anti-abuse rules should not be used when viable alternatives exist. In this case, we believe the Partial Entity Approach is a significantly better alternative than the use of anti-abuse rules.

increase the amount of capital gain to which section 1061(a) applies if a Partner-Level Redetermination is not permitted.⁵⁰

We believe all three are reasonable approaches. On balance, however, we believe that the Partial Entity Approach, with appropriate exceptions, strikes the most appropriate balance for the reasons discussed above.

D. Consideration of certain types of income, gain, or loss

1. Qualified dividend income as defined in section 1(h)(11)(B)

As discussed above, section 1061(a) specifically recharacterizes net long-term capital gain determined by applying sections 1222(3) and (4) but substituting “3 years” for “1 year.” Qualified dividend income is included in net capital gain (*i.e.*, gain eligible for preferential capital gain rates) without regard to the application of section 1223(3) or (4). Specifically, the term “net capital gain,” for purposes of section 1(h), includes net capital gain determined without regard to section 1(h)(11) and is increased by qualified dividend income.⁵¹ In light of the specific language of section 1061, which defines net long-term capital gain by reference to sections 1222(3) and 1222(4), and the fact that qualified dividend income is treated as capital gain by reason of section 1(h)(11) and not section 1222(3) or (4), we do not believe that section 1061(a) should be applied to recharacterize qualified dividend income eligible for preferential capital gain rates.

We recommend that Treasury and the Service confirm that section 1061 does not alter the inclusion of qualified dividend income in net capital gain for purposes of applying the preferential capital gains rate under section 1(h).

2. Amounts treated as long-term capital gain under section 1231

As discussed above, section 1061(a) applies to a taxpayer’s net long-term capital gain, which is calculated by reference to gain from the sale of capital assets under section 1222(7).⁵² Section 1231 gains and losses, however, are not gains and losses from the sale of capital assets. Rather, they are merely treated as long-term capital gains and losses from the sales or exchanges of capital assets provided specific requirements are met under section 1231. Generally, capital assets exclude property used in a taxpayer’s trade or business that is subject to the allowance for

⁵⁰ While the Partner-Level Redetermination would add to the complexity of the regime, this complexity would be optional as the partner may, but is not required, to perform a Partner-Level Redetermination.

⁵¹ I.R.C. § 1(h)(11)(A). While the amount of net capital gain (determined without regard to section 1(h)(11)(A)) is computed using the holding period rules of sections 1223(3) and (4), the addition of qualified dividend income to that amount for applying the appropriate tax rate under section 1(h) is not impacted by these holding period rules.

⁵² Section 1222(7) defines “net long-term capital gain” as the excess of long-term capital gains for the taxable year over the long-term capital losses for such year. “Long-term capital gains” and “long-term capital losses” are defined in sections 1222(3) and (4), respectively, which are modified for purposes of section 1061(a).

depreciation provided in section 167 or real property used in the taxpayer's trade or business.⁵³ Property described in section 1231, for purposes of determining if a gain is a section 1231 gain, is property used in a taxpayer's trade or business that is of a character that is subject to the allowance of depreciation provided in section 167, held for more than one year, and real property used in the trade or business, held for more than one year.⁵⁴ If section 1231 gains exceed section 1231 losses for the taxable year, the net gains are treated as long-term capital gains.⁵⁵ In short, section 1231 gain is gain from the sale or exchange of property described in section 1231, provided that that property has been held for more than one year.⁵⁶

Section 1061(a) clearly identifies the capital gain netting rules of section 1222 as the mechanism by which certain net long-term capital gain from the sale or exchange of capital assets will be recharacterized as short-term capital gain from the sale or exchange of capital assets. Section 1231 property is not a capital asset,⁵⁷ and neither section 1222(3) nor (4) is relevant in determining whether gain qualifies for long-term capital gain treatment under section 1231. Rather, section 1231 includes its own holding period requirement.

For these reasons, we recommend that Treasury and the Service confirm that section 1231 gain or loss is not subject to recharacterization under section 1061(a).⁵⁸

3. Capital gain dividends as defined in section 852(b)(3)(C) or 857(b)(3)(B)

There has been some debate regarding whether and how capital gain dividends by regulated investment companies ("RICs") or real estate investment trusts ("REITs") are impacted by section 1061. In general, a RIC or a REIT is not subject to entity-level tax on its net capital gain, to the extent that the RIC or REIT designates any dividend as a capital gain dividend in a written statement provided to its shareholders and timely distributes the capital gain dividend to its shareholders.⁵⁹ In either case, the amount of a capital gain dividend is calculated by reference to the net capital gain determined at the corporate level.⁶⁰ The RIC or REIT shareholders treat a

⁵³ I.R.C. § 1221(a)(2).

⁵⁴ I.R.C. § 1231(a)(3) and 1231(b)(1).

⁵⁵ I.R.C. § 1231(a)(1).

⁵⁶ Section 1231 does not reference section 1222(3) or (4) in determining whether gain on the sale of property qualifies as section 1231 gain.

⁵⁷ See, e.g., *Cri-Leslie, LLC v. Comm'r*, 882 F.3d 1026 (11th Cir. 2018) (explaining that section 1234A applies only to property appropriately classified as capital assets, and section 1231 property is not a capital asset), *aff'g* 147 T.C. 217 (2016).

⁵⁸ Similar to section 1231 gains, section 1256 contracts, section 1235 sales of patents, and section 1092 straddles use different rules to determine characterization of capital gain. We recommend that Treasury and the Service provide similar guidance to these items of income, gain, or loss as well.

⁵⁹ I.R.C. §§ 852(b)(3)(A), 852(b)(3)(C), and 857(b)(2)(B).

⁶⁰ I.R.C. §§ 852(b)(3)(A) and 857(b)(3)(B) (limiting REIT capital gain dividend to net capital gain of REIT).

capital gain dividend as a gain from the sale or exchange of a capital asset held for more than one year.⁶¹

Because a capital gain dividend is treated as a gain from the sale or exchange of a capital asset held for more than one year, there is uncertainty regarding whether a capital gain dividend can ever meet the “more-than-three-year” holding period required under section 1061(a) for long-term capital gain treatment. Even if a RIC or REIT has held a capital asset giving rise to a capital gain dividend for longer than three years, it is not clear whether a capital gain dividend treated as held for more than one year would meet the three-year holding period requirement for long-term capital gain treatment under section 1061.

We do not believe that long-term capital gain treatment should be denied to a RIC or REIT shareholder, provided the RIC or REIT has held the capital asset (or assets) giving rise to the capital gain dividend for more than three years. In addition, we do not believe that a RIC or REIT shareholder’s holding period in its stock should impact the application of section 1061 to capital gain dividends, even if a shareholder holds RIC or REIT stock for less than three years, for the same reasons we support the 68-79 Approach discussed above.⁶²

We recommend that Treasury and the Service exercise their authority provided under section 1(h)(9)⁶³ to prescribe rules that would provide that capital gain dividends would be treated as greater than three-year capital gains in the hands of RIC and REIT shareholders for purposes of applying section 1061(a) to the extent the RIC or REIT held the capital asset (or assets)⁶⁴ giving rise to the capital gain dividend for more than three years.⁶⁵

⁶¹ I.R.C. §§ 852(b)(3)(B) and 857(b)(3)(A). *See also* Reg. § 1.199A-3(e)(2)(ii) (providing that for certain purposes under section 199A, qualified REIT dividends, *inter alia*, received by a partnership are treated as received by the partner).

⁶² A shareholder’s holding period of stock is currently not relevant to the taxation of RIC or REIT capital gain dividends. *See* I.R.C. § 857(b)(3)(B) and Reg. § 1.857-6(b).

⁶³ Treasury and the Service previously have exercised their authority provided under section 1(h)(9) to permit various classes of long-term capital gain to flow through to RIC and REIT shareholders. *See* Notice 2015-41, 2015-35 I.R.B. 1058; Notice 2004-39, 2004-1 C.B. 982; Notice 97-64, 1997-2 C.B. 323. Under that authority, the Secretary may prescribe regulations as are appropriate to apply section 1(h) in the cases of sales and exchanges by passthrough entities and of interests in such entities, including RICs and REITs. I.R.C. § 1(h)(10)(A) and (B).

⁶⁴ We believe that the holding period of the underlying asset giving rise to the dividend is relevant only if the event at the REIT level that generates the long-term capital gain is the sale or exchange of a capital asset (or a similar transaction, the tax consequences of which depend on the holding period rules of section 1222(3) or (4)). For example, we do not believe that any capital gain dividend paid by a REIT out of the REIT’s section 1231 gains should be subject to recharacterization under section 1061(a). That is because, for the reasons discussed above, a change in the holding period requirements under sections 1222(3) and (4) should have no impact on the tax treatment of section 1231 gain at the REIT level.

⁶⁵ If our recommendation is accepted, Treasury and the Service may want to consider reporting requirements that would provide shareholders with the necessary information to apply section 1061(a) to their reported capital gain dividends.

4. **Gain or loss from the sale of capital assets by a passive foreign investment company (“PFIC”) for which the taxpayer has made a qualifying electing fund (“QEF”) election**

A foreign corporation is a PFIC for a taxable year if the foreign corporation satisfies either an income test or an asset test for that year.⁶⁶ A taxpayer (a U.S. person) who owns stock of a PFIC generally is subject to an interest charge regime pursuant to which interest is charged on the tax deferral of certain PFIC distributions and dispositions of PFIC shares.⁶⁷ The shareholder can avoid the interest charge regime by making an election under section 1295 to treat the PFIC as a QEF. In that event, the PFIC shareholder must include in its gross income, as ordinary income, the shareholder’s pro rata share of ordinary earnings of the QEF for the taxable year and as “long-term capital gain, such shareholder’s pro rata share of the net capital gain of the QEF for the taxable year.”⁶⁸ If a domestic partnership owns a PFIC and has made a QEF election with respect to the PFIC shares that it owns, directly or indirectly, the domestic partnership takes into account its pro rata share of the ordinary earnings and net capital gain attributable to the QEF shares held by the partnership.⁶⁹ A U.S. person that indirectly owns QEF shares through the domestic partnership accounts for its pro rata shares of ordinary earnings and net capital gain attributable to the QEF shares according to the general rules applicable to inclusions of income from the partnership.⁷⁰

A QEF determines its net capital gain at the corporate level and then reports that gain under one of three options. First, the QEF may calculate and report the amount of each category of long-term capital gain provided in section 1(h) that was recognized by the PFIC in the taxable year. Second, the QEF may calculate and report the amount of net capital gain recognized by the PFIC in the taxable year, stating that the amount is subject to the highest capital gain tax rate applicable to the shareholder. Third, the QEF may simply calculate all of its earnings and profits for the taxable year and report the entire amount as ordinary income.⁷¹ Provided that a domestic partnership that has issued an API owns shares of a PFIC, a QEF election is in effect, and the QEF elects the first alternative, it must be determined how to apply section 1061, if at all, to the pro rata share of net capital gain attributable to the QEF shares.⁷²

If the QEF elects the first alternative, we believe that it is reasonably clear that the QEF should calculate the amount of each category of long-term capital gain provided in section 1(h)

⁶⁶ I.R.C. § 1297(a). *But see* I.R.C. § 1298(b)(1), which provides, in part, that stock held by a taxpayer is treated as stock in a PFIC if, at any time during the holding period of the taxpayer with respect to such stock, such corporation (or any predecessor) was a PFIC which was not a QEF.

⁶⁷ I.R.C. § 1291.

⁶⁸ I.R.C. § 1293(a).

⁶⁹ Reg. § 1.1293-1(b)(1).

⁷⁰ *Id.*

⁷¹ Reg. § 1.1293-1(a)(2)(i).

⁷² As the second and third alternative do not provide for the most preferential capital gains rate, we are not addressing those alternatives in these Comments.

at the corporate level. Absent guidance to the contrary and because the QEF must determine its net capital gain, which is defined in section 1222(11), the QEF arguably must incorporate the netting and holding period rules of section 1222 for this determination. If the QEF determines its net capital gain under the section 1222 rules, one could argue that this determination should use the section 1222 holding period requirement, as modified by section 1061, for purposes of reporting to a taxpayer holding an API. Under such an approach, a taxpayer that holds an API would include in its gross income as long-term capital gain its pro rata share of the QEF's net capital gain (as categorized), provided the three-year holding period is met with respect to the underlying assets giving rise to the capital gain (and if the three-year holding period is not met, such gain would be treated as short-term capital gain).⁷³

Under an alternate approach, one could argue that the corporate-level determination of whether the character of gain is treated as long-term capital gain is made without regard to the adjustment for the holding period requirements of section 1061. Under such an approach, amounts reported as long-term capital gain provided in section 1(h) that were recognized by the PFIC in the taxable year would not be subject to the holding period requirements of section 1061(a).

Lastly, one might look at the holding period of the PFIC stock. In that case, the holding periods with respect to amounts reported as long-term capital gain that were recognized by the PFIC would have to be analyzed.

We recommend that Treasury and the Service provide guidance regarding the potential application of section 1061(a) to inclusions resulting from the sale of capital assets by a PFIC for which the taxpayer made a QEF election.⁷⁴

E. Treasury and the Service should exercise their authority under section 1061(b) to exclude from section 1061(a) income or gain attributable to any asset not held for portfolio investment on behalf of third-party investors

Under section 1061(b), Treasury and the Service may provide by regulations or other guidance that section 1061(a) does not apply to “income or gain attributable to any asset not held for portfolio investment on behalf of third party investors.” We recommend that Treasury and the Service exercise this authority to, at a minimum, confirm that section 1061(a) does not apply to recharacterize income or gain attributable to the value of intangibles created or used in an applicable trade or business (ATB) (these intangibles typically are customer-based intangibles and are often referred to as “enterprise value”). Absent such guidance, if a taxpayer sells an API, section 1061(a) could recharacterize long-term capital gain attributable to intangibles, such as goodwill, created by the partnership's ATB. We believe that section 1061(a) was not intended

⁷³ Similar to the consideration discussed in note 64 for certain REIT dividends, we believe that the holding period of the underlying asset giving rise to the income inclusion is relevant only if the event at the PFIC that generates the income inclusion is the sale or exchange of a capital asset (or a similar transaction, the tax consequences of which depend on the holding period rules of section 1222(3) or (4)).

⁷⁴ Depending on the guidance provided, Treasury and the Service may consider reporting requirements that would provide PFIC shareholders with the necessary information to apply section 1061(a).

to, and should not, extend the holding period necessary to achieve long-term capital gain with respect to intangibles created in an ATB conducted directly or indirectly by a taxpayer.⁷⁵

F. Confirm that capital interests and profits interests owned by the same persons can be bifurcated for purposes of section 1061(a), and provide guidance on how each of those interests is determined⁷⁶

As noted above, section 1061(c)(4)(B) provides that the definition of an API does not include “any capital interest in the partnership which provides the taxpayer with a right to share in partnership *capital* commensurate with—(i) the amount of *capital* contributed (determined at the time of receipt of such partnership interest) or (ii) the value of the interest included in income under section 83 upon receipt or vesting.”⁷⁷ We refer to this exception as the “commensurate with capital interest exception” or the “CCI Exception” and use the term “CCI” to describe any interest that qualifies for the CCI Exception.

A profits interest received in connection with the performance of substantial services in an ATB clearly is intended to be treated as an API if no exceptions apply. This result should not be changed if, when the interest is issued, the partner contributes capital to the partnership. However, gains and losses attributable to the capital contribution should not be subject to recharacterization as short-term capital gain or loss under section 1061(a) even if gains and losses attributable to the performance of services are recharacterized.

Consistent with these observations, the legislative history of section 1061 indicates that it was not intended that a partnership interest fail to be treated as transferred in connection with the performance of services merely because a partner also made contributions to the partnership.⁷⁸ That is, a person can hold an API and a CCI in the same partnership. This bifurcated treatment is supported by the descriptions of the CCI Exception in the Reports, which state that if the partnership agreement provides that the partner’s share of partnership capital is commensurate with the amount of capital contributed, then the partnership interest is not an API “to that extent.”⁷⁹

⁷⁵ Commentators raised similar concerns, and made similar recommendations, with respect to prior legislative proposals to change the tax treatment of profits interests issued in connection with certain businesses, like investment management services. *See, e.g.,* James B. Sowell, *Carried Interest: Line Drawing and Fairness (or Lack Thereof)*, Part 3, TAX NOTES, Nov. 25, 2013, at 857; Jack S. Levin, Donald E. Rocab, & William R. Welke, *Baucus Bill Proposals and Enterprise Value Tax*, TAX NOTES, Nov. 1, 2010, at 565.

⁷⁶ Guidance regarding the allocation of items of income, gain, and loss with respect to a CCI in a tiered partnership structure would be helpful. For example, if a partner contributes money to an upper-tier partnership that the upper-tier partnership uses to acquire a CCI in a lower-tier partnership, it seems as though the upper-tier partnership should be able to specially allocate the items of income, gain, and loss attributable to the CCI to the partner whose capital was used to acquire the CCI if that special allocation is desired by the parties.

⁷⁷ Emphasis added.

⁷⁸ House Report at 278; Conference Report at 420; Blue Book at 201.

⁷⁹ House Report at 279; Conference Report at 420-21; Blue Book at 201-2.

Many practitioners believe that the definition of an API would make more sense if it required all allocations of *profits*, rather than partnership *capital*, to be shared in proportion to the capital contributed by a partner.⁸⁰ As a technical matter, whereas it is clear that a profits interest never would qualify for the CCI Exception, an API that is issued at the same time (and to the same person) as a CCI superficially may appear to qualify for the CCI Exception because, if the partnership were to liquidate, the partner's interest in partnership capital would be proportionate to the aggregate capital of the partnership at that time.⁸¹ One way for regulations to harmonize this aspect of the language of section 1061 with its evident intent would be to provide that a partnership interest qualifies as a CCI only to the extent that the partner's interest in partnership capital over the life of the partnership is commensurate with the partner's proportionate share of partnership capital when the interest is received. Said another way, because a partnership's profits are included in the partners' capital accounts, a partner will, in the future, have a disproportionate share of capital if it has a disproportionately large share of profits.⁸² Consider the following example:

Example 6. A and B form partnership PRS, with A contributing \$10 and B contributing \$90. PRS is engaged in an ATB, and A (but not B) provides substantial services in connection with that ATB. PRS's partnership agreement provides that the first \$100 of distributions are made 10% to A and 90% to B. All subsequent distributions are made 40% to A and 60% to B. If PRS were to liquidate immediately after formation, A's share of partnership capital is commensurate with the capital that A contributed. Under this interpretation, because A is entitled to a disproportionate allocation of income if PRS earns any profits, however, A's entire interest cannot qualify as a CCI. For example, if PRS earned \$100 without making any distributions, A's interest in partnership capital would be \$50 and B's interest in partnership capital would be \$150.

Neither the statute nor the available legislative history provides guidance on what it means for a right to share in partnership capital to be "commensurate" with the amount of capital contributed. Consistent with prior legislative proposals to address carried interests, in applying section 1061(a) to an interest that is partially an API and partially a CCI, we believe that the

⁸⁰ A technical correction would be helpful and may even be necessary under certain desired interpretations.

⁸¹ For example, if A contributed 10% of partnership capital in exchange for a partnership interest that received 20% of partnership profits, A's interest in partnership capital would be proportionate to the aggregate capital of the partnership at the time of the contribution notwithstanding A's disproportionate share of profits. This would not be true in the case of a "capital shift," in which a partner's initial capital account exceeds the amount of cash or property contributed by the partners. We do not believe that the CCI Exception should apply in every case in which there is no capital shift.

⁸² For this purpose, the partnership could be presumed not to make any distributions during its lifetime and the interest would be treated as having a disproportionate allocation of income if there are any circumstances under which the interest would entitle the holder to a disproportionate allocation of partnership items. In making this determination, we believe that management fees or other similar partner-specific charges that may be charged to non-service-providing partners should be disregarded. Fund sponsors do not charge the same amounts to every non-service-providing partner and, in some cases, do not charge any amounts to certain non-service-providing partners. Due to this variation, we believe the appropriate return on a non-service-providing partner's contributed capital for purposes of the commensurate test should be determined on a pre-charge basis.

determination of the amount of the taxpayer's distributive share of gain that is considered to be with respect to the taxpayer's CCI (and thus not subject to recharacterization under section 1061(a)) should be determined, whenever possible, by comparing the taxpayer's total gain to the gain the taxpayer would have recognized had the taxpayer been an investor (*i.e.*, a non-service-providing partner) in a manner similar to that described above in determining eligibility for the CCI Exception. We recommend that Treasury and the Service issue regulations clarifying how taxpayers should make this determination in other situations in which there are only service-providing partners in the partnership that issued the API.

We believe a taxpayer should be able to transfer the portion of its interest that is treated as an API separate from the portion of its interest that is treated as a CCI. We understand that Treasury and the Service may have concerns that taxpayers could inappropriately avoid the application of section 1061(a) by engaging in such separate transfers, but we believe Treasury and the Service could adopt anti-abuse rules that could mitigate this concern. For example, Treasury and the Service could adopt regulations providing that a taxpayer can generally characterize a transfer of a portion of its partnership interest as a transfer of a CCI separate from an API (or vice versa), but only if certain conditions are satisfied, including:

- The taxpayer's characterization properly reflects the economic entitlements that the taxpayer is transferring;
- The portion of the taxpayer's section 704(b) capital account balance that is transferred is determined consistently with the principles of the CCI Exception; and
- The partnership applies section 704(c) to the portion of the interest transferred and the portion of the interest retained in a manner that is consistent with the principles of section 1061(a) and the CCI Exception.

We believe that applying section 704(b) and section 704(c) in a manner that puts the holder of the CCI in the same position as a non-service-providing partner would have been had they held the CCI since its issuance should be considered consistent with the principles of the CCI Exception.

G. Suspend the application of section 1061(d) until Congress amends the provision to clarify its application

If a taxpayer transfers an API, directly or indirectly, to a person related to the taxpayer, section 1061(d)(1) requires the taxpayer to include in gross income (as short-term capital gain) the excess (if any) of an amount described in section 1061(d)(1)(A) over any amount treated as short-term capital gain under section 1061(a) with respect to the transfer of the interest. The "amount" described in section 1061(d)(1)(A) is "so much of the taxpayer's long-term capital gains with respect to such interest for such taxable year attributable to the sale or exchange of any asset held for not more than 3 years as is allocable to such interest." Based on the statute alone, it is unclear how to determine this amount and even what the amount is intended to

represent.⁸³ Moreover, the legislative history of section 1061(d) does not provide enough guidance regarding the purpose or intended result of section 1061(d) to apply section 1061(d)(1)(A) in a manner that achieves that purpose or result.⁸⁴ Given the significant amount of uncertainty regarding the application and purpose of section 1061(d), we recommend that Treasury and the Service suspend the application of section 1061(d) until Congress amends the provision to clarify its application and purpose.

⁸³ Commentators have noted this uncertainty. See, e.g., Wesley Elmore, *Practitioners Want Fixes to Problematic Carried Interest State*, TAX NOTES, Nov. 19, 2018, at 1008 (describing a panel discussion of section 1061 in which Blake D. Rubin of Ernst & Young noted “But we can’t figure out when or how it [*i.e.*, section 1061(d)] applies, honestly.”); Eric Yauch, *Carried Interest Related-Party Language Needs Clarity*, TAX NOTES, NOV. 5, 2018, at 756 (describing a panel discussion during which Eric B. Sloan of Gibson, Dunn & Crutcher LLP said of section 1061(d) “truthfully, it doesn’t make any sense at all”); Walter D. Schwidetzky, *Carried Interests Under the TCJA: Progress or Regress?*, TAX NOTES, Sept. 17, 2018, at 1673 (referring to section 1061(d) as “perplexing”); Marie Sapirie, *Carrying On With Carried Interest*, TAX NOTES, Jun. 18, 2018, at 1707 (noting that section 1601(d) is “hardly a model of clarity”); Kurt R. Magette, *Carried Interest in a Tax Partnership: Reflection, Reaction, and Regs*, TAX NOTES, Apr. 23, 2018, at 491 (noting that “The regulations must clarify what section 1061(d) means. It may be instructions on rearranging your sock drawer.”); James B. Sowell & Jon G. Finkelstein, *Tax Reform and Investment in U.S. Real Estate*, TAX NOTES, Apr. 16, 2018, at 285 (referring to section 1061(d) as “very difficult to interpret”); Blake D. Rubin, Andrea M. Whiteway & Maximilian Pakaluk, *New Partnership Carried Interest Provision: Plugging a Loophole with a Labyrinth*, 21 J. PASSTHROUGH ENTITIES 41, at 47 (2018) (describing section 1061(d) as “particularly abstruse”); Lee A. Sheppard, *News Analysis: Money Talks: Passthrough Provisions of the Tax Reform Bills*, TAX NOTES, Dec. 11, 2017, at 1477 (noting that “The drafters appear to have plucked language from the Camp draft without fully understanding the implications. No one knows what it means.”).

⁸⁴ For example, the intended purpose of section 1061(d) could be to subject certain taxable transfers of APIs to related persons to further recharacterization based on the holding periods of the assets of the partnership (similar to the Underlying Asset Approach, discussed above). Alternatively, the intended purpose of section 1061(d) could be to subject certain transfers of APIs to taxation even if those transfers would have been, but for section 1061(d), a non-taxable transaction. If our recommendation to suspend the application of section 1061(d) is not accepted, we recommend that Treasury and the Service provide guidance that section 1061(d) will not cause an otherwise non-taxable transaction to become taxable absent Congress explicitly expressing an intention for section 1061(d) to cause such a result.