Section 1061 – Oil & Gas and Real Estate
ABA 2019 Mid-Year Meeting

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Determining Holding Period on Partner Exits
**IRC Section 1061(a)**

Re-characterizes as short term capital gain (STCG) a taxpayer’s net long term capital gain (LTCG) with respect to an “applicable partnership interest” as though the long-term holding period under IRC 1222 was three years rather than one year.
**IRC Section 1061(a)**

“Capital gain” results from the sale of a “capital asset.”

A capital asset does **not** include property used in the taxpayer’s trade or business of a type depreciable under 167 or real property used in a trade or business.

IRC 1231 treats gain as LTCG if from the sale of property held >1 year used in a real estate trade or business.
**Development Assets**

- May give rise to Section 1231 gains when sold, exchanged, or converted.

- IRC 1231 holding period determined “brick-by-brick” – i.e., progressively as completed. Rev. Rul. 75-524.

- Development property need not be placed in service to yield LTCG when sold.
**IRC Section 1061(a)**

Applied literally, IRC 1061(a) does not apply to:

- IRC 1231 gains
- Stock in trade
- Dividends
**REIT Capital Gain Dividends**

- Section 857(b)(3)(B) deems REIT capital gain dividend income to be gain from an asset held for greater than 1 year.
  - Can this ever satisfy a three-year holding period requirement?
Holding Period May Depend on Property Sold

Service Provider  
JV  
Asset

4 Year HP  
6 Month HP

Service Provider  
JV  
Asset

6 Month HP  
4 Year HP

Section 1061 – Oil & Gas and Real Estate Funds

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Sale of Assets vs. Sale of Partnership Interest

- U.S. tax characterization of transaction generally controls.

- Notable scenarios:
  ◦ Rev. Rul. 99-6
  ◦ Redemption of JVP
Additional Issues for Non-U.S. Deals

- Impact of U.S. “check the box” elections

- Carry partner treatment of PFICs; timing of QEF elections
Watch Out!

(for split holding periods)
**Holding Period Impacts – Follow on Investments**

Funds may make follow on investment calls for subsequent contributions into portfolio companies.

<table>
<thead>
<tr>
<th>Partnerships</th>
<th>Corporations</th>
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<tbody>
<tr>
<td>Partners have one capital account / basis in partnership interest.</td>
<td>Shares of stock newly issued for contributed property in a section 351 transaction take a holding period based on the holding period of the contributed property (may be divided between short- and long-term).</td>
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<td>Partners can have bifurcated holding period.</td>
<td>- Shares of stock newly issued for cash have a holding period that begins on the date of the contribution/issuance</td>
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<td>- Portion of interest issued for cash and hot assets = ST holding period starts.</td>
<td>Although not entirely clear, a cash contribution by a shareholder without the issuance of new shares will likely result in a segmented holding period for the shareholder’s pre-existing shares.</td>
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<tr>
<td>- Portion of interest issued for long term capital and section 1231 assets = HP tacks.</td>
<td></td>
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<tr>
<td>- Cash contributions start a new holding period for the portion of the interest acquired with cash.</td>
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Consider funding the entity expected to be sold (i.e., JV), with debt.
Consider funding a sister entity (i.e., JV 2).
99-5 Transaction

- 2014: Fund acquires property via REIT
- 2016: JV Partner buys interest in disregarded LLC from REIT
- 2018: JV sells real property

- JV has a split holding period in real property (55% long-term, 45% short-term)
- 704(c) gain to REIT is long-term
Does IRC 1061 Apply to Oil and Gas Partnerships?

- IRC 1061 applies to partnership interests transferred for services in “Applicable Trade or Business.”
Does IRC 1061 Apply to Oil and Gas Partnerships?

• An “Applicable Trade or Business” is:

1. Conducted on “regular, continuous, and substantial basis;” and

2. Consists in whole or in part of:
   a. Raising or returning capital, and
   b. Investing in, disposing of, or developing “Specified Assets”
Does IRC 1061 Apply to Oil and Gas Partnerships?

• “Specified Assets” include:
  • Securities
  • Commodities
  (defined in IRC 475 mark-to-market rules)
  • Cash /cash equivalents
  • Rental/investment real estate
  • Interests in partnership holding above assets
Are working oil and gas interests “commodities”?

Upstream  Midstream  Downstream
Does an Oil and Gas Partnership Invest in, Dispose of, or Develop Specified Assets?

• Legislative history says “commodities” include:
  1) commodity that is actively traded,
  2) notional principal contract with respect to a commodity,
  3) interest in, or derivative financial instrument in, the commodity or notional principal contract
  4) clearly identified hedge to a commodity.
Does an Oil and Gas Partnership Invest in, Dispose of, or Develop Specified Assets?

• Does it matter that an oil and gas partnership engages in an active trade or business?
  • Rev. Rul. 68-226
  • Rev. Rul. 73-428
Do Oil and Gas Partnership Activities Consist in Whole or in Part of Raising and Returning Capital?

• Does it raise and return capital?
• Does the type of partnership matter:
  • PE fund
  • PE portfolio company
  • Family office
**How much “bad” activity is too much?**

- Is it “regular, continuous, and substantial”?  
  - Does this apply to both prongs?

- Does the partnership activity consist “in whole or in part” raising / returning capital and investing / developing specified assets?

- If held by lower-tier partnership, IRC 1061 may apply only “to the extent” of the bad activity.
Waiver of Partnership Items

- Waive <3 year gains; attempt to make whole from >3 year gains?
  - Substantiality?
  - Book-up?
- Management fee waiver reg principles?
  - Discretion on waivers?
  - Unrealized/unbooked gains and losses?
  - Data points re value; sales discussions?
Thank You.