How Far Will You Carry Your Client?  
Section 1061 As It Stands Today

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Partnership Interests Held in Connection with Performance of Services

Section 1061(a) treats as short-term capital gain the excess (if any) of:

• The taxpayer’s net long-term capital gain with respect to any applicable partnership interests for a taxable year, over

• The taxpayer’s net long-term capital gain with respect to the interests for the taxable year computed by applying section 1222(3) and (4) by substituting “3 years” for “1 year.”

Section 1222(3) defines “long-term capital gain” as gain from the sale or exchange of a capital asset held for more than 1 year, if and to the extent such gain is taken into account in computing gross income.

Section 1222(4) defines “long-term capital loss” as loss from the sale or exchange of a capital asset held for more than 1 year, if and to the extent that such loss is taken into account in computing taxable income.
Simplified Investment Structure
Applicable Partnership Interest

**Applicable partnership interest** ("API") means, subject to various exceptions, 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.

Section 1061 does not define the term “related person” for purposes of determining whether a partnership interest is an API.

- The Joint Committee on Taxation has indicated that “it is intended that for this purpose a related person means a related person within the meaning of section 267(b) or 707(b). A technical correction may be needed to carry out this intent.”
Applicable Trade or Business

**Applicable trade or business** 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:

- Raising or returning capital, and
- Either
  - investing in (or disposing of) specified assets (or identifying specified assets for such investing or disposition), or
  - developing specified assets.
Specified Assets

*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 (see next slide).
Specified Assets (cont.)

For purposes of determining the proportionate interest of a partnership in any specified asset:

• The Conference Report states that, if a hedge fund acquires “an interest in an operating business conducted in the form of a non-publicly traded partnership that is not widely held,” the partnership interest is a specified asset.

• The Joint Committee on Taxation report, however, provides that, 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.
Exceptions Under Section 1061

Exception to Section 1061(a):
To the extent provided by the Secretary, section 1061(a) does not apply to income or gain attributable to any asset not held for portfolio investment on behalf of third party investors.

Exceptions to the Definition of an API:
An API does not include:

• An interest held by a person who is employed by another entity that is conducting a trade or business (which is not an applicable trade or business) and who provides services only to the other entity,
• An interest in a partnership directly or indirectly held by a corporation (not including S corporations, per Notice 2018-18; but see, Charleston Area Medical Ctr. v. United States in which the Court of Appeals for the Federal Circuit, in dictum, “question[ed] whether the regulations described in the Notice, if codified, would be proper in view of the government’s position in this case that the Code incorporates the broad, common law meaning of ‘corporation,’....”), or
• A capital interest in a partnership that provides the taxpayer with a right to share in partnership capital commensurate with
  − the amount of capital contributed (determined at the time of receipt of such partnership interest), or
  − the value of such interest subject to tax under section 83 upon the receipt or vesting of such interest.
Related Party Transfers

If a taxpayer transfers any API, directly or indirectly, to a person related to the taxpayer, the taxpayer includes in gross income (as short term capital gain) the excess (if any) of:

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

• Any amount treated as short term capital gain under section 1061(a) with respect to the transfer of such interest.

For purposes of related party transfers, a person is related to the taxpayer if:

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

• 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.
THE REGS ARE COMING!

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