October 5, 2020

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

Re: Comments on Applicable Partnership Interests under Section 1061

Dear Commissioner Rettig:

Enclosed please find comments on proposed regulations under section 1061 with respect to applicable partnership interests. 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,

Joan C. Arnold
Chair, Section of Taxation

Enclosure

cc: Hon. David Kautter, Assistant Secretary (Tax Policy), Department of the Treasury
Krishna P. Vallabhaneni, Tax Legislative Counsel, Department of the Treasury
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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 (the "Section") 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, Laura Cable, David Franklin, Sarah Ritchey Haradon, Drew Johnson, Kevin M. Jacobs, David Kahen, Beverly Katz, Morgan Klinzing, Erik Loomis, and Todd McArthur. These Comments were reviewed by Eric B. Sloan of the Committee on Government Submissions and Kurt L. Lawson, Vice Chair for Government Relations for the 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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Executive Summary

These Comments respond to Prop. Treas. Reg. §§ 1.1061-1 through 1.1061-6 (the “Proposed Regulations”) issued by the U.S. Department of Treasury (“Treasury”) and the Internal Revenue Service (the “Service”) under section 1061. They supplement, in part, comments on section 1061 that the Section submitted on March 22, 2019 (the “2019 Comments”). However, they focus on the guidance in the Proposed Regulations.

Below is a summary of our recommendations concerning the Proposed Regulations. Section I of these Comments provides certain background information on section 1061 and the promulgation of the Proposed Regulations, and Section II provides a detailed discussion of the recommendations.

A. Capital Interest Exception

1. Separate and Apart Requirement. We recommend that the final regulations not require that a partnership agreement clearly identify capital interest allocations separate and apart from API allocations. However in situations where a partnership agreement does not clearly identify capital interest allocations separate and apart from API allocations, and the partnership does not liquidate by positive capital account balances, we believe it would be reasonable for the final regulations to provide that the “separate and apart” requirement will be treated as satisfied if the partnership agreement distribution provisions clearly identify the capital interest distributions separate and apart from distributions with respect to APIs.

2. Same Manner Requirement. We recommend that the final regulations clarify that “the cost of services provided by the API Holder or a Related Person to the partnership” covers not only fees (such as management fees), but also API allocations made for the benefit of another partner; and that regulatory allocations required under the Treasury Regulations will not cause allocations to fail to satisfy the Capital Interest Exception. We further recommend that the final regulations provide that a right to receive tax distributions does not prevent allocations from qualifying under the Capital Interest Exception, provided that such distributions are treated under the

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2 Unless otherwise indicated, references to a “section” are to a section of the Internal Revenue Code of 1986, as amended (the “Code”), and all “Treas. Reg. §” references are to the Treasury Regulations promulgated under the Code, all as in effect (or, in the case of proposed regulations that remain outstanding, as proposed) as of the date of these Comments.

3 ABA Tax Section, Comment on the Treatment of Applicable Partnership Interests Under Section 1061 (March 22, 2019), available at https://www.americanbar.org/content/dam/aba/administrative/taxation/policy/032219comments.pdf.

4 Capitalized terms used in this list are defined in the Proposed Regulations or in the body of these Comments.
partnership agreement as advances against future distributions; and the fact that an API Holder or a Related Person to the partnership has rights that differ from those of other partners (e.g., differing withdrawal rights or advance notice requirements) will not be disqualifying if (i) the rights do not affect the economic rights of the partners, apart from timing of distributions, or (ii) the rights of the API Holder or Related Person are less advantageous than those of other partners. Lastly, we recommend that the final regulations clarify that regulatory allocations required under the Treasury Regulations will not cause allocations to fail to satisfy the capital interest exception (as are allowed under section 721(c) and the Treasury Regulations thereunder).

3. **Relative Capital Account Requirement.** We recommend that the final regulations provide that, as an alternative to making allocations based on relative capital account balances, a partnership may satisfy the Relative Capital Account Requirement by making allocations based on invested capital, capital commitments, or a similar reasonable metric, and that this rule be drafted to make clear that it applies for purposes of Prop. Treas. Reg. § 1.1061-3(c) generally.

4. **Market Rate Preferred Returns.** We recommend that the final regulations provide an exception to the Significant Similar Allocation Requirement for market rate preferred returns that are determined at arm’s length and to which a partnership and an unrelated investor reasonably could be expected to agree for equity having similar risk and where the unrelated investor did not provide any services to the partnership. We further recommend that the final regulations provide that a market rate preferred return on invested capital will be respected.

5. **Tracking and Similar Allocations.** We recommend that the final regulations clarify that partnership interests with interests in tracking or similar allocations can qualify for the Capital Interest Exception, provided that all partners with economic interests in such arrangements are entitled to the same economic return on a particular pool of partnership assets.

6. **Returns on Realized and Unrealized API Gain.** We recommend that the final regulations clarify whether returns on realized and Unrealized API Gain that remain in an API Holder’s section 704(b) capital account are eligible for the Capital Interest Exception. We also recommend that the final regulations provide that returns on realized (i.e., taxed) API Gain that remain in an API Holder’s section 704(b) capital account are eligible for the Capital Interest Exception.

7. **Related Party Loans.** We recommend that the final regulations not include Prop. Treas. Reg. § 1.1061-3(c)(3)(ii)(C). If our primary recommendation is not adopted, we recommend that the final regulations include a more narrowly tailored rule for nonrecourse loans made, advanced, or guaranteed by related parties. In such case, we also recommend that the final regulations (1) clarify how to treat a partner that has fully funded a capital
contribution with Impermissible Loan Proceeds and then later repays such amounts using Permissible Proceeds before there is a Capital Interest Allocation, 
(2) clarify the requirements for a Capital Interest Allocation so that a capital account may be bifurcated between contributions from Impermissible Loan Proceeds, and Permissible Proceeds and allocations on the portion of the capital account funded with Permissible Proceeds will meet the Same Manner Requirement, and (3) provide transition rules for the timing of the application of this provision.

B. Section 1061(b)

1. Family Offices. We recommend that the final regulations contain a specific exception under section 1061(b) that would apply in the case of family offices and other partnerships that do not hold assets for portfolio investment on behalf of third-party investors. We recommend that the exception cover transfers subject to either section 1061(a) or section 1061(d). In addition, because section 1061(b) is not limited only to family offices, we recommend that it also apply to other situations where assets are not held for portfolio investment on behalf of third-party investors.

2. Enterprise Value. We recommend that the final regulations broaden the Passthrough Interest Direct Investment Allocation rules in order to exempt enterprise value and similar assets from generating API Gains and Losses.

C. Miscellaneous

1. Scope of Section 1061(d) Transfers. We recommend that the final regulations provide that section 1061(d) does not apply to transfers otherwise entitled to nonrecognition treatment under the Code. Additionally, we recommend that the final regulations make clear that the forfeiture of an API and a reallocation of future profits and capital by application of a partnership agreement is not a “transfer” for purposes of section 1061(d).

2. In-Kind Distributions and Transfers of Non-Section 1222 Property. We recommend that the final regulations clarify that items of long-term capital gain and loss attributable to non-section 1222 property are excluded from the calculation of the Owner Taxpayer’s One Year and Three Year Disposition Amount, and not just from the API One Year and Three Year Distributive Share Amount.

3. Third-party Purchaser Exception. We recommend that the final regulations provide that the third-party purchaser exception of Proposed Regulation applies to an API purchased directly as well as an API purchased indirectly by an unrelated third-party. We also recommend that they provide that the exception applies regardless of whether the lower-tier partnership interest is acquired after the third-party purchases the interest in the upper-tier partnership or acquires the upper-tier partnership interest by contribution.
4. **PFICs Subject to QEF Elections.** We recommend that the final regulations clarify that an Owner Taxpayer includes in its API Three Year Distributive Share Amounts the same base amount as determined for the API One Year Distributive Share Amounts as adjusted to reflect only net long-term capital gains and losses calculated by substituting a greater-than-three-year holding period for a greater-than-one-year holding period. Also, we recommend that the final regulations provide a rule that would apportion any E&P limitation on a shareholder’s pro rata share of net capital gain in proportion to the shareholder’s related API One Year Distributive Share Amount and related API Three Year Distributive Share Amount. Furthermore, we recommend that the final regulations permit an Owner Taxpayer otherwise to substantiate the amounts of greater-than-one-year capital gain, greater-than-three-year capital gain, and Excluded Gains, absent reporting from a QEF and provide a rule that would identify an Owner Taxpayer’s distributive share of a QEF’s net capital gain from a Passthrough Entity attributable to the Owner Taxpayer’s qualifying capital interest and API. Lastly, we recommend that consideration be given to include in final regulations a rule that would bypass netting capital gains and losses at the PFIC level and would clarify the manner in which a QEF shareholder would distinguish between reported gross items and any residual net capital gain and ordinary earnings.

5. **Elective Transition Rule.** We recommend that the final regulations include an example illustrating, or otherwise better explaining, the importance of the API Holder Transition Amount rules, *i.e.*, what benefit(s) the API Holder Transition Amount rules are intended to confer on taxpayers. Additionally, we recommend that the final regulations clarify that an interest that is held for more than three years as of the date the final regulations are published is not subject to section 1061, including the Lookthrough Rule.

6. **Distributed API Property.** We recommend that the final regulations clarify that a distribution to a partner is not Distributed API Property to the extent that it is distributed with respect to the portion of the partner’s interest qualifying for the Capital Interest Exception.

7. **Application of Section 1061 to Section 704(c) Aggregation Method.** We recommend that the final regulations confirm that partnerships can change their section 704(c) aggregation method in order to address section 1061 in a manner consistent with the regulations and that any such change would not violate the Consistency Rule. We further recommend that the final regulations provide examples illustrating the intended application of the creation of separate disparity accounts for APIs and capital interests.

8. **Passthrough Interest Direct Investment Allocations.** We recommend that the final regulations provide that Passthrough Interest Capital Allocations can be allocations of Capital Interest Allocations or Passthrough Interest Direct Investment Allocations. Alternatively, given the overall complexity of the Proposed Regulations and the wide range of possible economic
arrangements that may be reflected in tiers of partnerships, we recommend adopting a more general rule that allows taxpayers to apply the Capital Interest Exception to a tiered setting in a manner that is consistent with the purpose of the exception.

D. S Corporation-Specific Issues

1. Passthrough Interests Allocations. We recommend that the final regulations provide further guidance on the application of the requirement that Capital Interest Allocations and Passthrough Interest Capital Allocations be made based on an API Holder’s relative capital account balance, in situations where the Passthrough Entity is an S corporation. More specifically, we recommend that the final regulations expressly provide that, where the Passthrough Entity is an S corporation, the allocation of tax items by the S corporation in accordance with the requirements applicable to S corporations (namely, pro rata to stock ownership) will be considered to be in compliance with this requirement regardless of whether the S corporation maintains capital accounts for its shareholders.

2. Applicable Partnership Interest. We recommend that a legislative clarification be sought prior to including a rule in the final regulations providing that S corporations are subject to section 1061.

We appreciate all consideration given to our recommendations concerning the Proposed Regulations, and we would be pleased to discuss these Comments further if that would be helpful.

Comments

I. Background

Section 1061 was enacted by Public Law 115-97 (the “Act”) on December 22, 2017, and is effective for taxable years beginning after December 31, 2017. It generally provides for a greater-than-three-year holding period requirement in the case of certain net long-term capital gain with respect to any applicable partnership interest (an “API”) held by the taxpayer. More particularly, 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 section 1222 by substituting “3 years” for “1 year” must be treated as short-term capital gain,

5 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” or “TCJA”).

6 Act § 13309(c).
notwithstanding section 83 or any election in effect under section 83(b). Thus, the provision treats as short-term capital gain, generally taxed at ordinary income rates, the amount of the taxpayer’s net long-term capital gain with respect to the taxpayer’s APIs for the taxable year that exceeds the amount of that gain calculated as if a three-year (rather than one-year) holding period requirement applied.

Section 1061(b) provides that, to the extent provided by the Secretary, section 1061(a) will not apply to “income or gain attributable to any asset not held for portfolio investment on behalf of third-party investors.” Section 1061(c)(5) provides that 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; 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 applicable trade or business.

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 applicable trade or business (“ATB”). Section 1061 does not define the term “related person” for this purpose.

Under section 1061(c)(2), an ATB means any activity conducted on a regular, continuous, and substantial basis which, 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.

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.7

There are three statutory exceptions to the general definition of an API. First, section 1061(c)(1) provides that an 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 provides services only to that other entity. Second, section 1061(c)(4)(A) provides that an API does not include any interest in a partnership directly or indirectly held by a corporation (the “Corporate Exception”). Third, section 1061(c)(4)(B)

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7 Staff of the Joint Committee on Taxation, JCS-1-18, General Explanation of Public Law 115-97, 203 (2018) (the “Bluebook”).
provides that an 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) (the “Capital Interest Exception”) or (ii) the value of the interest that is subject to tax under section 83 upon the receipt or vesting of the interest.

Section 1061(d)(1) provides that, 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 three 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. Section 1061(d)(2) provides that 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.

On August 14, 2020, Treasury and the Service issued the Proposed Regulations under section 1061. The Proposed Regulations are organized into six sections. The first section (Prop. Treas. Reg. § 1.1061-1) contains defined terms. The second section (Prop. Treas. Reg. § 1.1061-2) contains rules that determine when an interest will be treated as an API that is subject to section 1061. The third section (Prop. Treas. Reg. § 1.1061-3) sets forth exceptions to section 1061, including rules describing when allocations with respect to invested capital will be exempt from the application of section 1061. The fourth section (Prop. Treas. Reg. § 1.1061-4) contains mechanical rules for calculating capital gain that is recharacterized as short-term under section 1061. The fifth section (Prop. Treas. Reg. § 1.1061-5) sets forth rules under section 1061(d) applicable to related-party transfers. Lastly, the sixth section (Prop. Treas. Reg. § 1.1061-6) describes reporting rules applicable to section 1061.

II. Detailed Discussion

A. Capital Interest Exception

The Proposed Regulations implement the Capital Interest Exception by excluding certain long-term capital gains and losses (“Capital Interest Gains and Losses”) that represent a return on the invested capital of a holder of an API (an “API Holder”) in a partnership, an S corporation, or a passive foreign investment company (a “Passthrough Entity”) from recharacterization under section 1061.8 Capital Interest Gains and Losses

8 Prop. Treas. Reg. § 1.1061-3(c)(1).
include “Capital Interest Allocations” under Prop. Treas. Reg. § 1.1061-3(c)(4) and “Passthrough Interest Capital Allocations” under Prop. Treas. Reg. § 1.1061-3(c)(5).

Along with certain gains and losses arising from the disposition of an API, Capital Interest Gains and Losses include Capital Interest Allocations, which are allocations of long-term capital gain or loss that meet (among other things) the following requirements:

(1) Allocations must be made in “the same manner to all partners” (the “Same Manner Requirement”). Allocations generally are considered to meet the Same Manner Requirement if, under the partnership agreement, the allocations are based on the relative capital accounts of the partners receiving the allocation, and the terms, priority, type and level of risk, rate of return, and rights to cash or property distributions during the partnership’s operations and on liquidation are the same for the API Holder and those partners who do not (and did not) provide services to the partnership and who are not (and were not) related to any API Holder in the partnership or any person who provides or has provided services to the partnership (the “Unrelated Non-Service Partners”). An allocation will not fail the Same Manner Requirement because the allocation is subordinated to allocations to Unrelated Non-Service Partners and is not reduced by the “cost of services performed by the API Holder or a Related Person” to the partnership.

(2) Allocations must be “based on the API Holder’s relative capital account balance” in a Passthrough Entity (the “Relative Capital Account Requirement”). If a partnership maintains capital accounts under the section 704 capital account maintenance regulations, then the allocation must be tested on the basis of those capital accounts. If a partnership does not maintain capital accounts but does maintain accounts for its owners using principles similar to those under the section 704 regulations, then the accounts will be treated as capital accounts under the Proposed Regulations.

(3) Similar allocations must be “made to Unrelated Non-Service Partners with a significant aggregate capital account balance” (the “Significant Similar Allocation Requirement”). The Proposed Regulations provide a safe harbor under which an aggregate capital account balance equal to 5% or more of the

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9 Prop. Treas. Reg. § 1.1061-3(c)(3)(i). This requirement is also covered in Prop. Treas. Reg. § 1.1061-3(c)(4)(i), which requires that Capital Interest Allocations must be made in the “same manner to API Holders and Unrelated Non-Service Partners.”


aggregate capital account balances of the partnership will be treated as significant.\textsuperscript{14}

(4) Allocations to the API Holder and the Unrelated Non-Service Partners are clearly identified both under the partnership agreement and on the partnership’s books and records as “separate and apart” from allocations made to the API Holder with respect to its API. In addition, both the partnership agreement and the partnership’s books and records must clearly demonstrate the satisfaction of the requirements applicable to Capital Interest Allocations (the “\textbf{Documentation Requirements}” and, together with requirements (1)–(3), the “\textbf{Capital Interest Allocation Requirements}”).\textsuperscript{15}

The Capital Interest Exception is important in the fund world, because it is very common for a fund sponsor to earn a limited-partner-like return on its capital. Such capital might be attributable to cash invested by the sponsor alongside unrelated investors, or (especially in hedge funds) attributable to previously earned “incentive allocations” that the sponsor has not withdrawn from the fund. Unfortunately, certain aspects of the Proposed Regulations appear to limit severely the usefulness of the Capital Interest Exception.

\begin{enumerate}
\item \textbf{“Separate and Apart” Requirement}

In order for allocations to qualify as Capital Interest Allocations, the Documentation Requirements require the following to be true:

The allocations to the API Holder and the Unrelated Non-Service Partners are clearly identified both under the partnership agreement and on the partnership’s books and records as separate and apart from allocations made to the API Holder with respect to its API, and both the partnership agreement and the partnership’s books and records clearly demonstrate that the requirements of paragraphs (c)(3) and (c)(4) of this section have been met.\textsuperscript{16}

It will not be possible for many existing fund agreements to satisfy the requirement that Capital Interest Allocations be “clearly identified . . . under the partnership agreement . . . as separate and apart from” the API allocations. While some fund partnership agreements do contain provisions providing for carried interest allocations that are separate from the provisions providing for Capital Interest Allocations, it is very common for fund partnership agreements to contain a single provision (for example, a targeted allocation provision) that governs both types of allocations. Accordingly, it would be impossible for many (possibly most) funds to satisfy a requirement that their partnership agreements clearly identify Capital Interest

\textsuperscript{14} \textit{Id.}

\textsuperscript{15} Prop. Treas. Reg. § 1.1061-3(c)(4)(iii).

\textsuperscript{16} \textit{Id.}
Allocations “separate and apart” from API allocations. However, in situations where the fund partnership agreement’s allocation provision does not clearly identify the carried interest allocations as separate and apart from the Capital Interest Allocations, the distribution provision generally does clearly identify carried interest distributions separate and apart from capital interest distributions.

We recommend that the final regulations not require that a partnership agreement clearly identify Capital Interest Allocations separate and apart from API allocations. However, in situations where a partnership agreement does not clearly identify Capital Interest Allocations separate and apart from API allocations, and the partnership does not liquidate by positive capital account balances, we believe it would be reasonable for the final regulations to provide that the “separate and apart” requirement will be treated as satisfied if the partnership agreement distribution provisions clearly identify the capital interest distributions separate and apart from distributions with respect to APIs. We recommend that the final regulations further clarify that no special language is required to be included in the partnership agreement, so long as the substance of the arrangement is clear. These changes will ensure that the Capital Interest Allocation Requirements reasonably permit capital interests to comply with such requirements.

2. “Same Manner” Requirement

The Same Manner Requirement strictly limits the Capital Interest Exception to capital interest allocations that are made in the same manner for both API Holders and Unrelated Non-Service Partners. In general, allocations will be considered to be made in the same manner if, under the partnership agreement, the allocations are based on the relative capital accounts of the partners (or owners in the case of a Passthrough Entity that is not a partnership) receiving the allocation, and the terms, priority, type and level of risk, rate of return, and rights to cash or property distributions during the partnership’s operations and on liquidation are the same. The Proposed Regulations provide exceptions for two scenarios: (i) where the API Holder’s allocation is subordinated to allocations to Unrelated Non-Service Partners and (ii) where the API Holder’s allocation is not reduced by the “cost of services” performed by the API Holder or a Related Person to the partnership.

Many funds make allocations to API Holders with respect to capital interests that are economically different from allocations to Unrelated Non-Service Partners. For example, funds often utilize a “two and twenty” model, whereby fund managers receive an annual management fee of 2% of committed capital or net asset value and 20% of the fund profits (sometimes after a minimum rate of return), which is an API. When management contributes capital, management’s interests typically are not subject to either the 2% fee or the 20% carried interest.

Under the Proposed Regulations, the 2% fee is a cost of services that would be excluded in determining whether management’s capital interest meets the Same Manner Requirement. It is less clear whether the 20% carried interest would be considered a cost of services. The 20% carried interest is an allocation to API Holders for services at the
expense of the Unrelated Non-Service Partners, rather than a deduction for a cost of services.

There are additional situations where API Holders commonly are treated differently than Unrelated Non-Service Partners. For example, the fund sponsor and related parties are sometimes entitled to receive tax distributions, where other partners are not so entitled. Provided that such tax distributions are treated under the partnership agreement as advances on future distributions, they do not fundamentally alter the partnership’s economics, but instead merely confer a timing and liquidity benefit on the distributee partners. Timing and liquidity benefits are potentially significant. However, because such benefits do not alter the manner in which the partners ultimately divide a partnership’s profits and losses, but instead merely affect the timing of distributions to the partners, such benefits do not seem so significant that they should cause allocations to a partner to be treated as allocations other than with respect to the partner’s capital investment in the partnership.

The fund sponsor and related parties also may be subject to different provisions regarding the liquidity of their investments in the fund (i.e., beyond just the ability to receive tax distributions). These liquidity rights are in some cases more, and in other cases less, favorable than the liquidity rights enjoyed by unrelated investors. However, for reasons similar to those discussed in the preceding paragraph in connection with tax distributions, provided that such differing rights relate only to the timing of distributions, rather than the aggregate amount that an API Holder (or a Related Person) is entitled to receive from the partnership, we believe that the differences in the rights should not disqualify the associated allocations from the Capital Interest Exception. In addition, we believe that these different situations should not disqualify an API Holder’s capital interest from meeting the Same Manner Requirement if the API Holder is subject to more stringent restrictions than Unrelated Non-Service Partners.

Finally, regulatory allocations under the section 704(b) or other Treasury Regulations, such as a qualified income offset, can result in disparate allocations among partners that have otherwise similar economic rights. The Treasury Regulations under section 721(c) acknowledge this and exclude regulatory allocations in determining whether a consistent allocation method is applied; similar provisions are contained in the Treasury Regulations under section 514(c)(9)(E). We believe that regulatory allocations should not disqualify allocations from qualifying under the Capital Interest Exception.

In order to provide clarity with respect to the Same Manner Requirement, we recommend that the final regulations:

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17 See Treas. Reg. § 1.721(c)-3(c)(4)(i).

18 See Treas. Reg. §§ 1.514(c)-2(e)(3) and (4) (minimum gain chargebacks attributable to prior nonrecourse deductions and distributions of nonrecourse debt proceeds), 1.514(c)-2(h) (provisions preventing deficit capital account balances), 1.514(c)-2(j) (partner nonrecourse deductions).
• Clarify that “the cost of services provided by the API Holder or a Related
   Person to the partnership” covers not only fees (such as management fees)
   but also API allocations;

• Clarify that a right to receive tax distributions is not disqualifying
   provided that such distributions are treated as advances against future
   distributions;

• Clarify that the fact that an API Holder or a Related Person to an API
   Holder or the partnership has rights that differ from those of other partners
   (e.g., differing withdrawal rights or advance notice requirements) will not
   be disqualifying if (i) the rights do not affect the economic rights of the
   partners, apart from the timing of distributions, or (ii) the rights of the API
   Holder or Related Person are less advantageous than those of other
   partners; and

• Clarify that regulatory allocations required under the Treasury Regulations
   will not cause allocations to fail to satisfy the capital interest exception (as
   are allowed under section 721(c) and the regulations promulgated
   thereunder).

3. Relative Capital Account Requirement

Pursuant to the Relative Capital Account Requirement, the Proposed Regulations
require that Capital Interest Allocations be “based on an API Holder’s relative capital
account balance in a Passthrough Entity.”19 The Proposed Regulations further provide
that:

In the case of a partnership that maintains capital accounts under
§ 1.704-1(b)(2)(iv), the allocation must be tested under paragraph (c)(3)(i)
of this section based on that capital account. In the case of a Passthrough
Entity that is not a partnership (or a partnership that does not maintain
capital accounts under § 1.704-1(b)(2)(iv)), if the Passthrough Entity
maintains and determines accounts for its owners using principles similar
to those provided under § 1.704-1(b)(2)(iv), the account will be treated as a
capital account for purposes of this paragraph (c) and an allocation must
be tested under paragraph (c)(3)(i) of this section based on those
accounts.20

Treas. Reg. § 1.704-1(b)(2)(iv)(b) provides the following:

. . . a partner who has more than one interest in a partnership shall have a
single capital account that reflects all such interests, regardless of the class


20 Id.
of interests owned by such partner (e.g., general or limited) and regardless of the time or manner in which such interests were acquired.

We believe that the Relative Capital Account Requirement should be modified to account for the differing ways in which different types of funds make Capital Interest Allocations. More specifically, the construct in the Proposed Regulations is generally consistent with the allocation methodology used by most hedge funds, but inconsistent with the allocation methodology used by most private equity funds. For the reasons set forth below, both allocation methodologies should satisfy the Capital Interest Exception. Therefore, we believe that the Relative Capital Account Requirement should be modified to ensure that many partnerships are not inadvertently made unable to satisfy that requirement.

The legislative history of the Act does not contain any detailed discussion of the purpose of the Capital Interest Exception, but the purpose presumably is to exempt from section 1061 a service provider’s economic return on its capital investment in a partnership, on the grounds that such returns on capital investment are not the intended target of section 1061. In the hedge fund world, the general partner of the fund typically is entitled to earn an incentive based on unrealized increases in a hedge fund’s net asset value. Moreover, in the hedge fund world, investors generally may elect to withdraw their capital from the fund (typically subject to limitations); similarly, a hedge fund generally continues to accept contributions of cash from incoming investors throughout the life of the fund. To the extent that a hedge fund general partner does not elect to withdraw its previously accrued incentive from the fund, the general partner typically is entitled, going forward, to earn an economic return on its previously accrued incentive, comparable to that which an unrelated investor would earn. That puts the general partner in substantially the same economic position as if it had withdrawn the accrued incentive from the fund in cash and then contributed the cash to the fund in exchange for a limited partner interest. Thus, in the hedge fund context, the general partner’s accrued, but not withdrawn, incentive is treated as part of the general partner’s capital investment in the hedge fund. For that reason, to the extent that a hedge fund general partner receives allocations with respect to its capital account in the fund (including any portion of the capital account attributable to previously accrued incentive) that match the allocations made to unrelated investors with respect to their capital accounts, such allocations should qualify under the Capital Interest Exception. That is the construct adopted by the Proposed Regulations, and we agree that the hedge fund allocation methodology should qualify under the Capital Interest Exception because in the hedge fund world the general partner’s previously accrued incentive represents part of the general partner’s capital investment in the fund. The concepts discussed in this paragraph can be illustrated by the following example:

Example. Assume that a limited partner and a general partner contribute $90 and $10, respectively, to a hedge fund (“Hedge Fund”). The general partner also has a 20% carried interest (classified as an API) that entitles the general partner to 20% of profits in excess of $100. With respect to their capital interests, the limited partner and general partner generally share in profits and losses pro rata.
based on capital accounts. However, under the partnership agreement, the general partner’s capital interest is not subject to the carried interest.

In year one, Hedge Fund purchases Stock X for $100. At the end of the first year, Stock X has appreciated in value to $200. Hedge Fund has no taxable income in year one, and neither partner takes a distribution during the year. At the end of year one, Hedge Fund allocates $100 of book gain to its partners as follows: $10 to the general partner with respect to its capital interest, $18 to the general partner with respect to its carried interest, and $72 to the limited partner.\(^{21}\) At the end of year one, the general partner’s capital account is $38 ($10 plus $10 plus $18), and the limited partner’s capital account is $162 ($90 plus $72). At the end of year one, the general partner’s capital account equals 19\% of the aggregate capital accounts of both partners.

At the end of the second year, Hedge Fund sells Stock X for $300. As a result, Hedge Fund has $100 of section 704(b) gain in year two. Typically, in the hedge fund world, the gain would be allocated as follows: $19 to the general partner with respect to its 19\% capital interest, $16.20 (20\% of the remaining $81) to the general partner with respect to its carried interest, and $64.80 (80\% of the remaining $81) to the limited partner. Thus, the Capital Interest Allocation to the general partner is based on the general partner’s book capital account. The capital accounts at each stage are listed below:

<table>
<thead>
<tr>
<th></th>
<th>General Partner</th>
<th>Limited Partner</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Initial</strong></td>
<td>$10</td>
<td>$90</td>
<td>$100</td>
</tr>
<tr>
<td><strong>After $100 Year One Appreciation</strong></td>
<td>$38 (10+$10+$18)</td>
<td>$162 ($90+$72)</td>
<td>$200</td>
</tr>
<tr>
<td><strong>Sale of Stock X (100 Section 704(b) Gain)</strong></td>
<td>$73.20 ($38+$19+$16.20)</td>
<td>$226.80 ($162+$64.80)</td>
<td>$300</td>
</tr>
</tbody>
</table>

\(^{21}\) The allocations in the above example follow a convention that is common in fund partnership agreements, i.e., the general partner receives a capital interest allocation that is not subject to the carried interest. Note, however, that under the Proposed Regulations, Capital Interest Allocations must be made in the same manner to all partners. Thus, in the above example, it would appear that only $8 of the allocation of revaluation gain to the general partner would be treated as a Capital Interest Allocation (in other words, an amount equal to the Capital Interest Allocation that the general partner would have received if the general partner had been an unrelated investor), and that $20 of the allocation of revaluation gain to the general partner would not be eligible for the Capital Interest Exception and so would give rise to Unrealized API Gain. This is consistent with how the examples in the Proposed Regulations conceptualize allocations to general partners that hold both APIs and capital interests. See, e.g., Prop. Treas. Reg. § 1.1061-3(c)(7), Ex. (1).
As discussed above, this allocation methodology generally is consistent with the construct adopted by the Proposed Regulations, in that Capital Interest Allocations to the general partner are based on the general partner’s book capital account. We agree that this allocation methodology should qualify under the Capital Interest Exception.

By contrast, unlike most hedge funds, private equity funds typically do not allow the general partner as a matter of course to take carried interest distributions merely because the net asset value of the fund has increased. They typically also do not allow investors to withdraw their capital from the fund early, nor do they generally accept contributions of cash from incoming investors on an ongoing basis throughout the life of the fund. Perhaps for those reasons, if a private equity fund were to revalue its assets under Treas. Reg. § 1.704-1(b)(2)(iv)(f), allocating book-up gain to the general partner with respect to its carried interest, going forward the general partner typically would not be entitled to earn a limited-partner-like return on the portion of its capital account attributable to the booked-up carried interest. That is logical because, in contrast to the hedge fund fact pattern, a private equity general partner typically could not elect to withdraw its capital account from the fund in cash early and reinvest it in the fund as a limited partner. Thus, under the private equity construct, the general partner’s capital investment in the fund typically is not treated as including any portion of the general partner’s capital account attributable to booked-in carried interest. Therefore, in the case of such a fund, future capital interest allocations will be made not on the basis of the partners’ booked-up capital accounts, but rather on the basis of another metric, such as the partners’ capital commitment or invested capital percentages. We firmly believe that this allocation methodology, although different from that typically employed in the hedge fund context, should also satisfy the Capital Interest Exception, because for the reasons discussed above, the portion of a private equity general partner’s capital account attributable to booked-in carried interest does not represent part of the general partner’s capital investment in the fund. Therefore, in the private equity context, permitting Capital Interest Allocations to be made on the basis of a different metric, such as percentages of capital commitments or invested capital, is consistent with the purpose of the Capital Interest Exception. The concepts discussed in this paragraph can be illustrated by the following example:

**Example.** Assume a private equity fund (“PE Fund”) with a limited partner and a general partner who contribute $90 and $10, respectively. The general partner also has a carried interest (classified as an API) that entitles the general partner to 20% of PE Fund’s profits. Under the partnership agreement, Capital Interest Allocations are generally made among the partners in accordance with their shares of invested capital (i.e., 90/10). However, the general partner’s capital interest is not subject to the carried interest.

In year one, PE Fund purchases all of the stock of PortCo for $100. PE Fund has no taxable income during its first year. At the end of the first year, the stock of PortCo has appreciated to $200, and there is an event that causes PE Fund to revalue its assets under Treas. Reg. § 1.704-1(b)(2)(iv)(f). As a result of the revaluation event, PE Fund allocates $100 of revaluation gain as follows: $10 to the general partner with respect to its capital interest, $18 to the general partner...
with respect to its carried interest, and $72 to the limited partner. At this point, the general partner’s capital account is $38 ($10 plus $10 plus $18).

At the end of the second year, PE Fund sells the PortCo stock for $300. There is $100 of section 704(b) gain in year two, which is allocated as follows: $10 to the general partner with respect to its capital interest, $18 to the general partner with respect to its carried interest, and $72 to the limited partner. The capital accounts at each stage are listed below:

<table>
<thead>
<tr>
<th></th>
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<td>$162</td>
<td>$200</td>
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<tr>
<td></td>
<td>($10+$10+$18)</td>
<td>($90+$72)</td>
<td></td>
</tr>
<tr>
<td>Sale of PortCo Stock ($100 Section 704(b) Gain)</td>
<td>$66</td>
<td>$234</td>
<td>$300</td>
</tr>
<tr>
<td></td>
<td>($38+$10+$18)</td>
<td>($162+$72)</td>
<td></td>
</tr>
</tbody>
</table>

If the Capital Interest Allocation Requirements are applied to the year two allocations by comparing the allocations to the partners’ section 704(b) capital accounts immediately prior to the allocations, we believe these results do not make sense. Specifically, immediately prior to the year two allocations, the general partner has 19% of the partnership’s total section 704(b) capital ($38/$200). Yet, under PE Fund’s partnership agreement, the general partner receives a capital interest allocation that is not based on the general partner’s share of section 704(b) capital immediately prior to the sale, but rather is based on the general partners’ share of invested capital. Therefore, under the Proposed Regulations, it would appear that the allocations are not eligible for the Capital Interest Exception. We believe that this result is not consistent with the purpose of the Capital Interest Exception. In the private equity example, the year-two allocations of section 704(b) income in accordance with the partners’ shares of invested capital should qualify for the Capital Interest Exception, because in the private equity example, the general partner’s capital investment in the fund does not include the general partner’s previously booked-in carried interest.

In sum, to avoid excluding a great many funds from the Capital Interest Exception, we believe that the Capital Interest Exception should be liberalized so that it permits allocations to be made using metrics other than relative book capital account balances, such as percentages of capital commitments or invested capital.

22 The considerations discussed in note 21 above apply here as well.
We recommend that the final regulations provide that, as an alternative to making allocations based on relative capital account balances, a partnership should be able to satisfy the Relative Capital Account Requirement by making allocations based on invested capital, capital commitments, or a similar reasonable metric. In addition, given that Prop. Treas. Reg. § 1.1061-3(c) refers in multiple places to making allocations in accordance with relative capital accounts, we believe that the rule permitting the use of alternative metrics should be broadly drafted, so that it is clear that it applies for purposes of Prop. Treas. Reg. § 1.1061-3(c) generally.

4. Market Rate Preferred Returns

Preferred returns on partnership equity may be structured in a variety of ways. Frequently they are structured as guaranteed payments, but very often they are structured instead as allocations of partnership income, in which case an allocation of a preferred return to a partner might be subject to section 1061. As described above, in order to qualify as a Capital Interest Allocation, the allocations must satisfy several requirements including the Significant Similar Allocation Requirement. As described above, under the Significant Similar Allocation Requirement Similar allocations must be “made to Unrelated Non-Service Partners with a significant aggregate capital account balance.” However, as a result of the Significant Similar Allocation Requirement, the Proposed Regulations could inadvertently cause certain market rate preferred returns on invested capital to be recharacterized as API Gains even though that would not accurately reflect the economic deal that the partners negotiated.

This can occur because many partnerships, particularly in the real estate and private equity industries, have multiple classes of equity, including multiple classes of preferred equity that earn different market rates of return for various economic reasons. For example, the partnership might have issued the preferred equity classes at different moments in time, and the market rate of return for preferred equity might have changed over time. In addition, the different classes of equity might have different distribution priorities that are reflected in their rates of return. Under the Proposed Regulations, the Significant Similar Allocation Requirement would be treated as being satisfied if it satisfies the safe harbor of having one or more Unrelated Non-Service Partners who own at least 5% or more of the aggregate capital account balance of the partnership at the time the allocation is made. However, it is not clear whether this safe harbor requires Unrelated Non-Service Partners to own at least 5% or more of each class of a partnership’s equity, including preferred equity. That is, it seems that, under the Proposed Regulations, if Unrelated Non-Service Partners do not own at least 5% or more of a class of preferred equity, then that class of preferred equity might not qualify for the safe harbor. The following example illustrates the issue:

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23 See, e.g., Prop. Treas. Reg. § 1.1061-3(c)(3)(i) and (ii).
25 Id.
Example. Assume that Unrelated Non-Service Partner X invests $20 in Class A preferred partnership equity that has a first-priority right to distributions and earns a 5% market-rate, preferred return. API Holder invests $10 of cash in Class B preferred partnership equity that has a second-priority right to distributions and earns a 6% market-rate, preferred return. Unrelated Non-Service Partners X and Y together invest $70 for the common equity of the partnership. The API Holder earns a 20% carried interest on this common equity investment. Under this arrangement, the 6% preferred return that the partners agreed would accrue on the capital that the API Holder invested in Class B equity might not qualify for the safe harbor for significant allocations to Unrelated Non-Service Partners, because an Unrelated Non-Service Partner does not hold 5% of this class of equity, even though it is a market rate preferred return.

We recommend that the final regulations provide an exception to the Significant Similar Allocation Requirement for market rate preferred returns. A market rate in this circumstance would be defined as an arm’s length preferred return to which a partnership and an unrelated investor reasonably could be expected to agree for equity having similar risk and where the unrelated investor did not provide any services to the partnership. An exception to the Significant Similar Allocation Requirement is appropriate for market rate preferred returns because the arm’s length standard would prevent potential abuse, and both taxpayers and the government have experience in applying this type of arm’s length standard when evaluating whether a partnership preferred return is a market rate. Moreover, failing to provide a clear exception for a market rate preferred returns could result in unnecessary complexity and uncertainty for common market transactions, particularly if the safe harbor that the Proposed Regulations currently provide for the Significant Similar Allocation Requirement were interpreted to apply only if Unrelated Non-Service Partners hold 5% or more of each class of partnership equity on which a preferred return is allocated. We believe that the determination of whether a preferred return is a market rate should be made at the time that the preferred return was set. Accordingly, in fact patterns where there are multiple classes of preferred interest with different rates, we believe that each class should be eligible for the exception, provided that the preferred return was at a market rate when the rate was set. We further recommend that the final regulations provide that a market rate preferred return on invested capital will be respected.

5. Tracking and Similar Allocations

As discussed above, only allocations that are made in the same manner to all partners can be Capital Interest Allocations that are not subject to recharacterization under section 1061 under the Capital Interest Exception. In general, allocations will be made in the same manner if, under the partnership agreement, the allocations are based on the relative capital accounts of the partners receiving the allocations and the terms, priority, type and level of risk, rate of return, and rights to cash or property distributions are the same.26 The scope of the Capital Interest Exception does not clearly cover

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numerous economic arrangements among API Holders and Unrelated Non-Service Partners that have nothing to do with APIs. A common example is tracking allocations.

At a high level, tracking allocations reflect an economic arrangement in which some, but not all, partners agree to disproportionately share in the benefits and burdens of ownership of one or more partnership investments. For example, some investors might have regulatory restrictions or investment rights that permit (or require) them to opt out of certain investments.

The Proposed Regulations suggest that tracking and similar allocations can satisfy the Same Manner Requirement of the Capital Interest Exception provided that the allocations are made in the same manner to all partners entitled to participate in the underlying economics, even when not all partners are entitled to participate in the underlying economics. Allocations will be considered to be made in the same manner if the allocations are based on the relevant capital accounts of the partners “receiving the allocations and the terms, priority, type and level of risk, rate of return, and rights to cash or property distributions during the partnership’s operations and on liquidation are the same.”27 The reference to “receiving the allocations” suggests that those partners might represent less than all partners. Similarly, Capital Interest Allocations “to more than one Unrelated Non-Service Partner may be aggregated for determining significance if such allocations are made in the same manner to each of the Unrelated Non-Service Partners.”28 The reference to “more than one Unrelated Non-Service Partner” suggests the same point.

The Same Manner Requirement is focused on ensuring that all partners participate in economic terms on a pro rata basis on terms that are no more or less favorable to them than to other partners. We believe this requirement can be applied on an asset-by-asset basis without requiring every partner to have an economic interest in all partnership assets. Nevertheless, the general requirement that Capital Interest Allocations must be based on the relative capital account balances of all partners creates some uncertainty.

We recommend that the final regulations clarify that partnership interests with interests in tracking or similar allocations can qualify for the Capital Interest Exception, provided that all partners with economic interests in such arrangements are entitled to the same economic return on a particular pool of partnership assets.

6. Returns on Realized and Unrealized API Gain

An important issue in the asset management industry is whether the earnings on capital attributable to prior allocations of API Gains can qualify for the Capital Interest Exception. We believe that the initial profit allocation attributable to the API is subject to section 1061 but that the earnings on the resulting section 704(b) capital that remains invested in a partnership should be eligible for the Capital Interest Exception, at least

27 Id.

with respect to previously taxed earnings. In order to facilitate the discussion, we use the following example.

Example. An API Holder holds only a profits interest (i.e., has no starting section 704(b) capital account). In year one, the fund’s investments appreciate by $100, entitling the API Holder to $20 of carry profits. Some of the fund’s investments were sold in year one, and the fund revalues the section 704(b) capital accounts of its partners at year end. At that time, the API Holder has a section 704(b) capital account balance of $20, $8 of which related to realized taxable profits and $12 of which related to section 704(b) revaluation gain. The API Holder has the right to receive a distribution of $20 at that time, but it decides to leave its capital invested in the fund, resulting in a section 704(b) capital account balance of $20 at that time. In year two, in addition to being allocated carry profits, the API Holder is allocated $5 of profits attributable to its year-one section 704(b) capital account balance, based on the relative section 704(b) capital accounts of all partners in the same manner as profits are allocated to all partners. The terms, priority, type and level of risk, rate of return, and rights to cash or property distributions are the same.

The $20 of carry profits in year one clearly does not qualify for the Capital Interest Exception. In order for allocations to qualify as Capital Interest Allocations (i.e., allocations eligible for the Capital Interest Exception), the allocations must be allocations of long-term capital gain made under the partnership agreement to an API Holder and to Unrelated Non-Service Partners in the same manner and based on their respective section 704(b) capital account balances (as discussed above). Capital Interest Allocations do not include amounts that are treated as API Gains and Losses and Unrealized API Gains and Losses (the “API Exclusion”). The $20 of carry profits allocated to the API Holder in the Example is either API Gain or Unrealized API Gain.


30 Prop. Treas. Reg. § 1.1061-3(c)(3)(iii)(A). The term “Unrealized API Gains and Losses” means all unrealized capital gains and losses that would be allocated to an API Holder with respect to an API, if all relevant assets were sold for fair market value on the relevant date, including, among other items, unrealized capital gains and losses that are allocated to the API Holder with respect to an API pursuant to a capital account revaluation under Treas. Reg. § 1.704-1(b)(2)(iv)(f) or Treas. Reg. § 1.704-1(b)(2)(iv)(s). Prop. Treas. Reg. § 1.1016-1(a) (definitions). Unrealized API Gains and Losses do not lose their character as such until they are recognized. Prop. Treas. Reg. § 1.1061-2(a)(ii).

The term “API Gains and Losses” means any long-term capital gains and losses with respect to an API, including, but not limited to, the “API One Year Distributive Share Amount” and the “API Three Year Distributive Share Amount.” Prop. Treas. Reg. § 1.1016-1(a) (definitions). The term “API One Year Distributive Share Amount” means the API Holder’s distributive share of net long-term capital gain from the partnership for the taxable year with respect to the partnership interest held by the API Holder calculated without the application of section 1061, less certain reductions for amounts excluded from the application of section 1061, including Capital Interest Gains and Losses. Prop. Treas. Reg. § 1.1061-4(a)(3)(i). The term “API Three Year Distributive Share Amount” means the API One Year Distributive Share Amount less items in the API One Year Distributive Share Amount that would not be
It is not clear how Capital Interest Allocations interact with the API Exclusion. Under one interpretation, allocations of earnings on realized API Gains and Unrealized API Gains qualify for the Capital Interest Exception, provided that the allocations meet the requirements of the Capital Interest Exception. Under this interpretation, the entire $5 of profits allocated with respect to the API Holder’s section 704(b) capital account in year two would be a Capital Interest Allocation.

The supplemental information section of the preamble to the Proposed Regulations (the “Preamble”) appears to corroborate this first interpretation, explaining that, in order for an allocation to be treated as a Capital Interest Allocation, the allocation must be based on the API Holder’s relative capital account balance in the Passthrough Entity. That section then states: “Although Unrealized API Gain or Loss is included in the owner’s capital account, the gain or loss will be treated as API Gain or Loss and not as Capital Interest Gain or Loss when recognized.” The statement indicates that Unrealized API Gain or Loss can be included in an API Holder’s section 704(b) capital account. At that point, any allocations based on the adjusted section 704(b) capital account arguably are eligible for the Capital Interest Exception. The statement also makes it clear that the recognition of Unrealized API Gain or Loss remains subject to section 1061.

Under a second interpretation, once a partnership interest is an API, the partnership interest remains an API, and no portion of that API can qualify for an exception unless the entire partnership interest qualifies for the exception. Earnings on realized or Unrealized API Gains are literally earnings with respect to an API. Under this interpretation, no portion of the $5 of profits allocated with respect to the API Holder’s section 704(b) capital account in year two would be a Capital Interest Allocation.

Under a third interpretation, an API Holder would receive section 704(b) capital account credit for realized API Gains but not Unrealized API Capital Gains for purposes of applying the Capital Interest Exception. We believe that, at a minimum, an API Holder should get section 704(b) capital account credit for section 704(b) income that has been fully taxed and essentially reinvested in the partnership. Absent clarity on this point, taxpayers might attempt to redeem their realized section 704(b) capital and later reinvest cash in an effort to qualify for the Capital Interest Exception.


32 85 Fed. Reg. at 49,755 (emphasis added). The supplemental information section emphasizes that “Capital Interest Gains and Losses never include API Gains and Losses, Unrealized API Gains and Losses, or API Holder Transition Amounts.” Id.

33 In many funds, an API Holder can redeem all or a portion of its entire section 704(b) capital account, whether the section 704(b) has been realized or not.
interpretation, $2 of earnings on the API Holder’s realized section 704(b) capital account in year two would be a Capital Interest Allocation.\textsuperscript{34}

We are not aware of any policy reason that would distinguish between the portion of a partner’s capital account attributable to realized gains and the portion of a partner’s capital account attributable to unrealized gains, so long as the character of the unrealized gains is preserved (unless a purpose of this portion of the Proposed Regulations is to not give “credit” for untaxed income earned in respect of an API). The Proposed Regulations clearly preserve the character of Unrealized API Gains. Accordingly, so long as the return earned by an API Holder on its capital satisfies the requirements of the Capital Interest Exception, arguably it should not matter how that capital arose (e.g., from cash contributions, realized profit allocations, unrealized profit allocations (made in accordance with section 704(b) principles)). We further believe that this approach is consistent with the Proposed Regulations, which do not appear to focus on how the API Holder acquired its capital account in the partnership for purposes of determining whether earnings on the capital account qualify under the Capital Interest Exception.

We recommend that the final regulations clarify whether returns on realized and Unrealized API Gain that remain in an API Holder’s section 704(b) capital account are eligible for the Capital Interest Exception. We recommend that, at a minimum, the final regulations provide that returns on realized (i.e., taxed) API Gain that remain in an API Holder’s section 704(b) capital account are eligible for the Capital Interest Exception.

7. Related Party Loans

As noted above, the principals in many investment funds contribute capital to the investment funds to invest alongside the limited partner investors. Many of these principals borrow the capital necessary to contribute their respective share of capital to the investment funds. In order to secure financing in a timely manner and on better terms, it is not uncommon for an affiliate of the investment fund (e.g., the management company) to make the loan or guarantee the borrowing. The principals generally are primarily liable for these obligations and, in many cases, the obligations are fully recourse to the principals.

The Proposed Regulations introduce a rule excluding amounts funded from certain related party loans from a partner’s capital account for purposes of determining Capital Interest Allocations and Passthrough Interest Capital Allocations. Specifically, under Prop. Treas. Reg. § 1.1061-3(c)(ii)(C), a partner’s capital account does not include the contribution of amounts directly or indirectly attributable to any loan or other advance made or guaranteed, directly or indirectly, by any other partner or the partnership (or any Related Person with respect to any such other partner or the partnership) (proceeds from such loans, “\textit{Impermissible Loan Proceeds}”). However, Prop. Treas. Reg.

\textsuperscript{34} Two dollars ($2) equals the portion of the entire allocation of $5 corresponding to the portion of realized carry profits in year one ($8) relative to total carry profits in year one ($20), or 40\% of total carry profits.
§ 1.1061-3(c)(ii)(C) provides that the repayments of principal on the loan are included in capital accounts as those amounts are paid by the partner, provided that the loan is not repaid with Impermissible Loan Proceeds (all such proceeds, whether in repayment or initial contribution, “Permissible Proceeds”).

Earlier versions of proposed carried interest legislation (i.e., legislation in earlier Congresses that preceded the enactment of the Act) included language regarding the treatment of certain loan proceeds.35 Congress, however, rejected similar provisions when it passed the Act with section 1061.36 Specifically, when debating the Act, Congress considered and rejected two similar versions of prior carried interest legislation during each Committee markup in November 2017.37 Thus, neither section 1061 nor its legislative history addresses the treatment of loan proceeds being used to fund capital contributions.

While not explicitly stated in the legislative history of the Act, we believe the policy behind the Capital Interest Exception was to ensure partners had capital at risk to qualify for the exception.38 The Preamble does not provide further explanation or clarity to the exception’s rationale.39 Given the policy noted above and the absence of further explanation, Prop. Treas. Reg. § 1.1061-3(c)(ii)(C) does not seem to be in line with the statute’s intent or the policy behind the Capital Interest Exception in section 1061(c)(4). If a partner contributed proceeds from a fully recourse loan, the partner would be fully at risk, and in our view the partner should qualify for exception. We understand that there are fact patterns in which a partner might be considered less at risk (e.g., a nonrecourse loan secured solely by the acquired partnership interest). We note, however, that in such cases (or in abusive loan transactions), general federal income tax principles should apply to recharacterize the loans.40 We believe, however, that the rule in the Proposed

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35 Versions of carried interest legislation have been introduced in several Congresses, including legislation introduced several times by former member, Rep. Sandy Levin (D-MI). See also, e.g., Carried Interest Fairness Act of 2015, H.R. 2889, 114th Cong. (2015); and Tax Reform Act of 2014, H.R. 1, 113th Cong. (2014) (the “Camp Proposal”).


38 The conference report for the Act provides that:

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 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.


40 See Rev. Rul. 72-135, 1972-1 C.B. 200 (a nonrecourse loan made by a general partner to a limited partner was treated as a capital contribution by the general partner to the partnership).
Regulations is unnecessarily broad and creates several uncertainties in its application, discussed in more detail below. We are entirely supportive of a rule that is consistent with the policy of ensuring that partners have capital at risk to meet the Capital Interest Exception in section 1061(c)(4).

We recommend that the final regulations not include Prop. Treas. Reg. § 1.1061-3(c)(ii)(C) because it does not appear to be supported by the language of the Act or its legislative history and, as discussed above, it does not appear that Congress intended such a provision. Further, given the general federal income tax principles that address respecting instruments as indebtedness, we do not think the provision is necessary.

Alternatively, if our primary recommendation is not adopted, we recommend that the final regulations include a more narrowly tailored rule for non-recourse loans made, advanced, or guaranteed by related parties. Such a rule would modify the related party loan rule in Prop. Treas. Reg. § 1.1061-3(c)(ii)(C) so that capital accounts do not include the contribution of amounts attributable to loans or other advances made or guaranteed by any other partner, the partnership, or a Related Person, only if the loans are (i) non-recourse to the borrowing partner and (ii) secured by only the partnership interest acquired with the applicable proceeds (an “Impermissible Loan”).

Furthermore, if our primary recommendation is not adopted, we recommend that the following issues be clarified or otherwise addressed in the final regulations:

- **Contributions Fully Funded with Impermissible Loan Proceeds.** We recommend that the final regulations clarify how to treat a partner that has fully funded a capital contribution with Impermissible Loan Proceeds and then later repays such amounts using Permissible Proceeds before there is a Capital Interest Allocation. In particular, clarity regarding the treatment of the pre-repayment economic appreciation on the assets would be helpful. While Prop. Treas. Reg. § 1.1061-3(c)(ii)(C) provides that the repayments on the loan are included in capital accounts as those amounts are paid by the partner using Permissible Proceeds, it does not specifically state whether the partner’s share of pre-repayment economic appreciation is treating as being attributable to a capital account that is funded with Permissible Proceeds. Further, it does not address whether a revaluation by the partnership of its assets with a share of the revaluation gain being allocated to that partner before the repayment would change that answer. We believe it is appropriate for the partner’s capital account to be treated as funded at the time of actual contribution upon a repayment using

41 In the event our primary recommendation is not adopted, but the Proposed Regulations are modified when finalized, we believe that a borrower should obtain capital account credit to the extent the loan is secured by property of the partner other than the partnership interest acquired with the proceeds of the Impermissible Loan (e.g., the partner has other partnership interests) under the principles of section 752.
Permissible Proceeds based on repayment provisions in Prop. Treas. Reg. § 1.1061-3(c)(ii)(C) so that Capital Interest Allocations made after repayment would include pre-repayment economic appreciation (and we believe the results should be the same even if pre-repayment appreciation is reflected in a partner’s capital account before repayment because of a revaluation of partnership assets). In any event, we believe that the final regulations should clarify the intended result.

- Contributions Partial Funded with Impermissible Loan Proceeds.

Similarly, it would be helpful for the final regulations to clarify how to treat a partner that has funded a capital contribution in part using Permissible Proceeds and in part using Impermissible Loan Proceeds. Specifically, we recommend that the requirements of a Capital Interest Allocation be clarified so that a capital account may be bifurcated between contributions from Impermissible Loan Proceeds and Permissible Proceeds, and allocations on the portion of the capital account funded with Permissible Proceeds will meet the Same Manner Requirement. Absent a clarification, the Capital Interest Allocation Requirements could be interpreted to mean that because the portion of the partner’s capital account is funded using Impermissible Loan Proceeds, the partnership would be making allocations to that partner in excess of what is warranted based on its capital account. Thus, it would not be in the same manner as API Holders and Unrelated Non-Service Partners and not meet the Capital Interest Allocation Requirements. As we believe that is not the intent of the Proposed Regulations, we welcome clarity on the intended result and an example illustrating the answer in final regulations.

These two issues are illustrated in the following example:

**Example.** On Date 1, Service Partner, an API Holder, contributes $100 to PRS using Impermissible Loan Proceeds. Using cash contributed by other partners, PRS acquires a capital asset for $1000. On Date 2, when the asset has appreciated to $1300, Service Partner repays $40 of its $100 loan using Permissible Proceeds. On Date 3, when the asset has appreciated to $1800, it is sold. Service Partner’s interest in PRS with respect to the $100 contribution entitles it to a cash distribution of $180 and a corresponding allocation of $80 of capital gain.

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42 A partial repayment of a related party loan raises the necessity for clarification for the issue discussed above regarding a full repayment of a related party loan using Permissible Loan Proceeds and the issue arising from a partial funding using Impermissible Loan Proceeds. See the example in the text below.

43 For simplicity, this example assumes other partners contributed the necessary cash to acquire the asset on Date 1. Further, it does not address allocations to the other partners or allocations of carried interest.
We believe that Service Partner’s capital account, for purposes of the Capital Interest Allocation, should be treated as though Service Partner contributed $40 using Permissible Proceeds on Date 1. In addition, we believe that Service Partner’s capital account should be bifurcated between the 40% obtained with Permissible Proceeds and the 60% obtained with Impermissible Proceeds when applying the Capital Interest Allocation requirements. Thus, assuming the other requirements under Prop. Treas. Reg. § 1.1061-3(c)(4) are met, we believe that Service Partner should have a qualifying Capital Interest Allocation of $32 (40% of $80), which is treated as made in the same manner as the API Holders and Unrelated Non-Service Partners. We believe that Service Partner also should have an allocation of $48 (60% of $80) that is not treated as a Capital Interest Allocation.

- **Transition Rules.** We further recommend that the final regulations provide transition rules for the timing of the application of this provision to (i) related party loans made, advanced, or guaranteed before the Proposed Regulations were issued or after the Proposed Regulations were issued but before they are finalized and (ii) the repayment of such loans before the Proposed Regulations were issued or after the Proposed Regulations were issued but before they are finalized.

B. Section 1061(b)

1. Family Offices

The Preamble\(^{44}\) acknowledges that section 1061(b) was intended to protect family offices (portfolio investments made on behalf of the service providers and persons related to the service providers) from the application of section 1061, and indicates that the drafters believed that “the section 1061(b) exception effectively is implemented in the proposed regulations with the exception to section 1061 for Passthrough Interest Direct Investment Allocations.”\(^{45}\) However, the Preamble requests comments on the application of this provision and whether the Proposed Regulations’ exclusion for “Passthrough Interest Direct Investment Allocations” properly implements the exception.

As discussed below, we believe that the rule on Passthrough Interest Direct Investment Allocations does not fully implement a family office exception. Section 1061(b) provides: “To the extent provided by the Secretary, subsection (a) shall not apply to income or gain attributable to any asset not held for portfolio investment on behalf of third-party investors.”

Stated another way, income or gain attributable to assets held other than for portfolio investment on behalf of third-party investors are not subject to section 1061(a)

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\(^{44}\) 85 Fed. Reg. at 49,763.

\(^{45}\) Id.
(to the extent provided by the Secretary). For these purposes a third-party investor is
defined at section 1061(c)(5) to mean:

A person who (A) holds an interest in the partnership which does not constitute property held in connection with an applicable trade or business; 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 paragraph (1) for such partnership or any applicable trade or business.

Prop. Treas. Reg. § 1.1061-3(c)(5)(iii), which deals with Passthrough Interest Direct Investment Allocations, provides that:

Allocations are treated as Passthrough Interest Direct Investment Allocations if (A) The allocations solely are comprised of long-term capital gain and loss derived from assets (other than an API) directly held by the Passthrough Entity; and (B) Allocations are made in the same manner (as provided in paragraph (c)(3)(i) of this section) based on each direct owner’s capital account as determined under paragraph (c)(3)(ii) of this section.

We believe that the rule on Passthrough Interest Direct Investment Allocations does not adequately protect partners in the family office context from being subject to section 1061. For example, assume that individuals X and Y are the parents of A, B, and C. X, Y, A, B, and C are all partners in a family office partnership, PRS. PRS invests in properties that are specified assets for purposes of section 1061. The assets of PRS are not held for portfolio investment on behalf of third-party investors nor are interests in PRS so held. The manager of PRS has been issued a carried interest entitling her to a 20% share of the profits that otherwise would be allocable to the other partners. Many family partnerships employ third-party managers, others are managed by family members. In either case, we believe that section 1061(b) should apply to the allocation, because PRS has not invested any funds on behalf of third-party investors.

The Capital Interest Exception will not apply to gains allocated to A pursuant to A’s profits interest. Such allocations are not Passthrough Interest Direct Investment Allocations because they are not made to all partners in partnership on the basis of their capital accounts (or other possible metrics). Rather, such allocations are made only to A pursuant to A’s profits interest. Nevertheless, we believe that section 1061(b) should apply to the allocation, because PRS has not invested any funds on behalf of third-party investors.

We recommend that the final regulations contain a specific exception under section 1061(b) that would apply in the case of family offices and other partnerships that do not hold assets for portfolio investment on behalf of third-party investors. We

46 See our comment in Section II.A.3 above on the Relative Capital Account Requirement.
recommend that the exception cover transfers subject to either section 1061(a) or section 1061(d). In addition, because section 1061(b) is not limited only to family offices, we believe that it also apply in other fact patterns where assets are not held for portfolio investment on behalf of third-party investors.

2. Enterprise Value

As discussed in the 2019 Comments, we recommend that Treasury and the Service exercise their authority under section 1061(b) to confirm that section 1061(a) does not apply to recharacterize income or gain attributable to the value of intangibles created or used in an ATB (these intangibles typically are customer-based intangibles and often are 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 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.47

We recognize that the Passthrough Interest Direct Investment Allocation rules in part operate to implement an exception for enterprise value, but this appears to be an unintended product, rather than an exception by design. Because we believe that section 1061(a) was not intended to change the current tax treatments applicable to enterprise value, we believe that the final regulations should provide specifically that section 1061(a) does not apply to recharacterize income or gain attributable to enterprise value. Similarly, we believe that the enterprise value exception should apply to allocations through tiers and should not require allocations in accordance with partner capital accounts (or a similar metric) in fact patterns in which the intangible asset is not held for portfolio investment on behalf of third-party investors (such as in the case of goodwill and other enterprise value intangibles created by a fund management company or sponsor operating company).

We recommend that the final regulations broaden the Passthrough Interest Direct Investment Allocation rules in order to exempt enterprise value and similar assets from generating API Gains and Losses. For example, consistent with our comment in Section II.A.5 above on tracking and similar allocations, allocations of enterprise value and similar assets should not be required to be made in accordance with capital account balances.

47 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. Rocap, & William R. Welke, Baucus Bill Proposals and Enterprise Value Tax, TAX NOTES, Nov. 1, 2010, at 565.
C. Miscellaneous

1. Scope of Section 1061(d) Transfers

Section 1061(d) generally provides that if a taxpayer “transfers” an API “directly or indirectly” to a related person, then 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 three years as is allocable to such interest over (B) any amount treated as short term capital gain under section 1061(a) with respect to the transfer of such interest. For this purpose, a related person includes a member of the taxpayer’s family within the meaning of section 318(a) and any person who performed services 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. Neither the Conference Report nor the Bluebook sheds any light on how section 1061(d) is intended to operate, or where it applies.48

The Proposed Regulations interpret section 1061(d) to override any otherwise applicable nonrecognition provisions to the extent of the amount described in section 1061(d)(1).49 The Preamble does not explain why Treasury and the Service believe the language of section 1061(d) as enacted overrides otherwise applicable nonrecognition provisions.

It is not clear that the statutory language of section 1061(d) supports overriding nonrecognition. Section 1061(d) itself does not refer to any nonrecognition provisions, nor does it contain any express statement of intent to override nonrecognition treatment. Further, the provision operates by reference to the taxpayer’s “long-term capital gains,” which as defined in section 1222(3) include only gains that are recognized for U.S. federal income tax purposes.50 Use of a defined term that includes only gains that are recognized for U.S. federal income tax purposes does not in, in our view, support Treasury and the Service’s interpretation of section 1061(d) as overriding nonrecognition.51

Similarly, the history of the language in section 1061(d) also does not support overriding nonrecognition. The language of section 1061(d) as enacted closely tracks and clearly is derived from proposed section 1061(e) of the Camp Proposal. However,

48 See Conference Report at 420-21; Bluebook at 200-03.
50 Section 1222(3) defines long-term capital gain as gain from the sale or exchange of a capital asset held for more than one year, if and to the extent such gain is taken into account in computing gross income. Under Treas. Reg. § 1.61-6(b), gross income excludes realized gains or losses that are not recognized.
51 We also note that neither Treasury nor the Service interprets section 751(a), another provision that recharacterizes certain gains or losses on the sale or exchange of a partnership interest, to override nonrecognition.
proposed section 1061 of the Camp Proposal included a separate provision explicitly overriding nonrecognition.52 There is no provision in section 1061 as enacted that explicitly overrides nonrecognition on the transfer of an API. Contrary to Treasury and the Service’s interpretation in the Proposed Regulations, we believe the more natural inference from Congress’s decision to adopt language from a proposal that included a provision explicitly overriding nonrecognition without including that explicit overriding provision is that Congress did not intend for section 1061(d) to override nonrecognition.

Additionally, other nonrecognition override provisions in the Code support the position that section 1061(d) does not override nonrecognition. Where Congress has intended a Code provision to override nonrecognition, it has used clear and explicit language to do so.53 Such language generally takes the form of “[the applicable] gain shall be recognized notwithstanding any other provision of [the Code].”54 The provision of the Camp Proposal that would have overridden nonrecognition was drafted similarly. Given how clear Congress has been in the past when enacting provisions that override nonrecognition, the lack of any similar language in section 1061 as enacted support the view that Congress did not intend for section 1061(d) to override nonrecognition.

Under the Proposed Regulations, for purposes of section 1061(d) the term “transfer” is broadly defined and “includes, but is not limited to, contributions, distributions, sales and exchanges, and gifts.”55 The only exception to this broad definition is that a contribution under section 721(a) to a partnership is not treated as a transfer subject to section 1061(d). According to the Preamble, the basis for excepting partnership contributions from section 1061(d) is that Treasury and the Service believe that section 704(c) principles would apply to prevent any Unrealized API Gains from being allocated to other partners.56 Treasury and the Service requested comments on transfers other than section 721(a) contributions that satisfy this standard and therefore should be excluded from section 1061(d).

We believe that there are transfers other than section 721(a) transfers that do not result in a decrease in any taxpayer’s pre-transfer share of Unrealized API Gains, and that such transfers similarly should be excluded from section 1061(d). For example, the distribution by a partnership of an API in another partnership does not necessarily result in a decrease in the Unrealized API Gains of any partner. Such distributions are not

52 See proposed section 1061(b)(3) of the Camp Proposal. This provision in the Camp Proposal is not limited to transfers between related parties but applies more broadly to any transfer of an interest subject to the proposed section.

53 See, e.g., I.R.C. §§ 291(a)(1), 467(c)(1), 617(d)(1), 995(c)(1)(B), 1038(b)(3), 1245(a)(1), 1250(a)(1)(A) and (a)(2)(A), 1251(a)(1), 1252(a)(1), 1254(a)(1), 1257(a), 1276(a)(1), 1291(f) (in each case, explicitly providing that the relevant gain shall be recognized notwithstanding any other provision of either the Code or Subtitle A of the Code, depending on the specific provision).

54 Id.


uncommon. In many hedge funds, the general partner of the fund periodically will distribute portions of its interest in the fund to the individual sponsors who, in turn, either will retain the interests or will contribute them to an onshore feeder. These API distributions have been common in the industry for years (including prior to the enactment of section 1061) and can be made for a number of non-tax reasons, including for the purpose of reducing the value of the sponsors’ interest directly held by the general partner of the master fund, as the general partner often has unlimited liability for the obligations of the master fund under applicable law. Given the “once an API, always an API” rule in the Proposed Regulations, it would appear that such distributions of APIs would offer little opportunity for abuse. However, the section 1061(d) rules in the Proposed Regulations could conceivably turn such distributions of APIs into fully taxable transactions even if the distribution did not result in a reduction in any partner’s pre-distribution share of Unrealized API Gains. Similar to the exclusion for section 721(a) distributions, we believe that section 731(a) distributions of APIs should be excluded from section 1061(d) as long as each partner’s pre-distribution share of Unrealized API Gains is preserved.

In addition to section 731(a) distributions in which the partners’ Unrealized API Gains are preserved, we believe the Proposed Regulations should explicitly exclude forfeitures of unvested partnership interests and reallocations of profits under Treas. Reg. § 1.761-1(c) from the definition of “transfer” for purposes of section 1061(d). The current broad definition of “transfer” under the Proposed Regulations leaves open the question of whether forfeitures or reallocations of profits among existing partners could be considered a transfer for purposes of section 1061(d). Because these are fairly common events, we recommend that Treasury and the Service provide a clear rule as to whether such events are or are not treated as transfers for these purposes.

We recommend that the final regulations provide that section 1061(d) does not apply to transfers otherwise entitled to nonrecognition treatment under the Code. We believe that the language of section 1061(d) and its legislative history do not support overriding nonrecognition. It also is not clear that overriding nonrecognition treatment is within the scope of the regulatory authority granted to Treasury and the Service by the statute. If Treasury and the Service conclude that section 1061(d) does override nonrecognition treatment, then we recommend that the final regulations exclude transfers of APIs from section 1061(d) that do not result in a decrease in the transferee’s pre-transfer share of Unrealized API Gains.

Finally, we strongly recommend that the final regulations make clear that forfeitures and reallocations are not transfers for purposes of section 1061(d). In excluding section 721(a) contributions from section 1061(d), Treasury and the Service indicate that section 1061(d) should not apply to circumstances in which the partners’ Unrealized API Gains are preserved. This standard implicitly assumes that the partners’ interests in Unrealized API Gains are necessarily fixed, but that is not always the case. Forfeitures and reallocations involve circumstances in which the partners’ legal and economic interests in the partnership’s Unrealized API Gains are contingent rather than fixed. Where a partner’s interest in Unrealized API Gains is contingent, we do not
believe it is appropriate to tax a partner on a reduction in that interest under section 1061(d).57

2. In-Kind Distributions and Transfers of Non-Section 1222 Property

Under the Proposed Regulations, the “Recharacterization Amount” is the amount treated as short-term capital gain and not as long-term capital gain under section 1061(a) by the person who must pay tax on the gains and losses recognized with respect to the API (the “Owner Taxpayer”). The Recharacterization Amount is calculated as (1) the Owner Taxpayer’s One Year Gain Amount less (2) the Owner Taxpayer’s Three Year Gain Amount (each as defined below).58 The Preamble provides that certain types of long-term capital gain, including long-term capital gains determined under section 1231 or section 1256, are excluded from both the One Year Gain Amount and Three Year Gain Amount.59 However, the calculations set forth in the Proposed Regulations to determine an Owner Taxpayer’s One Year and Three Year Gain Amounts do not fully exclude these types of long-term capital gain.

Under the Proposed Regulations, the “One Year Gain Amount” is the sum of (1) the Owner Taxpayer’s combined net API One Year Distributive Share Amount from all APIs held during the taxable year and (2) the API One Year Disposition Amount.60 A similar calculation is provided for the “Three Year Gain Amount.”61 The Proposed Regulations state that certain items of long-term capital gain and loss are excluded from an Owner Taxpayer’s API One Year and Three Year Distributive Share Amount, including long-term capital gain and long-term capital loss determined under section 1231 and section 1256.62 However, a similar carveout is not provided for an Owner Taxpayer’s API One Year and API Three Year Disposition Amount. This suggests that certain long-term capital gain or loss, such as gain or loss determined under section 1231, could be included in an Owner Taxpayer’s One Year Gain Amount or Three Year Gain Amount calculation if such gain is included in the Owner Taxpayer’s API One Year Disposition Amount or API Three Year Disposition Amount. For example, under the calculation set forth in the Proposed Regulations, section 1231 gain recognized on the disposition of Distributed API Property (property distributed from a partnership with

57 This approach is consistent with the treatment of reallocations under Treas. Reg. § 1.761-1(c) as nontaxable events.


respect to an API and subsequently disposed of by the distributee-partner) could be included in an Owner Taxpayer’s API One Year Disposition Amount, and therefore included in the Owner Taxpayer’s One Year Gain Amount. This is inconsistent with the language set forth in the Preamble that long-term capital gains determined under section 1231 or section 1256 are to be excluded from the calculation of the One Year and Three Year Gain Amounts entirely.63

Further, the Proposed Regulations regarding transfers to related persons rely on the calculation of an Owner Taxpayer’s API One Year Disposition Gain Amount to determine whether or not a transfer will result in the recognition of short-term capital gain under section 1061(d).64 If gains such as those from section 1231 property are included in the calculation of an Owner Taxpayer’s One Year Disposition Amount, those gains could trigger recharacterization under the related party rules. This result would be inconsistent with the explanation provided in the Preamble, which provides that the recharacterization rules under section 1061(a), to which section 1061(d) cross references, apply only to capital gains or losses that are treated as long-term capital gain under paragraphs (3) and (4) of section 1222.

To address this issue, we recommend clarifying that the items of long-term capital gain and loss identified in Prop. Treas. Reg. § 1.1061-4(b)(6) are excluded from the calculation of the Owner Taxpayer’s One Year and Three Year Disposition Amount, and not just from the API One Year and Three Year Distributive Share Amount.

3. Third-Party Purchaser Exception

Under Prop. Treas. Reg. § 1.1061-3(d), if a taxpayer acquires an interest in a partnership by taxable purchase for fair market value and such interest would otherwise be an API, then the taxpayer will not be treated as acquiring an API if each of following three conditions are met immediately prior to the purchase: First, the taxpayer must not be related (within the meaning of sections 267(b) and 707(b)) to any person who provides services to the ATB in respect of which the API was issued or any service provider who provides services to or for the benefit of such partnership (or any lower-tier partnership in which such partnership holds an interest, directly or indirectly). Second, the transfer must not be subject to the related-party rule in section 1061(d). Third, the taxpayer must not have provided services, must not currently provide services, and must not anticipate providing services in the future to or for the benefit of the partnership, directly or indirectly, or any lower-tier partnership in which the partnership directly or indirectly holds an interest.

The Proposed Regulations are unclear as to whether the exception applies only to an API that is directly acquired or also to an API in which the buyer acquires an indirect interest through an upper-tier partnership. Like the exception provided to corporations

under Prop. Treas. Reg. § 1.1061-3(a), we recommend that the third-party purchaser exception apply to both direct and indirect acquisitions of partnership interests.

We also see no policy reason why third-party purchaser should be subject to section 1061 for APIs acquired either directly or indirectly. Rather, we believe that the third-party purchaser exception should operate through tiers like the corporate exception—in other words, it should be an exemption from section 1061 applicable not only to the purchased API, but also to any interests in lower-tier APIs that are held indirectly through the purchased upper-tier partnership interest. Therefore, we recommend that it be clarified that the exception applies regardless of whether a lower-tier API is acquired before or after the third-party purchases the upper-tier partnership interest. If the exception does not apply to lower-tier APIs, we are concerned that it will be of very limited benefit, given the prevalence of tiered partnership structures in the fund world.

We note that the purchaser might not be able rely on Rev. Rul. 87-11565 to adjust the basis of the underlying fund assets to prevent the recognition of built-in gain, as fund sponsors generally do not make section 754 elections at the fund level. Rev. Rul. 87-115 also would not prevent the purchaser from being subject to section 1061 with respect to taxable income attributable to post-acquisition increases in value. Thus, we believe the exception for indirect acquisitions is needed.

An additional question is whether it matters whether the lower-tier API is already present in the structure when the third party purchases an upper-tier partnership interest. Assuming that the rationale behind the exception is that a third-party, non-service-provider purchaser should not be subject to section 1061 with respect to any amounts that otherwise would be subject to section 1061, then it should not matter whether a lower-tier API was already present in the structure when the purchaser acquired its interest.

We also believe that the exception should be expanded to include the acquisition of a partnership interests by an unrelated non-service-provider through the contribution of cash, as we see no substantive difference between acquiring an interest by purchase from another partner or by contribution.66

4. **PFICs Subject to QEF Elections**

The Proposed Regulations apply a modified look-through approach to passive foreign investment companies ("PFICs") with respect to which a taxpayer has made a qualifying electing fund ("QEF") election, provided that the QEF provides relevant

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66 Cf. Treas. Reg. § 1.197-2(h)(12)(ii)(E), (iv)(E)(1), (v)(B) (treating the acquisition of a partnership interest in exchange for a contribution of property to the partnership as an acquisition of the partnership interest from the historic partners for purposes of applying the section 197(f)(9) “anti-churning” rules to partnership basis adjustments under sections 732(b), 734(b), and 743(b).
information to electing taxpayers. 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. In general, a U.S. person who owns stock of a PFIC is subject to an interest charge regime in which interest is charged with respect to certain PFIC distributions and dispositions. The interest charge can be avoided if the U.S. person makes a QEF election with respect to the PFIC. In that event, the U.S. person owning stock of a QEF generally must include in gross income as ordinary income the shareholder’s pro rata share of “ordinary earnings” of the QEF and as long-term capital gain the shareholder’s pro rata share of “net capital gain.” Net capital gain for a taxable year cannot exceed a QEF’s earnings and profits (“E&P”) for the year. If a domestic partnership owns PFIC shares 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. A U.S. person that indirectly owns QEF shares through a 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. The rules are less clear when a foreign partnership with U.S. partners owns PFIC shares. In that event, any QEF election would be made by the U.S. partners.

Under the Proposed Regulations, partnership interests held by a QEF can constitute APIs; we believe that is supportive of this rule. The Corporate Exception from the definition of APIs does not apply to QEFs.

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67 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.

68 See I.R.C. § 1291.

69 See I.R.C. § 1291(d)(1).

70 The term “ordinary earnings” means the excess of the earnings and profits (“E&P”) of the QEF for the taxable year over its net capital gain for the taxable year. I.R.C. § 1293(e)(1). As discussed below, the calculation of net capital gain and ordinary earnings requires netting at the PFIC level under the general QEF rules.

71 A shareholder’s pro rata share generally is the amount which would have been distributed with respect to the shareholder’s stock if, on each day during the taxable year, the QEF had distributed to each shareholder a pro rata share of the day’s ratable share of the QEF’s ordinary earnings and net capital gain for such taxable year. I.R.C. § 1293(b).

72 I.R.C. § 1293(e)(2).

73 See I.R.C. § 7701(a)(30) (defining a United States person to include domestic partnerships).

74 Prop. Treas. Reg. § 1.1061-3(b)(2)(ii). 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 QEFs. I.R.C. § 1(h)(10)(G). 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. We believe there is authority for this distinction and recommend retaining this provision. In addition to the general grant of authority to
As indicated above, a U.S. person who has made a QEF election with respect to a PFIC generally includes in his or her gross income, as long-term capital gain, his or her pro rata share of the PFIC’s “net capital gain.” A QEF determines its net capital gain at the corporate level, limited to the E&P the taxable year, 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 E&P for the taxable year and report the entire amount as ordinary income.\textsuperscript{75}

If a QEF determines and reports its net capital gain under the first option, it generally will have to apply netting rules at the corporate level and potentially limit its net capital gain to the E&P of the QEF for the taxable year (in the event there were ordinary losses). A QEF’s net capital gain (disregarding specific categories of gain provided in section 1(h)), equals the excess of the QEF’s net long-term capital gain (i.e., the excess of long-term capital gains over long-term capital losses) for the taxable year over the QEF’s net short-term capital loss (i.e., the excess of short-term capital losses over short-term capital gains) for the taxable year.\textsuperscript{76} The distinction between long-term and short-term capital gains and losses is determined by reference to a greater-than-one-year holding period. A QEF’s computation of net capital gain does not take into account the greater-than-three year holding period required for long-term capital gain treatment under section 1061 or the other categories of capital gain and capital loss that are not subject to recharacterization under section 1061 (e.g., section 1231 gain and loss, qualified dividend income or section 1256 gain and loss). In addition, for this purpose, a QEF’s net capital gain is limited to the QEF’s E&P for the taxable year. If, for example, a QEF has net capital gain of $100x but a $30x ordinary loss, the QEF’s net capital gain of the QEF would be limited to the E&P of $70x.

The corporate-level calculation of net capital gain is inconsistent with the approach of netting of gains and losses at the individual owner level, which the Proposed Regulations generally permit. The Proposed Regulations partially address this concern by permitting a QEF to provide additional information to its shareholders to enable API Holders to determine the amount of their QEF inclusion that would be included in API One Year Distributive Share Amounts\textsuperscript{77} and API Three Year Distributive Share Amounts provide guidance as necessary or appropriate to carry out the purposes of section 1061, we believe that the authority granted under section 1(h)(9) supports the distinction.

\textsuperscript{75} Treas. Reg. § 1.1293-1(a)(2)(i).

\textsuperscript{76} See I.R.C. § 1222(11).

\textsuperscript{77} “API One Year Distributive Share Amount” is defined to exclude gains and losses that are not subject to recharacterization under section 1061, such as section 1231 gain and loss, qualified dividend income, section 1256 gain and loss, and other gains and losses characterized as long-term capital gain or loss without regard to the holding period rules of section 1222 (“Excluded Gains”). Prop. Treas. Reg.
Amounts. With that information, an Owner Taxpayer’s QEF inclusion of net capital gain, subject to reduction for items of Excluded Gain, is included in its API One Year Distributive Share Amount.\(^{78}\) An Owner Taxpayer includes in its API Three Year Distributive Share Amount the Owner Taxpayer’s QEF inclusion of net capital gain determined for its API One Year Distributive Share Amount, presumably reduced to an amount that would be the net long-term capital gain if that amount were calculated by reference to a greater-than-three-year holding period, if the QEF provides information to determine the amount of the inclusion that would constitute net long-term capital gain for section 1293 purposes if the QEF’s net capital gain were determined by substituting a greater-than-three-year holding period rather than a greater-than-one-year holding period.\(^{79}\) If the information is not provided, an API Holder must include all amounts of long-term capital gain from the QEF in its API One Year Distributive Share Amounts (i.e., all amounts would be short-term capital gain).\(^{80}\) The Proposed Regulations also do not address how an Owner Taxpayer should apportion its distributive share of a QEF’s net capital gain from a Passthrough Entity between a capital interest and an API. We recommend that the final regulations:

- Clarify that an Owner Taxpayer includes in its API Three Year Distributive Share Amounts the same base amount as determined for the API One Year Distributive Share Amounts as adjusted to reflect only net long-term capital gains and losses calculated by substituting a greater-than-three-year holding period for a greater-than-one-year holding period.
- Provide a rule that would apportion any E&P limitation on a shareholder’s pro rata share of net capital gain in proportion to the shareholder’s related API One Year Distributive Share Amount and related API Three Year Distributive Share Amount.
- Permit an Owner Taxpayer otherwise to substantiate the amounts of greater-than-one-year capital gain, greater-than-three-year capital gain, and Excluded Gains, absent reporting from a QEF. This approach would

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\(^{78}\) Prop. Treas. Reg. § 1.1061-4(b)(5)(i).

\(^{79}\) Prop. Treas. Reg. § 1.1061-4(b)(5)(ii). This provision is not entirely clear and could be clarified. It provides that the API Three Year Distributive Share Amount includes an Owner Taxpayer’s share of an inclusion under section 1293(a)(1) of the pro rata share of the net long-term capital gain of a QEF determined for one-year QEF net capital gain purposes “if the QEF provides information to determine the amount of the inclusion that would constitute net long-term capital gain . . . if the QEF’s net capital gain for the taxable year were calculated under section 1222(11) applying paragraphs (3) and (4) of section 1222 by substituting three years for one year.” Id.

\(^{80}\) Prop. Treas. Reg. § 1.1061-6(d).
be consistent with the general reporting guidelines applicable to Passthrough Entities. A QEF is a Passthrough Entity.

- Provide a rule that would identify an Owner Taxpayer’s distributive share of a QEF’s net capital gain from a Passthrough Entity attributable to the Owner Taxpayer’s qualifying capital interest and API.

- Consider a rule, consistent with QEF principles, that would bypass netting capital gains and losses at the PFIC level and would clarify the manner in which a QEF shareholder would distinguish between reported gross items and any residual net capital gain and ordinary earnings. Any such rule would need to address and allocate the impact of limitation of net capital gain to a QEF’s current E&P.

5. Elective Transition Rule

The Preamble acknowledges that prior to the enactment of section 1061, taxpayers had no reason to track what portion of the unrealized appreciation in partnership assets was attributable to capital interests and, as such, might not have information readily available to enable them to comply with the Proposed Regulations with respect to property that the partnership held for more than three years as of the effective date of section 1061. For this reason, the Proposed Regulations provide a transition rule for partnership property that was held by the partnership for more than three years as of the effective date of section 1061.

Under the transition rule, a partnership that was in existence as of January 1, 2018, may irrevocably elect to treat all long-term capital gains and losses from the disposition of all assets, regardless of whether they would be API Gains or Losses in prior periods, that were held by the partnership for more than three years as of January 1, 2018, as “Partnership Transition Amounts.” Partnership Transition Amounts that are allocated to an API Holder (such amounts, “API Holder Transition Amounts”) are not taken into account for purposes of determining the Recharacterization Amount. Instead, they are treated as long-term capital gains and losses and are not subject to recharacterization under section 1061.

The API Holder Transition Amount in any year is the amount of the Partnership Transition Amount for the year that is included in the amount of long-term capital gains and losses allocated to the API Holder under section 704 in respect of its interest in the partnership under the current partnership agreement. However, the amount allocated to the API holder in any tax year cannot exceed the amount of the Partnership Transition Amount that would have been allocated to the API Holder regarding its partnership interest under the partnership agreement for the 2017 tax year if it was amended on or before March 15, 2018.

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81 See Prop. Treas. Reg. § 1.1016-6(a)(2).
82 Prop. Treas. Reg. § 1.1016-1(a) (definition of Passthrough Entity).
It is not clear what benefit the API Holder Transition Amount rules are intended to provide even though the Proposed Regulations contain an example illustrating the mechanical operation of the rules. (in the example it does not appear that the Recharacterization Amount would have been different if a transition amount election had not been made). Moreover, if a partnership interest is held for more than three years as of the date the final regulations are published in the Federal Register, the interest would not be subject to the recharacterization rules of section 1061, including the lookthrough rule described in Prop. Treas. Reg. § 1.1061-4(b)(9) (the “Lookthrough Rule”).

We recommend that the final regulations include an example illustrating, or otherwise better explaining, the importance of the API Holder Transition Amount rules, i.e., what benefit(s) the API Holder Transition Amount rules are intended to confer on taxpayers. Additionally, we recommend that the final regulations clarify that an interest that is held for more than three years as of the date the final regulations are published is not subject to section 1061, including the Lookthrough Rule.

6. Distributed API Property

The Proposed Regulations treat long-term capital gain or loss on the disposition of a capital asset distributed by a partnership with respect to an API (“Distributed API Property”) as API Gain or Loss if the asset is held for more than one year but not more than three years at the time the distributee-partner disposes of the property. The holding period of the asset in the partner’s hands includes the partnership’s holding period with respect to the asset.

The Proposed Regulations are unclear as to how the Distributed API Property rules apply where an API Holder owns both a profits interest and a capital interest in a partnership. The Proposed Regulations could be read to suggest that the Distributed API Property rules apply in their entirety to a distribution of property to a partner that owns an API, even where the distribution is attributable in whole or in part to the capital interest. For example, assume that GP and LP form Fund. LP contributes $90 of cash, and GP contributes $10 of cash. GP also is issued a 20% profits interest; however, the profits interest receives allocations only after the capital interest partners are allocated a 10% return on their invested capital. In each of years one through three, Fund generates $0 of net income. By the end of year three, the Fund’s assets still are worth $100. Fund owns 10 shares of Corp X stock, with each share having a value of $1. Fund distributes 9 shares of Corp X stock to LP and 1 share of Corp X stock to GP. Under the Proposed Regulations, it could be argued that GP’s Corp X stock is Distributed API Property. We do not believe this is the better interpretation of the Proposed Regulations and further believe that it is not an appropriate result.

We recommend that the final regulations clarify that a distribution to a partner is not Distributed API Property to the extent that it is distributed with respect to the portion of the partner’s interest qualifying for the Capital Interest Exception, provided that the

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facts and circumstances indicate that the distribution is made with respect to the capital interest. In this regard, if both the API portion of the interest and the capital interest portion of the interest have value and non-service-provider partners are not receiving a distribution on the same terms, the parties might need to designate clearly whether the distribution is made with respect to the capital interest, API, or both. The capital interest portion of the interest is the portion of the interest that would be eligible for the Capital Interest Exception.

7. Application of Section 1061 to Section 704(c) Aggregation Method

The Proposed Regulations require any partnership that uses a section 704(c) aggregation method to take into account section 1061 “in an appropriate manner.” Section 704(c) generally must be applied on an asset-by-asset basis; however, “securities partnerships” (and other qualified partnerships) may aggregate gains and losses from “qualified financial assets” using any reasonable method that is consistent with the purposes of section 704(c). Once a partnership adopts an aggregate approach, that partnership must apply the same aggregate approach to all of its qualified financial assets for all taxable years in which the partnership qualifies as a security partnership (the “Consistency Rule”).

Section 704(c) aggregation methods are particularly relevant to hedge funds that invest predominantly in actively traded personal property (e.g., stock and securities). Hedge funds can have thousands of individual assets subject to relatively frequent section 704(b) revaluation events that can make section 704(c) compliance on an asset-by-asset basis challenging and costly.

Absent unusual circumstances, a partial netting approach and a full netting approach can be reasonable methods. In order to implement either method, a securities or qualified partnership must establish appropriate accounts to establish each partner’s share of section 704(b) book gains and losses and to establish each partner’s share of tax gains and losses. Under the partial netting approach, on the date of each capital account restatement (at least once a year) a partnership (i) determines its section 704(b) book gains and losses, separately from qualified financial assets since its last capital account restatement and allocates the gross amounts to its partners, (ii) separately allocates all tax gains and all tax losses from qualified financial assets since the last capital account restatement, and (iii) separately allocates aggregate tax gain and aggregate tax loss to the partners in a manner that reduces the disparity between the book capital account balances and the tax capital balances (“book-tax disparities”) of the individual partners, depending on whether they have a positive or negative disparity.

The full netting approach takes the same approach as the partial netting approach, except that tax gains and tax losses are fully netted and the net tax gain (or net tax loss) is allocated to the partners to reduce the book-tax disparities of the individual partners, depending on

84 Treas. Reg. § 1.704-3(e)(3); see also Rev. Proc. 2007-59, I.R.B 2007-40 (expanding the application of section 704(c) aggregation methods to “qualified partnerships” and expanding the definition of qualified financial assets).

whether they have a positive or negative disparity. In each case, the character and other tax attributes of gain or loss allocated to the partners must preserve the tax attributes of each item of gross gain or loss realized by the partnership, be determined in a manner that is consistently applied by the partnership, and not be determined for a tax avoidance purpose.

If a partnership uses the partial netting approach or the full netting approach, the Proposed Regulations require the partnership to “appropriately take into account” the application of section 1061 to any person who directly or indirectly holds an API. Any such partnership must establish appropriate accounts to take into account the book Unrealized API Gains and Losses and realized API Gains and Losses separate from the book Capital Interest Gains and Losses of an API Holder and to determine the API Holder’s share of taxable gains and losses that are API Gains and Losses and Capital Interest Gains and Losses, separately. The Proposed Regulations provide a transition rule, permitting partnerships as of January 1, 2018, to use any reasonable method to apportion existing accounts for this purpose.

By requiring a partnership that uses a section 704(c) aggregation method to take into account the application of section 1061 and providing a transition rule, the Proposed Regulations suggest that a partnership can modify its section 704(c) aggregation method.

We recommend that the final regulations confirm that partnerships can change their section 704(c) aggregation method in order to address section 1061 in a manner consistent with the regulations without violating the Consistency Rule. We further recommend that the final regulations provide examples illustrating the intended application of the creation of separate disparity accounts for APIs and capital interests.

We believe are other ways that a partnership that uses a section 704(c) aggregation method can appropriately take into account section 1061. For example, a partnership could establish accounts to track separately qualified financial interests having a three-year-or-less holding period and qualified financial interests having a greater-than-three-year holding period. We recommend that the final regulations permit partnerships to incorporate other approaches consistent with applying section 1061 in an appropriate manner.

8. Passthrough Interest Direct Investment Allocations

Under the Proposed Regulations, certain Passthrough Interest Direct Investment Allocations are not subject to recharacterization under section 1061(a). However, such allocations seemingly cannot be allocated through more than a single partnership. That

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is, if an upper-tier partnership is allocated Passthrough Direct Investment Allocations from a lower-tier partnership, it is not clear under the Proposed Regulations how or whether the upper-tier partnership could further allocate such allocations among its partners in a manner that would satisfy the requirements of the exception for Capital Interest Gains and Losses under Prop. Treas. Reg. § 1.1061-4(c).

Under the Proposed Regulations, for an allocation of capital gain or loss to qualify as a Passthrough Interest Direct Investment Allocation it must relate to assets that are held directly by the partnership.90 However, once a capital gain or loss is allocated to an upper-tier partnership, such capital gain or loss could not qualify as a Passthrough Interest Direct Investment Allocation by the upper-tier partnership as it does not relate to an asset held directly by that upper-tier partnership. Thus, for an allocation of such capital gain or loss to the partners of the upper-tier partnership to continue to qualify for the Capital Interest Exception, such allocation presumably must satisfy the requirements of a different rule under that exception. For example, if there are Unrelated Non-Service Partners in the upper-tier partnership, it might be possible that the allocation could qualify as a Capital Interest Allocation.91 However, if there are no Unrelated Non-Service Partners in the upper-tier partnership, the further allocation could not qualify as a Capital Interest Allocation. Nor could such an allocation qualify as a Passthrough Interest Capital Allocation because the allocation from the lower-tier partnership was not itself a Capital Interest Allocation.92 As a result, absent there being Unrelated Non-Service Partners in the upper-tier partnership, no allocation of the capital gain or loss from the lower-tier partnership would appear to be eligible for the Capital Interest Exception.

It seems that this result was not intended.93 If it was intended, it is not clear to us why Passthrough Interest Direct Investment Allocations by a lower-tier partnership should not continue to qualify as Passthrough Interest Capital Allocations when allocated by the upper-tier partnership.

For these reasons, we recommend that the final regulations provide that Passthrough Interest Capital Allocations can be allocations of Capital Interest Allocations or Passthrough Interest Direct Investment Allocations.

Alternatively, given the overall complexity of the Proposed Regulations and the wide range of possible economic arrangements that might be reflected in tiers of partnerships, we recommend adopting a more general rule that allows taxpayers to apply

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91 Prop. Treas. Reg. § 1.1061-3(c)(4).
92 Prop. Treas. Reg. § 1.1061-3(c)(5)(ii).
93 A separate rule in the Proposed Regulations makes reference to the application of Passthrough Interest Direct Investment Allocation in the context of tiers of partnerships but does not clearly state that Passthrough Interest Direct Investment Allocations may be made through tiers of partnerships. Prop. Treas. Reg. § 1.1061-3(c)(3)(ii)(B)(2).
the Capital Interest Exception to a tiered setting in a manner that is consistent with the purpose of the exception.

D. S Corporation-Specific Issues

1. Passthrough Interest Allocations

Under the Proposed Regulations, Capital Interest Gains and Losses are not subject to section 1061 and therefore are not subject to recharacterization as short-term capital gain.94

As previously discussed, Capital Interest Allocations and Passthrough Interest Capital Allocations are required to be based on an API Holder’s relative capital account balance in a Passthrough Entity.95 If the Passthrough Entity is an entity that is not a partnership, the Proposed Regulations state that the requirement will be met “if the Passthrough Entity maintains and determines accounts for its owners using principles similar to those provided in section 1.704-1(b)(2)(iv).” There is no further indication in the Proposed Regulations as to how this requirement will be applied where the Passthrough Entity is an S corporation. The relevant discussion in the Explanation of Provisions section of the Preamble (Part II, Subpart C, Paragraph 1.b) is consistent with the statement quoted above regarding the application of this requirement to a Passthrough Entity that is not a partnership, but does not provide further clarification.

Under section 1366(a), tax items of an S corporation, including items of income, loss, deduction and credit, are allocated to each shareholder to the extent of such shareholder’s “pro rata share” as such share is determined under section 1377(a) and regulations under that provision.96 Under section 1377(a), a shareholder’s pro rata share of an item for a taxable year is determined by assigning an equal portion of the item to each day of the year and then by dividing that item pro rata among the shares outstanding on that day. The capital or capital account associated with shares of a shareholder do not have a role in this allocation. S corporations are not required to maintain capital accounts for their shareholders and, unlike partnerships, cannot allocate tax items by agreement other than in proportion to stock ownership. Further, under section 1361, an S corporation cannot have more than one class of stock, and each share of stock must confer the same right to distributions and liquidation proceeds as every other share.97 Thus, the application of the requirement in the Proposed Regulations that the Passthrough Entity “maintains and determines accounts for its owners using principles similar to those provided in section 1.704-1(b)(2)(iv)” is unclear where the entity is an S corporation.

94 Prop. Treas. Reg. § 1.1061-3(c)(1).
We recommended that the final regulations provide further guidance on the application of the requirement that Capital Interest Allocations and Passthrough Interest Capital Allocations be made based on an API Holder’s relative capital account balance where the Passthrough Entity is an S corporation. More specifically, we recommend that the final regulations expressly provide that, where the Passthrough Entity is an S corporation, the allocation of tax items by the S corporation in accordance with the requirements applicable to S corporations (namely, pro rata in accordance with stock ownership) will be considered to be in compliance with this requirement regardless of whether the S corporation maintains capital accounts for its shareholders.

2. **Applicable Partnership Interest**

Section 1061(c)(4)(A) provides that the term “applicable partnership interest” does not include “any interest in a partnership directly or indirectly held by a corporation.” Section 1361(a)(1) defines the term “S corporation” as a “small business corporation for which an election under section 1362(a) is in effect.” A “small business corporation” is in turn defined in section 1361(b) as a domestic corporation that meets certain requirements. Thus, an S corporation must be a domestic corporation.98

However, consistent with the Service’s position as set forth in Notice 2018-18,99 Prop. Treas. Reg. § 1.1061-3 provides that “a corporation does not include an entity for which an election was made to treat the entity as a Passthrough Entity,” and that “an S corporation for which an election under section 1362(a) is in effect” is not treated as a corporation for purposes of section 1061.100 Accordingly, under the Proposed Regulations, an API may include an API held by an S corporation.

Congress did not indicate in the legislative history for section 1061 that “a corporation” as referred to in section 1061(c)(4)(A) would not include an S corporation. Specifically, the committee reports issued before enactment (that is, other than the Bluebook published by the Joint Committee on Taxation) refer to the rule in section 1061(c) that an API does not include a partnership interest held by a corporation, but do not indicate that interests held by S corporations are excluded from this rule.

Section 1061(f) provides that the Secretary “shall issue such regulations or other guidance as is necessary and appropriate to carry out the purposes of this section.” The Preamble, in its discussion of the Corporate Exception, notes this grant of authority and,

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98 The terms “domestic” and “corporation” are in turn defined in I.R.C. § 1377(a)(3)-(4). See also I.R.C. § 1371(a), providing that, except as otherwise provided in Title 26 of the U.S. Code and except to the extent inconsistent with subchapter S of the Code, subchapter C of the Code (relating to corporate distributions and adjustments, including reorganizations) applies to an S corporation and its shareholders; and Trugman v. Commissioner, 138 T.C. 390 (2012), regarding the inapplicability of the section 36 tax credit to property acquired by a corporation, at 392 (“a[n] S election does not alter the corporation’s corporate status; it merely alters the corporation’s Federal tax implications”).


100 Prop. Treas. Reg. § 1.1061-3(b)(2).
further, that the Conference Report directed Treasury to issue regulations as needed to prevent abuse of the purposes of section 1061. The Preamble concludes that the grant of regulatory authority under section 1061 is sufficient to authorize Treasury to issue a regulation to the effect that the exception for section 1061(c)(4)(A) does not include S corporations.

We understand and appreciate the concern about the potential avoidance of section 1061 through the acquisition of partnership interests by S corporations. We are concerned, however, that, absent a legislative clarification, many taxpayers will take the position that the regulation is invalid in this respect. We recommend that Treasury and the Service seek such a clarification.