KPMG

What's News in Tax

Analysis that matters from Washington National Tax

Final Regulations on Carried Interest

January 15, 2021

by James B. Sowell, Sean Austin, Matt Busta, Rob Keller, and Sarah Staudenraus, Washington National Tax*

I. Background

Changing the taxation of "carried interests" has been a topic of discussion for many years now. Between 2007 and 2018, numerous bills were introduced that would have addressed this topic. Former Representative Sander Levin (D-MI) was a frequent sponsor of bills setting forth the approach advocated by Democratic tax writers.[1] A different approach was proposed by former Representative Dave Camp (R-MI) in 2014.[2]

As part of the Tax Cuts and Jobs Act of 2017, Congress enacted section 1061[3] addressing the taxation of carried interests and took a dramatically different approach than those set forth in the prior bills. As a general matter, section 1061 requires a three-year holding period for certain capital gain with respect to "applicable partnership interests" or "APIs" to be treated as long-term capital gain. Applicable

---

* *James B. Sowell is a principal; Sean Austin and Matt Busta are managing directors; and Rob Keller and Sarah Staudenraus are partners in the Passthroughs group of Washington National Tax ("WNT").*

1 *See, e.g.*, Carried Interest Fairness Act of 2015, H.R. 2889, 114th Cong. [hereinafter the Levin Bill].

2 The Tax Reform Act of 2014, H.R. 1, 113th Cong. [hereinafter the Camp Bill]. In 2019, after the enactment of section 1061, Senator Ron Wyden (D-OR), ranking minority member of the Senate Finance Committee, introduced a bill proposing still another approach for taxing carried interest. *See* J. Sowell & J. Tod, *The Wyden Bill: A New Approach to Taxing Carried Interest*, KPMG What's News in Tax (Aug. 26, 2019), https://portal.us.kworld.kpmg.com/tax/wnt/WNiT2/082619-PT-WydenCarriedIntererstBill.pdf.

3 Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

partnership interests generally include what is commonly referred to as the carried interest—i.e., the profit share distributable to fund sponsors—although income allocated to interests other than carried interests may be captured by this rule. Section 1061 provides for several exceptions to the three-year holding period requirement, including for interests held by corporations and interests that are commensurate with contributed capital.

On August 14, 2020, the Treasury Department ("Treasury") and the Internal Revenue Service ("IRS") published proposed regulations under section 1061 (the "Proposed Regulations").[4] The Proposed Regulations significantly expanded on the statutory language and incorporated concepts reflected in earlier legislative proposals, in particular with respect to the exception for contributed capital.

On January 7, 2021, the Treasury and IRS issued final regulations (the "Final Regulation") which made a number of important changes to the Proposed Regulations. The Final Regulations substantially revise the exception for contributed capital as set forth in the Proposed Regulations and make significant modifications to the approach taken in the Proposed Regulations for related-party transfers subject to section 1061(d). The Final Regulations generally would apply to taxable years of Owner Taxpayers or Passthrough Entities beginning on or after the date when published in the Federal Register. The Final Regulations were released to the Federal Register on January 13, 2021 and are expected to be published on January 19, 2021. If the Final Regulations are not published by January 19, 2021, it is possible that the Final Regulations may not become effective and may instead be pulled, reviewed, and revised by the new Administration.

II. The Final Regulations Generally

The Final Regulations retain the general format of the Proposed Regulations and are organized into six sections. The first section contains defined terms— 34 defined terms, to be exact. The second section contains rules largely similar to those in the Proposed Regulations that determine when an interest will be treated as an API that is subject to section 1061. The third section sets forth exceptions to section 1061, including a section describing when allocations with respect to invested capital will be exempt from the application of section 1061. The fourth section contains the mechanical rules for calculating capital gain that is recharacterized as short-term under section 1061. The fifth section interprets section 1061(d) applicable to related-party transfers. Finally, the sixth section describes reporting rules applicable to section 1061.

III. Detailed Summary of Final Regulations

A. What Are the Major Changes from the Proposed Regulations?

The most significant changes from the Proposed Regulations relate to the exception for contributed capital and related-party transfers subject to section 1061(d).

In general, the Proposed Regulations exempted allocations of gain from recharacterization to the extent the allocations were commensurate with the partner's section 704(b) capital account. As described in

---

[4] 85 FR 49754 (August 14, 2020).

more detail below, the Final Regulations instead generally exempt allocations that are commensurate with the partner's contributed capital. With respect to the issue of reinvested carry, the Final Regulations effectively exclude from recharacterization earnings on reinvested *taxable* carry, provided certain requirements are met. The Proposed Regulations had appeared to more broadly exempt earnings on reinvested *704(b) book* carry.

With regard to related-party transfers under section 1061(d), the Final Regulations reverse the approach adopted in the Proposed Regulations and provide that section 1061(d) only applies to transactions in which gain is otherwise recognized. The Proposed Regulations had provided that section 1061(d) operated to override nonrecognition. The Final Regulations also include several clarifications to the scope of transfers that are subject to section 1061(d).

The Final Regulations also significantly simplify the "Lookthrough Rule" introduced in the Proposed Regulations, which provides that, upon the disposition of an API, in certain instances, one-to-three-year gain will be determined by reference to the partnership's holding period in its capital assets rather than the partner's holding period in the API itself.

B. Who Is Subject to Section 1061 and What Is the Effect?

Section 1061(a) references a "taxpayer" as the person whose partnership allocations may be subject to recharacterization if section 1061 applies. Consistent with the Proposed Regulations, the Final Regulations adopt a "partial entity approach." Under this approach, "the existence of an API (defined below) is determined at the entity level, but the Recharacterization Amount is determined at the owner level."[5] More specifically, under the Final Regulations, the "Owner Taxpayer" is the person who is subject to tax on the amount recharacterized under section 1061, while a "Passthrough Taxpayer" is any "Passthrough Entity"[6] that is treated as a taxpayer for purposes of determining the existence of an API. The Final Regulations expanded the definition of Passthrough Entity from the Proposed Regulations to include trusts and estates. Each Passthrough Taxpayer in a tiered structure is treated as an API Holder—that is, an Owner Taxpayer or Passthrough Taxpayer may hold an API directly or indirectly through one or more Passthrough Entities. An API that is held through one or more Passthrough Entities is referred to as an Indirect API.[7] There may be any number of Passthrough Taxpayers between the lowest-tier API Holder and the Owner Taxpayer.

Any long-term capital gains and capital losses with respect to an API are defined as "API Gains and Losses". API Gains and Losses include not only a partner's distributive share in respect of an API but also include any long-term gain or loss from a sale of the API itself as well as any long-term gain or loss from the sale of any distributed property received in respect of the API that has a holding period of less than three years at the time of disposition ("Distributed API Property"). API Gains and Losses retain their character as API Gains and Losses as they are allocated from one Passthrough Entity to another

---

5 The Recharacterization Amount is the amount that an Owner Taxpayer must treat as short-term capital gain as a result of the application of section 1061(a). Reg. §1.1061-4(a)(1).

6 A Passthrough Entity is a partnership, trust, estate, S corporation, or passive foreign investment company with respect to which a shareholder has made a QEF election. Reg. §1.1061-1(a) (definitions).

7 Reg. §1.1061-1(a) (definitions).

and ultimately to any Owner Taxpayer.[8] Thus, a passive partner who does not hold an API in an upper-tier partnership still may be allocated API Gain that is subject to recharacterization under section 1061.[9]

C. Applicable Partnership Interest

As described above, section 1061 operates by reference to allocations made with respect to an "Applicable Partnership Interest" or "API," so determining the parameters of such an interest is obviously important. Under the Final Regulations, an API is any interest in a partnership which, directly or indirectly, is transferred to (or is held by) an Owner Taxpayer or a Passthrough Entity in connection with the performance of substantial services by the Owner Taxpayer or Passthrough Entity, or by a related person in any Applicable Trade or Business (defined below) unless an exception applies.[10] Like the Proposed Regulations, the Final Regulations essentially read the "substantial services" requirement out of the rule by presuming the partnership interest recipient to have provided substantial services if an interest is transferred to that party in connection with the performance of services.[11] The Final Regulations also provide that, once a partnership interest qualifies as an API, it remains an API unless and until it qualifies for one of the exceptions (e.g., a partnership interest does not cease to be an API upon the retirement of a service provider).[12]

In order for an Owner Taxpayer or Passthrough Entity to hold an API, that person must participate (or be related to a person who participates) in an "Applicable Trade or Business" or "ATB." Under the Final Regulations, an ATB is any activity for which the "ATB Activity Test" with respect to "Specified Actions" is met.[13]

Specified Actions are actions that either:

- Involve raising or returning capital ("Raising or Returning Capital Actions") or
- Involve either:
  - Investing in (or disposing of) "Specified Assets" (or identifying Specified Assets for such investing and disposition), or
  - Developing Specified Assets ("Investing or Developing Actions").[14]

---

8 Reg. §1.1061-2(a)(1)(iii).

9 If applicable, a passive partner may be excepted under the corporation exception or the unrelated purchaser exception, discussed *infra* at III.D.

10 Reg. §1.1061-1(a) (definitions). Note, services performed as an employee are considered for these purposes. Related person for this purpose means a person or entity who is treated as related to another person or entity under sections 707(b) or 267(b). Reg. §1.1061-1(a) (definitions).

11 Reg. §1.1061-2(a)(1)(iv).

12 Reg. §1.1061-2(a)(1)(i) and (a)(2)(i), Ex. 1.

13 Reg. §1.1061-1(a) (definitions).

14 *Id.*

Under the Final Regulations, in order to meet the ATB Activity Test, the activity must include both Raising and Returning Capital Actions as well as Investing or Developing Actions.[15] The ATB Activity Test is satisfied if these Specified Actions are conducted by one or more related persons (within the meaning of section 267(b) or 707(b))[16] *and* the total level of Specified Actions satisfies the level of activity that would be required to establish a trade or business under section 162.[17] Actions of agents or delegates are included for this purpose.[18]

The Final Regulations are clear that the Raising or Returning Capital Actions and Investing or Developing Actions need not each independently rise to the level of a section 162 trade or business. Instead, one looks to the combined Specified Actions in determining the existence of a trade or business.[19] In addition, both types of Specified Actions do not have to occur within the same taxable year for the ATB Activity Test to be met. Rather, in determining whether the ATB Activity Test is met, the test takes into account activities that are anticipated to be met in future years.[20] The Final Regulations also specify that the ATB Activity Test can be met even if either Raising and Return Capital Actions or Investing or Developing Actions are taken only infrequently.[21]

For purposes of the ATB Activity Test, the definition of Specified Assets generally follows the statutory definition, which includes securities (within the meaning of 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, and an interest in a partnership to the extent that the partnership holds other Specified Assets.[22]

Under the Final Regulations, developing Specified Assets takes place if it is represented to investors, lenders, regulators, or other interested parties that the value, price, or yield of a portfolio business may be enhanced or increased in connection with choices or actions of a service provider.[23] With respect to partnership interests, Investing or Developing Actions does not include actions taken to manage a partnership's working capital but does include actions taken to manage other Specified Assets held by a partnership.[24]

According to the Final Regulations, in addition to a partnership interest, an API includes any financial instrument or contract, the value of which is determined in whole or in part by reference to the

---

[15] Note that a person does not have to undertake both activities to hold an API. Once such activities are conducted on the whole by the relevant group of individuals and entities, mere participation in the overall activity will render a partnership interest granted to a participant an API.

[16] Although the statute did not define "related party" for purposes of this portion of section 1061, the Final Regulations provide for the application of sections 267(b) and 707(b) for this purpose. Reg. §1.1061-1(a) (definitions).

[17] Reg. §1.1061-2(b)(1).

[18] Reg. §1.1061-2(b)(2).

[19] Reg. §1.1061-2(b)(1)(i)(A) and (b)(2)(i), Ex. 1.

[20] Reg. §1.1061-2(b)(1)(i)(B).

[21] Reg. §1.1061-2(b)(1)(i)(A).

[22] Reg. §1.1061-1(a) (definitions).

[23] Reg. §1.1061-2(b)(1)(ii).

[24] Reg. §1.1061-2(b)(1)(iii).

partnership (including the amount of partnership distributions, value of partnership assets, or results of partnership operations).[25] This broadening of the term "partnership interest" for purposes of section 1061 calls to mind the concept of "disqualified interests" in the Levin Bill where investment instruments and structures beyond partnership interests were made subject to those rules.[26]

D. Exceptions to the Definition of API

Before discussing the manner in which section 1061 recharacterizes capital gain that is allocated to an API, it is important to understand the situations where allocations to a service provider (or certain other persons) may be exempt from section 1061. The Final Regulations describe four exceptions to the definition of an API, three of which are derived from the statutory provisions of section 1061. These exceptions are not defined in the Final Regulations but for convenience we will refer to them as the "one employer exception", the "corporation exception", the "capital interest exception", and the "unrelated purchaser exception".

1. One Employer Exception

An API does not include any interest transferred to a person in connection with that person's performance of substantial services as an employee of another entity that is conducting a trade or business that is not an ATB so long as the person provides services only to such other entity.[27] The regulation simply tracks the language of the statute.[28]

2. Corporation Exception

Under the statute, an API does not include any interest held directly or indirectly by a corporation.[29] The Final Regulations interpret this to mean that a corporation cannot be an Owner Taxpayer such that API Gains and Losses allocated to a corporation from a Passthrough Entity are not subject to

---

[25] Reg. §1.1061-1(a) (definitions).

[26] Levin Bill, §710(e).

[27] Reg. §1.1061-3(a).

[28] This provision generally is thought to address employees of portfolio companies in a fund structure. Note that there is a question as to whether such employees, who are not providing services in the investment management business of the API holder, are receiving the profits interest "to or for the benefit of" the partnership that is issuing the interest as is required by Rev. Proc. 93-27 (1993-2 C.B. 343) and Rev. Proc. 2001-43 (2001-2 C.B. 191). The preamble to the Final Regulations does not provide explicit guidance as to whether such a person can receive such interests in a manner that qualifies under the revenue procedures. The preamble to the Proposed Regulations, however, stated: "[T]hese proposed regulations address only the application of section 1061 and should not be interpreted as providing guidance regarding the application of Revenue Procedure 93-27 to transactions in which one party provides services and another party receives a seemingly associated allocation and distribution of partnership income and gain."

[29] Section 1061(c)(4)(A). For some history regarding the concerns that lead to the corporation exception, s*ee* C. Kulish, J. Sowell & D. Fields, *I Spy an ISPI: Expansive Breadth of Carried Interest Proposals*, 2010 TNT 147-9 (Aug. 2, 2010).

recharacterization under section 1061.[30] Consistent with Notice 2018-18[31] and the Proposed Regulations, for these purposes the term "corporation" does not include an S Corporation, effective for taxable years beginning after December 31, 2017. Consistent with the Proposed Regulations, the Final Regulations also provide that the term "corporation" does not include a passive foreign investment company (PFIC) for which the shareholder has made a qualified electing fund (QEF) election.[32] This rule is effective for taxable years of an Owner Taxpayer or Passthrough Entity beginning after August 14, 2020 (the date the Proposed Regulations were published in the Federal Register).[33]

3. Capital Interest Exception

In relevant part, section 1061(c)(4)(B) provides that the term API does not include "any capital interest in the partnership which provides the taxpayer the 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 an interest that is subject to tax under section 83 upon the receipt or vesting of such interest." Since the enactment of section 1061, practitioners and commentators have struggled with interpreting and applying this definition.[34] The Final Regulations do not define what it means to share in partnership capital "commensurate" with the amount of capital contributed (determined at the time of receipt of such interest). Instead, they provide an exception that is based on qualifying allocations of capital gain and loss.

The Final Regulations further define "Capital Interest Gains and Losses"[35] and provide that Capital Interest Gains and Losses are not subject to recharacterization under section 1061.[36] Capital Interest Gains and Losses generally consist of allocations that are made with respect to a capital interest, provided certain requirements are met,[37] as well as certain gains and losses from the sale of a

---

[30] API Gains and Losses allocated to any non-corporate owner of the Passthrough Entity would continue to be treated as API Gains and Losses. That is, the corporation exception under the Final Regulations only excludes the gains and losses that are ultimately allocated to a corporation and does not exclude the underlying partnership interest itself from being treated as an API. A partnership interest that otherwise qualifies as an API is treated as an API even it if is owned indirectly by a corporation.

[31] 2018-2 I.R.B. 443.

[32] Reg. §1.1061-3(b)(2)(ii). Note that the preamble to the Proposed Regulations indicated this rule means that a partnership interest held by a PFIC with respect to which the shareholder has a QEF election in effect will be treated as an API if the interest otherwise meets the API definition. Preamble to the Proposed Regulations, Part II, Section B.

[33] Prop. Reg. §1.1061-3(c).

[34] *See ABA Members Address Treatment of Applicable Partnership Interests*, 2019 TNT 58-24 (Mar. 22, 2019) [hereinafter the ABA Report]; S. Austin, O. Borosh, M. Busta & S. Staudenraus, *If I Knew Then What I Know Now . . . Establishing a Capital Interest for Purposes of Section 1061 – Part 1*, KPMG What's News in Tax (Oct. 29, 2018), https://portal.us.kworld.kpmg.com/tax/wnt/WNiT/102918-PT-S1061.pdf.

[35] Reg. §1.1061-3(c)(2).

[36] Reg. §1.1061-3(c)(1).

[37] The Final Regulations define a "capital interest" consistent with the definition in Rev. Proc. 93-27, 1993-2 C.B. 343, to mean an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value at the time the interest was received and the proceeds were then distributed in complete liquidation of the partnership. Reg. §1.1061-3(c)(3)(i). While the allocations that are exempt under the Final Regulations are made with respect to capital interests, the analysis under the regulations operates by reference to the capital contributions that funded the capital

Passthrough Interest (i.e. an interest in a Passthrough Entity that represents in whole or in part an interest in an API).[38] In general, this approach is functionally similar to the concept of "qualifying capital" as set forth in earlier proposed carried interest legislative drafts, in particular the Levin Bill.[39] The approach in the Final Regulations differs from the approach in the Proposed Regulations by focusing on the partner's contributed capital rather than the partner's capital account.

a) The Importance of Contributed Capital

Section 1061(c)(4)(B) describes the capital interest exception by reference to "contributed capital (determined at the time of receipt of such partnership interests)" which led many practitioners to believe that the provision operated solely by reference to contributed cash or property. As a result, many practitioners did not believe that a sponsor's allocated but undistributed share of carry would be considered "contributed capital" for purposes of this exception. The treatment of allocated but undistributed carry is of particular importance in the hedge fund or open end fund context where carry participants commonly reinvest their allocated and undistributed carry (including carry that is realized for purposes of section 704(b) but not for purposes of section 1001) into common units that generally share in future profits and losses in the same manner as the common units held by non-service partners. If allocated but undistributed carry is not considered "contributed capital" for purposes of this exception, then earnings on such 'reinvested' carry would be subject to recharacterization under section 1061(a), absent additional planning.

Unlike the Proposed Regulations, the Final Regulations do not treat gain from a revaluation of partnership assets under Reg. §1.704-1(b)(2)(iv)(*f*) as giving rise to a capital interest upon which exempt allocations may be made.[40] The Final Regulations do, however, treat as contributed capital any allocation of API Gain from a Passthrough Entity that is reinvested in that Passthrough Entity.[41] For these purposes API Gain is considered reinvested whether it is actually distributed and recontributed or simply retained by the Passthrough Entity.[42] Note that API Gains include only long-term capital gains

---

interest, essentially looking to see that the terms, and circumstances surrounding the issuance, of capital interests received in exchange for capital contributions are reasonably consistent.

38 Reg. §1.1061-1(a) (definitions).

39 Levin Bill, §710(d).

40 As a result, the Final Regulations do not adopt the mandatory revaluation requirement that had been in the Proposed Regulations. Prop. Reg. §1.1061-2(a)(1)(ii)(B). The Final Regulations do retain the concept of "Unrealized API Gains and Losses", but the significance of this concept is diminished as compared to the Proposed Regulations. Under the Final Regulations, this term means all unrealized capital gains and losses that would be realized by a Passthrough Entity if all of its assets were disposed of for fair market value in a taxable transaction and that would be allocated to an API Holder with respect to its API "taking into account the principles of section 704(c)." Reg. § 1.1061-1(a) (definitions). The Final Regulations are explicit that Unrealized API Gains and Losses become API Gains and Losses subject to section 1061 once they are realized and recognized and that Unrealized API Gains and Losses retain their character as such until recognized. Reg. §1.1061-2(a)(1)(ii).

41 Reg. § 1.1061-3(c)((3)(iii).

42 *Id.* It is unclear when such API Gain is considered reinvested for this purpose. Many hedge funds make their tax allocations monthly, consistent with their book allocation periods, but others make their tax allocations on an annual basis.

with respect to an API, so this rule would not seem to provide capital contribution credit for undistributed income that is not long-term capital gain, including for section 1231 gains.[43]

b) Capital Interest Allocations

Under the Final Regulations, Capital Interest Gains and Losses include Capital Interest Allocations that meet certain requirements.[44] "Capital Interest Allocations" are typically made first at the fund or joint venture level to the general partner. In order for allocations to qualify as Capital Interest Allocations, the allocations must be determined and calculated in a "similar manner" as the allocations with respect to the capital interests held by similarly situated "Unrelated Non-Service Partners"[45] who have made five percent or more of the aggregate capital contributed to the partnership at the time the allocations are made.[46] If an API Holder has allocation and distribution rights attributable to a particular interest class or partnership investment, this requirement must be met with respect to that particular interest class or partnership investment.[47]

In general, Capital Interest Allocations are considered to be made in a similar manner if the allocations are clearly identified and if allocations and distribution rights with respect to the capital contributed by an API Holder are clearly identified and reasonably consistent with allocation and distribution rights with respect to capital contributed by Unrelated Non-Service Partners.[48] Where an API Holder's allocation and distribution rights are limited to a particular class of capital interests or a particular investment, then this determination is made on a class-by-class or investment-by-investment basis, as applicable.[49] For allocations to be clearly identified, the allocations to the API Holder and the Unrelated Non-Service Partners with respect to the partners' contributed capital must be 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 must clearly demonstrate that this requirement is met.[50]

In determining whether allocations and distributions to the API Holder are reasonably consistent with those to an Unrelated Non-Service Partner, the Final Regulations provide that the following factors are relevant but not exclusive: the amount and timing of capital contributed, the rate of return on capital contributed, the terms, priority, type and level of risk associated with the capital contributed, and rights

---

43 Also note that API Gain is a gross gain definition so the reinvested capital provision does not seem to require a reduction for any offsetting allocation of API Loss. Query whether this was an oversight.

44 Reg. §1.1061-3(c).

45 "Unrelated Non-Service Partners" mean "partners who do not (and did not) provide services in the Relevant ATB and who are not (and were not) related to any API Holder in the partnership or any person who provides or has provided services in the Relevant ATB." Reg. §1.1061-1(a) (definitions).

46 Reg. § 1.1061-3(c)(3)(i), (iv).

47 Reg. § 1.1061-3(c)(3)(iv).

48 Reg. § 1.1061-3(c)(3)(ii).

49 *Id.*

50 Reg. § 1.1061-3(c)(3)(ii)(B). Treasury and the IRS defended their decision to retain the strict identification rules from the Proposed Regulations by emphasizing that the clear identification "shows that the partnership's Unrelated Non-Service Partners considered these allocations a valid return on their contributed capital." Preamble, Part II.A.2.

to cash or property distributions during the partnership's operations and on liquidation.[51] An allocation will not fail to qualify solely because the allocation is subordinated to allocations made to Unrelated Non-Service Partners. Further, an allocation will not fail to qualify because it is not reduced by the cost of services provided to the partnership. The Final Regulation clarify that cost of services includes both management fees and the carried interest for these purposes. The Final Regulations also clarify that the right to receive tax distributions will not cause the API Holder's allocations to fail so long as such distributions are treated as advances against future distributions.

For purposes of the section 1061 regulations, "an allocation is not a Capital Interest Allocation to the extent the allocation is attributable to the contribution of an amount of capital to a partnership that, directly or indirectly, results from, or is attributable to, any loan or other advance made or guaranteed, directly or indirectly, by the partnership, a partner in the partnership, or any Related Person with respect to such persons," unless the borrower is personally liable for the loan or advance.[52] Repayments on a nonrecourse loan or advance will count as capital contributed as they are paid by the partner so long as the loan is not repaid with the proceeds of another such loan.[53] For these purposes, an individual service provider is personally liable for a loan or advance if: 1) the loan or advance is fully recourse to the individual service provider, 2) the individual service provider has no right to reimbursement from any other person, and 3) the loan or advance is not guaranteed by any other person.[54] The prohibition on guarantees may be problematic for many client sponsors as it is not uncommon for sponsors to negotiate with third-party lenders to provide individual service providers with loans under a common set of terms with a sponsor guarantee.[55] In addition, the failure to favorably address other common arrangements where the partner has undertaken true risk of loss, including recourse loans from the partnership and over-secured nonrecourse loans, is problematic. If an individual service provider owns his or her interest through a disregarded entity and the disregarded entity borrows such loan or advance to make capital contributions, then the individual service provider must be personally liable for such borrowing by the disregarded entity for the capital contributions to be taken into account in testing whether allocations constitute Capital Interest Allocations.[56]

One small change was made to the Final Regulation lending rule that likely has gone unnoticed by many. The Proposed Regulation operated by reference to a loan or guarantee made by "any other partner or the partnership (or any Related Person with respect to such other partner or the partnership)."[57] The Final Regulation references loans and guarantees made "by the partnership, a

---

51 *Id.*

52 Reg. § 1.1061-3(c)(3)(v)(A).

53 *Id.*

54 *Id.*

55 The Preamble states: "The Treasury Department and IRS continue to study the treatment of guarantees in light of the questions about who the borrower is for federal tax purposes." Preamble, Part II.B.

56 *Id.*

57 Prop. Reg. §1.1061-3(c)(3)(ii)(C).

partner, or any Related Person with respect to such persons."[58] Note that the Proposed Regulation reference to "other" partners became a blanket reference to all partners in the Final Regulations. This change has significance in that, under the Final Regulations, a partner is essentially prohibited from lending to himself or herself (i.e., related-party loans are prohibited). For example, wife borrows on a nonrecourse basis from her husband to invest in a partnership in which she also provides investment services. Wife is a partner, and she is borrowing from a Related Person, her husband, so she is caught by the lending rule under the Final Regulations. Obviously, this arrangement does not raise any of the concerns that the lending provision is intended to police. Hopefully, this technical "glitch" created in the Final Regulations will be corrected.

Moving beyond lending transactions, with respect to tiered partnerships, the Final Regulations drop the detailed and complicated concept of "Passthrough Interest Capital Allocations", which had been included in the Proposed Regulations,[59] and instead adopt a more general rule. Under the Final Regulations, a Capital Interest Allocation that is made by a lower-tier partnership to an upper-tier partnership will retain its character as such if it is properly allocated to the upper-tier partnership's partners with respect to their capital interests in the upper-tier partnership consistent with principles generally applicable to Capital Interest Allocations (other than the Unrelated Non-Service Partner requirement) and in a manner that is respected under section 704(b) (taking into account the principles of section 704(c)).[60] In order to satisfy this rule, it appears that the allocations must be made in a manner that is reasonably consistent with the indirect partners' capital contributions.[61]

Note that the Final Regulations only address the allocation of lower-tier Capital Interest Allocations and do not directly address the allocation of capital gains or losses realized with respect to assets held directly by an upper-tier Passthrough Entity (such as the general partner).[62] If the sponsor's interest in the upper-tier partnership is itself an API, then allocations with respect to directly-held investments are presumably subject to the general rule for Capital Interest Allocations, including the requirement for an Unrelated Non-Service Partner. This oversight would seem to be problematic for any sponsor-held Passthrough Entity that holds a carried interest and is also investing its own capital in directly-held investments. While the Final Regulations contain an example that would find a Capital Interest Allocation under these facts, the operative rule would not appear to sanction such a result.[63]

---

[58] Reg. §1.1061-3(c)(3)(v)(A). Oddly, the recourse debt carve-out in the Final Regulations does reference loans made by "another partner or the partnership." Reg. §1.1061-3(c)(3)(v)(B). Thus, it appears that even a recourse loan from a person related to a partner will not be excepted from the lending rule. Obviously, this cannot be the intended result.

[59] Prop. Reg. §1.1061-3(c)(5).

[60] Reg. § 1.1061-3(c)(5).

[61] Reg. § 1.1061-3(c)(6)(i), Ex. 1(C).

[62] The Proposed Regulations addressed such allocations under the rules for "Passthrough Interest Direct Investment Allocations." See Prop. Reg. §1.1061-3(c)(5)(iii).

[63] *See.* Reg. § 1.1061-3(c)(6)(i), Ex. 2, which includes an analogous fact pattern and concludes, without discussion of the pertinent regulations, that the gain upon the sale of a Passthrough Entity interest attributable to assets acquired by the Passthrough Entity with contributed capital represents a Capital Interest Disposition Amount. While the result in the regulation is the right policy result given the overarching Capital Interest Allocation regime provided for in the Final Regulations, it is unclear what rule the IRS was relying on for this result.

c) Capital Interest Disposition Amounts

In addition to Capital Interest Allocations, Capital Interest Gains and Losses include certain Capital Interest Disposition Amounts. In general, if a partner holds a Passthrough Interest that includes a right to allocations of Capital Interest Gains and Losses, then a portion of the long-term capital gain or loss from the sale of that interest may be exempt as a Capital Interest Disposition Amount.[64] To determine the Capital Interest Disposition Amount, first determine the long-term capital gain or loss that would be allocated to the Passthrough Interest (or portion of the Passthrough Interest sold) if all assets were sold at fair market value immediately before the disposition.[65] Second, determine the amount that would be allocated to the interest as Capital Interest Allocations if all assets were sold at fair market value immediately before the disposition. [66] (For these purposes, assets are deemed sold at the lowest tier in the structure.)[67] The seller's Capital Interest Disposition Amount is generally equal to the product of the long-term capital gain or long-term capital loss recognized on the disposition of the Passthrough Interest multiplied by a fraction, the numerator of which is equal to the second determination above (i.e., the hypothetical qualifying allocations) and the denominator of which is equal to the first determination above (i.e., all hypothetical long-term allocations).[68]

d) Unrelated Purchaser Exception

Under the Final Regulations, 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 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,

---

[64] The Proposed Regulations included an example that applied the principles of Rev. Rul. 84-53 in determining the basis of a partial interest sold where the partner disposed solely their capital interest. *See also* Prop. Reg. §1.1061-3(c)(7)(v), Ex. 5(C). In response to comments that such an allocation of basis may not be appropriate, this example was removed from the Final Regulations and the Preamble notes that the Treasury and IRS continue to study the issue.

[65] Reg. §1.1061-3(c)(4)(ii)(A). Note this calculation includes amounts referenced in Reg. §1.1061-4(b)(7) – that is, section 1231 gain, section 1256 gain, qualified dividend income, and other capital gains and losses that are characterized as long term or short term without regard to section 1222.

[66] Reg. §1.1061-3(c)(4)(ii)(B). Note this calculation does not include amounts referenced in. Reg. §1.1061-4(b)(7).

[67] Reg. §1.1061-3(c)(4)(ii)(A) & (B).

[68] Reg. §1.1061-3(c)(4)(ii)(D). If the second determination produces gain, but the sale of the partnership interest produces a long-term capital loss, there is no Capital Interest Disposition Amount. If the second determination produces loss, but the sale of the partnership interest produces long term capital gain, there also is no Capital Interest Disposition Amount. Reg. §1.1061-3(c)(4)(ii)(C).

directly or indirectly, or any lower-tier partnership in which the partnership directly or indirectly holds an interest.[69]

The Final Regulations retain the requirement in the Proposed Regulations that the acquisition by the unrelated taxpayer constitute a taxable purchase. Accordingly, the Final Regulations exclude from this exception any transactions in which an interest in an API is acquired in a nonrecognition transfer by the unrelated non-service partner, including for this purpose a contribution of cash in exchange for the issuance of an interest in a partnership that holds an API.[70] In that case, the allocations to the unrelated non-service partner with respect to that API retain their character as API Gains and Losses.

4. Exception for Gain from Portfolio Investment on Behalf of Third-Party Investors

Section 1061(b) provides as follows: "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." Section 1061(c)(5) defines "third party investor" as a person who (i) holds an interest in the partnership which does not constitute property held in connection with an applicable trade or business; and (ii) 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 in an ATB Activity for such partnership or any applicable trade or business.

Like the Proposed Regulations, the Final Regulations do not implement section 1061(b) but instead reserve on the provision.[71] Section 1061(b) is similar to a provision in the Levin Bill that limited application of that bill to "investment partnerships."[72] The Levin Bill provision was intended, at least in part, to address the "enterprise value" issue (i.e., goodwill associated with sponsor organization).[73] The Preamble states that "[t]he Treasury Department and the IRS continue to study the comments regarding section 1061(b) and may address the application of the provision in future guidance, including whether section 1061(a) applies to recharacterize income or gain attributable to enterprise value."[74]

E. Section 1061 Computations

Consistent with the Proposed Regulations, the Final Regulations provide a significantly more detailed calculation than the statute in determining the amount that is recharacterized as short-term capital gain under section 1061, which the Final Regulations refer to as the "Recharacterization Amount".

---

69 Reg. §1.1061-3(d).

70 Preamble, Part III, Section B, Subsection 2 (providing that "[t]he Treasury Department and the IRS intend that the third-party purchaser exception be limited to API purchases and not apply when a third party contributes cash or property to a Passthrough Entity holding an API in a transaction qualifying for nonrecognition under section 721(a), or any similar provision….").

71 Reg. §1.1061-3(e).

72 Levin Bill, §710(c)(3).

73 *See* J. Sowell, *Levin Takes Another Shot at Carried Interest*, 2015 TNT 155-7 (Aug. 12, 2015).

74 Preamble, Part IV, Section A.

1. Excluded Capital Gain Items

Before discussing the formulaic calculation of an Owner Taxpayer's Recharacterization Amount, it is important to highlight the items that are excluded from the calculation.

Section 1061(a) recharacterizes net long-term capital gain allocated with respect to an API "by applying paragraphs (3) and (4) of sections 1222 by substituting '3 years' for '1 year'." While a taxpayer may recognize short-term or long-term capital gain with respect to numerous types of assets and transactions, section 1222 addresses the nature of capital gain only with respect to capital assets. Consistent with the literal terms of the statute, the following items of long-term capital gain and loss that are not dependent on section 1222 are excluded under the Final Regulations in calculating the Recharacterization Amount: (i) section 1231 gain or loss, (ii) section 1256 gain or loss, (3) qualified dividends under section 1(h)(11)(B), and (iv) other capital gain and loss characterized as long-term or short-term without regard to the holding period rules in section 1222, including gains and loss under the mixed straddle rules in section 1092(b) and the applicable regulations.[75]

The Proposed Regulations had included a transition rule that permitted a taxpayer to elect to exclude from API Gains and Losses capital gains and losses from assets held for more than three years as of December 31, 2017.[76] In response to comments questioning the purpose of and need for the transition rule, the Treasury and IRS determined to remove this rule from the Final Regulations.[77]

2. Determining Recharacterization Amount

The Final Regulations generally provide that the relevant holding period in analyzing a transaction under section 1061 is by reference to the holding period of the assets sold.[78] The Final Regulations provide for two exceptions to this general rule. The first is the related-party transfer rule in section 1061(d). The second relates to a non-statutory "Lookthrough Rule" first introduced in the Proposed Regulations and significantly simplified in the Final Regulations. Each of the exceptions is described in more detail below.

As stated above, the amount that an Owner Taxpayer must recharacterize as short-term capital gain under section 1061 is referred to as the Owner Taxpayer's Recharacterization Amount.[79] In determining an Owner Taxpayer's Recharacterization Amount, amounts allocated with respect to an API and amounts realized as gain or loss on the disposition of an API are first analyzed separately and then combined to determine the final Recharacterization Amount.[80] The Final Regulations also retain a rule

---

75 Reg. §1.1061-4(b)(7).

76 Prop. Reg. § 1.1061-4(b)(7).

77 Preamble, Part III, Section C, Subsection 7.

78 Reg. §1.1061-4(b)(8)(ii).

79 Reg. §1.1061-4(a)(1).

80 As described above, the approach adopted by Treasury and the IRS represents a "partial aggregate" approach. *See supra* note 4 and accompanying text.

that continues the API taint for property distributed with respect to an API and analyzes the disposition of such property like the disposition of an API.[81]

In general, the Final Regulations retain the formula introduced in the Proposed Regulations for determining the Recharacterization Amount. That formula starts with all relevant capital gain or loss that might be recharacterized under section 1061 (i.e., all long-term capital gain or loss that is not excluded from the scope of section 1061) and then subtracts from that amount the relevant capital gain or loss related to capital assets that were held for more than three years. More specifically, under the Final Regulations, the Recharacterization Amount equals the Owner Taxpayer's "One Year Gain Amount" less the Owner Taxpayer's "Three Year Gain Amount".[82] The One Year Gain Amount is the sum of the Owner Taxpayer's combined net "API One Year Distributive Share Amount" from all APIs held during the taxable year and the Owner Taxpayer's "API One Year Disposition Amount".[83] The "Three Year Gain Amount" is the corresponding sum of the Owner Taxpayer's "API Three Year Distributive Share Amounts" and "API Three Year Disposition Amount".[84] This portion of the calculation requires that the Passthrough Entity that has issued an API furnish the API One Year Distributive Share Amount and the API Three Year Distributive Share Amount with respect to that API, so that these amounts can be netted by the Owner Taxpayer with the comparable amounts from other APIs.[85]

The Final Regulations provide that the API One Year Distributive Share Amount equals the "API holder's distributive share of net long-term capital gain *or loss* from the partnership for the taxable year (including capital gain or loss on the disposition of Distributed API Property by an API Holder that is a Passthrough Entity or the disposition of all or a part of an API by an API Holder that is a Passthrough Entity),[86] with respect to the partnership interest held by the API holder without regard to the application of section 1061" *less* (to the extent included in the foregoing) long-term capital gain excluded from the application of section 1061 (e.g., long-term capital gain and loss under section 1231, etc.) and Capital Interest Gains and Losses. [87] If the computation results in a net long-term capital gain, it constitutes the API One Year Distributive Share Amount. The Final Regulations added "or loss" as the Proposed Regulations had only included amounts that resulted in a net long-term capital gain.[88] As a result, net

---

81 Reg. §§1.1061-1(a) ("Distributed API Property" definition) and 1.1061-4(a)(4)(i)(C) (taking long-term capital gain recognized on the disposition of Distributed API Property held for more than one year but less than three years into account for purposes of determining an API One Year Disposition Amount).

82 Reg. §1.1061-4(a)(1). If an Owner Taxpayer's One Year Gain Amount is zero or result in a loss, the Recharacterization Amount is zero and section 1061(a) does not apply. Reg. §1.1061-4(b)(1). If an Owner Taxpayer's Three Year Gain Amount results in a loss, it is treated as zero for purposes of calculating the Recharacterization Amount. Reg. §1.1061-4(b)(2).

83 Reg. §1.1061-4(a)(2)(i).

84 Reg. §1.1061-4(a)(2)(ii).

85 Reg. §1.1061-6(b)(1)(i).

86 Capital gain or loss from the disposition of an API held by a Passthrough Entity will be allocated as an API One or Three Year Distributive Share Amount. Only the direct sale of an API by an Owner Taxpayer will be reflected as an API One or Three Year Disposition Amount.

87 Reg. §1.1061-4(a)(3)(i) (emphasis added).

88 *Compare*. Prop. Reg. § 1.1061-4(a)(3)(i).

long-term gain and loss allocated from separate APIs to an Owner Taxpayer may be netted in determining the API Holder's One Year Distributive Share Amount.

The API Three Year Distributive Share Amount is the API One Year Distributive Share Amount[89] less items included in the API One Year Distributive Share Amount that would not be treated as long-term capital gain or loss if three years is substituted for one year in paragraphs (3) and (4) of section 1222, and, if the Lookthrough Rule (described below) applies to the disposition, the adjustments required under that rule.[90]

The API One Year Disposition Amount equals the combined net amount of three items. First, long-term capital gains and losses recognized during the taxable year by an Owner Taxpayer on the disposition of all or a portion of an API that had been held for more than one year, including a disposition to which the Lookthrough Rule applies.[91] Second, long-term capital gain and loss recognized on a distribution with respect to an API during the taxable year that is treated under section 731(a) (and 752(b) if applicable) as gain or loss from the sale or exchange of a partnership interest held for more than one year.[92] Third, long-term capital gains and losses recognized on the disposition of Distributed API Property (taking into account deemed exchanges under section 751(b)) during the taxable year that has a holding period of more than one year but no more than three years on the date of disposition.[93]

The API Three Year Disposition Amount equals the combined net amount of three items. First, long-term capital gains and losses recognized during the taxable year by an Owner Taxpayer on the disposition of all or a portion of an API that had been held for more than three years and to which the Lookthrough Rule does not apply.[94] Second, long-term capital gains and losses recognized by an Owner Taxpayer on the disposition during the taxable year of an API that has been held for more than three years less any adjustments required under the Lookthrough Rule.[95] Third, long-term capital gains and losses recognized on a distribution with respect to an API during the taxable year that is treated under sections 731(a) as gain or loss from the sale or exchange of a partnership interest held for more than three years.[96]

---

89 By using API One Year Distributive Share Amount as the starting amount, items like long-term section 1231 gains and loss, Transition Amounts, and Capital Interest Gains and Losses are already excluded, so the starting point for the calculation has already been narrowed down to long-term capital gain and loss that is potentially subject to recharacterization.

90 Reg. §1.1061-4(a)(3)(ii).

91 Reg. §1.1061-4(a)(4)(i)(A).

92 Reg. §1.1061-4(a)(4)(i)(B).

93 Reg. §1.1061-4(a)(4)(i)(C). By including in the API One Year Disposition Amount only such gain or loss as relates to Distributed API Property held for more than one year but less than three years, there is no need to account for such property in API Three Year Disposition Amount (i.e., the amount that otherwise reduces API One Year Disposition Amount) because the gain and loss included in API One Year Disposition Amount with respect to such property all should be accounted for in determining the Recharacterization Amount.

94 Reg. §1.1061-4(a)(4)(ii)(A).

95 Reg. §1.1061-4(a)(4)(ii)(B).

96 Reg. §1.1061-4(a)(4)(ii)(C).

The Final Regulations contain specific rules for capital gain dividends from RICs and REITs and net capital gain inclusions in respect of QEFs. With respect to a RIC or REIT, if the RIC or REIT provides the One Year Amounts Disclosure[97] and the Three Year Amounts Disclosure,[98] then the amount disclosed in the former is included in the calculation of the API One Year Distributive Share Amount and the amount disclosed in the latter is included in the calculation of the API Three Year Distributive Share Amount.[99] Note that, because section 1231 gain is excluded for purposes of calculating the API One Year Distributive Share Amount, this rule effectively allows a RIC or REIT to report to its shareholders section 1231 gain recognized by the RIC or REIT as excluded from section 1061.[100] If no disclosure is provided, then the entire capital gain dividend must be included in the API One Year Distributive Share Amount, and no such amount will be included in the API Three Year Distributive Share Amount.[101] If a RIC or REIT provides a Three Year Amounts Disclosure then any loss on the sale or exchange of a share of the RIC or REIT held for six months or less is treated as a capital loss on an asset held for more than three years, to the extent of the amount of the Three Year Amounts Disclosure from the RIC or REIT (i.e., the favorable dividend gain amount is effectively offset by the loss amount from the stock sale).[102] A similar lookthrough rule applies to net capital gain inclusions in respect of QEFs but only if the QEF provides information to determine the amount of the inclusion that would constitute a net long-term capital gain if the QEF's net capital gain were calculated under section 1222(11) applying paragraphs (3) and (4) of section 1222 by substituting three years for one year.[103]

3. Installment Sale Gain

As with the Proposed Regulations, the Final Regulations confirm that gain recognized under the installment sale method in a taxable year beginning after December 31, 2017, is subject to section 1061 regardless of the year in which the asset was sold and that section 1061 applies by reference to the seller's holding period in the asset at the time of sale.[104]

4. Lookthrough Rule

The Final Regulations significantly simplify a rule introduced in the Proposed Regulations that, in limited circumstances, effectively requires a selling partner to look to the partnership's holding period in its assets rather than the partner's holding period in the partnership interest for purposes of applying section 1061 (the "Lookthrough Rule").[105]

---

97 *See infra* text accompanying note 127.

98 *See infra* text accompanying note 128.

99 Reg. §1.1061-4(b)(5)(i) & (ii).

100 Reg. §1.1061-4(c)(2), Ex. 3.

101 Reg. §1.1061-4(b)(5)(i) & (ii).

102 Reg. §1.1061-4(b)(5)(iii).

103 Reg. §1.1061-4(b)(6). Note that this rule is independent of the rule that provides that a PFIC with respect to which a shareholder that has made a QEF election is not treated as a corporation for purposes of the corporation exception of Reg. §1.1061-3(b)(2)(ii).

104 Reg. §1.1061-4(b)(4).

105 Reg. §1.1061-4(b)(9). *Cf.* Prop. Reg. §1.1061-4(b)(9).

Under the Final Regulations, the Lookthrough Rule applies if, at the time of disposition of an API held for more than three years, either of two conditions are met.[106] The first targets circumstances in which a sponsor essentially uses a shell entity to begin the holding period for their carry in a future fund. Specifically, the Lookthrough Rule will apply if the API would have a holding period of three years or less if the holding period of such API were determined by not including any period before the date that an Unrelated Non-Service Partner is legally obligated to contribute substantial money or property directly or indirectly to the Passthrough Entity to which the API relates.[107] For these purposes, a substantial legal obligation to contribute money or property is an obligation to contribute a value that is at least five percent of the partnership's total capital contribution as of the time of the API disposition. In addition, this rule does not apply to the extent the gain recognized upon the disposition is attributable to any asset not held for portfolio investment on behalf of third party investors. The second rule provides that the Lookthrough Rule will apply in a transaction or series of transactions that take place with a principal purpose of avoiding potential gain recognition under section 1061(a).[108]

The Lookthrough Rule is a gating rule. If the Lookthrough Rule applies, then an Owner Taxpayer must include the entire amount of capital gain recognized in the API One Year Disposition Amount.[109] The Owner Taxpayer's Three Year Disposition Amount must include the same amount less the Owner Taxpayer's share of the amount of any gain, directly or indirectly, from assets held for three years or less that would have been allocated to the Owner Taxpayer (in respect of the transferred API) by the partnership if the partnership had sold all of its property for fair market value in a fully taxable transaction.[110] If a Passthrough Entity disposes of an API subject to the Lookthrough Rule, then the same principles apply to determine the amount to include in the Owner Taxpayer's One Year Distributive Share Amount and Three Year Distributive Share Amount.[111]

5. Carry Waivers

Following the enactment of section 1061, many fund sponsors began to consider a concept known as a "carry waiver" whereby the sponsor would waive its right to allocations with respect to its carried interest of gain from the sale of capital assets held for three years or less and receive in the future allocations of such gain from the sale of capital assets held for more than three years. The Proposed Regulations did not address these arrangements, but the preamble to the Proposed Regulations contained the following warning: "Taxpayers should be aware that these and similar arrangements may not be respected and may be challenged under section 707(a)(2)(A), §§1.701-2 and 1.704-1(b)(2)(iii), and/or the substance over form or economic substance doctrines."[112] The Final Regulations (including the Preamble) do not further address carry waivers.

---

106 Reg. §1.1061-4(b)(9).

107 Reg. §1.1061-4(b)(9)(i).

108 Reg. §1.1061-4(b)(9)(ii).

109 Reg. §1.1061-4(b)(9)(ii)(A).

110 Reg. §1.1061-4(b)(9)(ii)(B).

111 Reg. §1.1061-4(b)(9)(ii)(C).

112 Preamble, Part I, Section A.1.f.

F. Related-Party Transfer Rule

The Final Regulations have narrowed the scope of the related-party transfer rule and simplified the computation of the inclusion amount from the Proposed Regulations. As with the Proposed Regulations, the Final Regulations interpret the section 1061(d) related-party transfer rule[113] to potentially increase short-term capital gain upon the sale of an API by applying a look-through approach to determine the holding period attributable to the gain for the disposed API by reference to the underlying assets. However, the Final Regulations depart from the Proposed Regulation in providing that the "Section 1061(d) Recharacterization Amount" includes only long-term capital gain that the owner Taxpayer recognizes under chapter 1 of the Code upon a transfer through a sale or exchange of an API to a Section 1061(d) Related Person.[114]

If section 1061(d) applies, an Owner Taxpayer's Section 1061(d) Recharacterization Amount is the Owner Taxpayer's share of the amount of net long-term capital gain from assets held for three years or less that would have been allocated to the Owner Taxpayer with respect to the transferred API had sold all of its property for cash in an amount equal to the fair market value of such property immediately prior to the Owner taxpayer's transfer of the API (or a portion of such gain if only a portion of the API is transferred).[115]

Long-term capital gain that is recharacterized to short-term under section 1061(d) is the *lesser of* (i) the amount of net long-term capital gain recognized by the Owner Taxpayer upon the transfer of such interest, or (ii) the Section 1061(d) Recharacterization Amount.[116] Thus, the Final Regulations institute

---

[113] Section 1061(d) appears to have been derived from a provision in the Camp Bill – specifically section 1061(e) as set forth in section 3621 of that bill. For a discussion of the relationship between these provisions, *see Legislative Past*, *supra* note 39. For a discussion of the Camp Bill and the related party provision in that bill, *see* J. Sowell, *Camp's Plan for Carried Interest: One Step Forward, One Step Back*, 2014 TNT 62-12 (Apr. 1, 2014).

[114] Proposed Regulation section 1.1061-5(a) provided that if an Owner Taxpayer transferred any API, or Distributed API Property, directly or indirectly, to a Section 1061(d) Related Person, or if a Passthrough Entity in which an Owner Taxpayer holds an interest, directly or indirectly, transfers an API to a Section 1061(d) Related Person, *regardless of whether gain is otherwise recognized on the transfer under the Code*, the Owner Taxpayer must include in gross income as short-term capital gain, the excess of: (1) the Owner Taxpayer's net long-term capital gain with respect to such interest for such taxable year determined as provided in Proposed Regulation section 1.1061-5(c), over (2) any amount treated as short-term capital gain under Proposed Regulation section 1.1061-4 with respect to the transfer of such interest (that is, any amount included in the Owner Taxpayer's API One Year Disposition Gain Amount and not in the Owner Taxpayer's Three Year Disposition Gain Amount with respect to the transferred interest). Proposed Regulation section 1.1061-5(b) provided that for purposes of section 1061(d), the term transfer would include contributions, distributions, sales and exchanges, and gifts. However, after considering several comments to the Proposed Regulations, the Treasury Department and the IRS determined in the Final Regulations that, in the absence of clear language to the contrary, it would be more appropriate to apply section 1061(d) only to transfers in which long-term capital gain is actually recognized under chapter 1 of the Code.

[115] Reg. §1.1061-5(c).

[116] The Final Regulation interpreting section 1061(d) reads as follows:

> If an Owner Taxpayer transfers any API or Distributed API Property, directly or indirectly, to a Section 1061(d) Related Person… the Owner Taxpayer must include in gross income as short-term capital gain, an amount equal to –
>
> (1) The short-term capital gain recognized upon the API transfer without regard to this paragraph (a) [related-party-transfer rules], and
>
> (2) The lesser of –

a “gain limitation” rule - only gain that would otherwise be treated as long-term gain upon the sale of an API is recharacterized under section 1061(d).[117]

Representing a significant change from the Proposed Regulations, the Final Regulations provide that the Section 1061(d) Recharacterization Amount does not include amounts which are not taken into account for purposes of section 1061 under Treas. Reg. section 1.1061-4(b)(7) (including section 1231 gains). The exclusion of section 1231 gain from the application of section 1061(d) is noteworthy for a number of industries and particularly the real estate industry.

A Section 1061(d) Related Person is any person that is a member of the taxpayer’s family within the meaning of section 318(a)(1), a person that performed a service within the current calendar year or the preceding three calendar year in the ATB in respect of which the API was issued, or any Passthrough Entity in which any such family member or service provider owns an interest directly, or indirectly.[118] The parties defined as “related” are somewhat unusual when compared to the more typical related party definitions in other parts of the Code, and special attention must be paid to determine when parties may be related.

An API in the hands of the transferee is still subject to section 1061(a) as an API includes interests held by or transferred to the taxpayer in connection with the performance of a substantial service by the taxpayer or a related person.[119]

G. Reporting Requirements

The Final Regulations generally retain the reporting requirements introduced in the Proposed Regulations with only conforming changes and the addition of clarifying change to QEF reporting. Under the Final Regulations, each Passthrough Entity that has issued an API must furnish to the API holder and the IRS the following information:

- The API One Year Distributive Share Amount and the API Three Year Distributive Share Amount,
- Capital gains and losses allocated to the API holder that are excluded from section 1061,
- Capital Interest Gains and Losses allocated to the API holder, and
- In the case of a disposition by an API Holder of an interest in the Passthrough Entity during the taxable year, upon the request of an API Holder, any information required by the API holder to properly take the disposition into account under section 1061, including information to apply the

(i) The amount of net long-term capital gain recognized by the Owner Taxpayer upon the transfer of such interest, or

(ii) The amount treated as short-term capital gain under paragraph (c) of this section (Section 1061(d) Recharacterization Amount).

Reg. §1.1061-5(a).

117 This operates differently than the look-through approach of section 751(a), for example.

118 Reg. §1.1061-5(e).

119 Reg. §1.1061-2(a).

Lookthrough Rule and to determine its Capital Interest Disposition Amount as well as information necessary to determine the Owner Taxpayer's Section 1061(d) Recharacterization Amount.[120]

If a Passthrough Entity requires information from a lower-tier entity to meet its reporting and filing requirements under the Proposed Regulations, then it must request such information from that entity by the later of the 30th day after the close of the taxable year to which the information request relates or 14 days after the date of a request for such information from an upper-tier Passthrough Entity.[121] If a Passthrough Entity receives such a request, then it must furnish the requested information to the person making the request in general no later than the date on which the entity is required to furnish such information under section 6031(b) or section 6037(b), as applicable.[122] A Passthrough Entity receiving a request for information must retain a copy of the request and the date received in its books and records.[123] Failure to provide the information required under the Proposed Regulations is subject to penalties under section 6722.[124]

If an upper-tier Passthrough Entity does not receive such required or requested information, then the upper-tier Passthrough Entity must take actions to otherwise determine and substantiate the missing information. To the extent that the upper-tier Passthrough Entity is not able to otherwise substantiate and determine the missing information, then the upper-tier Passthrough Entity must treat the amounts as described below and is required to provide notice to the API holder and the IRS regarding such inability.[125]

If an Owner Taxpayer (or Passthrough Entity) is not furnished with the information described above and is not otherwise able to substantiate all or a part of these amounts, then essentially all of the Owner Taxpayer's distributive share of items of capital gain or loss are treated as items of short-term capital gain or loss. More specifically, the Owner Taxpayer is not permitted to reduce its API One Year Distributive Share Amount by amounts otherwise excluded from section 1061, API Holder Transition Amounts, or Capital Interest Gains and Losses and, for purposes of determining its API Three Year Distributive Share Amount, no items in the API One Year Distributive Share Amount are treated as items that would be long-term capital gain or loss if three years is substituted for one year in paragraphs (2) and (3) of section 1222.[126]

---

[120] Reg. §1.1061-6(b)(1).

[121] Reg. §1.1061-6(b)(2)(iii)(A).

[122] Reg. §1.1061-6(b)(2)(iii)(B)(1). Note, Reg. §1.1061-6(b)(2)(iii)(B)(2) states that the time and manner for responding to late requests by an upper-tier Passthrough Entity shall be prescribed by forms, instructions and other guidance.

[123] Reg. §1.1061-6(b)(2)(v).

[124] Reg. §1.1061-6(b)(2)(viii).

[125] Reg. §1.1061-6(b)(2)(vi). Such notice to the IRS is to be provided as required in forms, instructions, and other guidance.

[126] Reg. §1.1061-6(a)(2).

1. RIC, REIT, and QEF Reporting

As noted above, the Final Regulations allow an Owner Taxpayer or Passthrough Entity to "look-through" capital gain dividends or net capital gain inclusions, provided the underlying RIC, REIT, or QEF supply the information described below.

With respect to a RIC or REIT, the shareholder must receive a One Year Amounts Disclosure and a Three Year Amounts Disclosure. The One Year Amounts Disclosure is a disclosure of an amount that is attributable to a computation of the RIC's or REIT's net capital gain excluding capital gain and capital loss not taken into account for purposes of section 1061 (e.g., section 1231 gain, qualified dividend income, etc.). This amount cannot exceed the RIC's or REIT's aggregate capital gain dividends for the taxable year.[127] The Three Year Amounts Disclosure is a disclosure of an amount that is attributable to the RIC's or REIT's One Year Amounts Disclosure substituting "three years" for "one year" in applying section 1222, provided that such computed amount cannot exceed the RIC's or REIT's aggregate capital gain dividends for the taxable year.[128] The One Year Amounts Disclosure and the Three Year Amounts Disclosure made to each shareholder must be proportionate to that shareholder's share of capital gain dividends reported or designated for the taxable year.[129] Such disclosures must be provided in writing to its shareholders with the statement described in section 852(b)(3)(C)(i) or the notice described in section 857(b)(3)(B) in which the capital gain dividend is reported or designated.[130]

A QEF may provide to each electing shareholder additional information to enable API holders to determine the amount of their inclusion under section 1293(a)(1) that would be included in the API One Year Distributive Share Amounts and API Three Year Distributive Share Amounts with respect to the QEF. If such information is not provided, an API holder must include all net capital gain inclusions with respect to the QEF in its API One Year Distributive Share Amount and no amount in its API Three Year Distributive Share Amount.[131]

H. Divided Holding Period Rules

A partner generally cannot isolate a portion of its holding period to a specific interest in the partnership. Instead, when a partner sells a portion of its interest in a partnership, the holding period of that partnership interest is divided taking into account all of the partner's separate holding periods in its interest.

A partner has a divided holding period in its partnership interest if the partner acquired portions of its interest at different times or if the partner acquired portions of the partnership interest in exchange for property transferred at the same time but resulting in different holding periods.[132] The current regulations provide that the portion of the partnership interest to which a holding period relates is determined with reference to a fraction, the numerator of which is the fair market value of the portion of

---

[127] Reg. §1.1061-6(c)(1)(i).

[128] Reg. §1.1061-6(c)(1)(ii).

[129] Reg. §1.1061-6(c)(2); *cf.* Rev. Rul. 89-81, 1989-1 C.B. 226.

[130] Reg. §1.1061-6(c)(3).

[131] Prop. Reg. §1.1061-6(d).

[132] Reg. §1.1223-3(a).

the partnership interest received in the transaction to which the holding period relates, and the denominator of which is the fair market value of the entire partnership interest determined immediately after the acquisition transaction.[133]

The rule in the current regulations does not work well for profits interests, since the "willing-buyer-willing-seller" value of such interests at the time of issuance often is highly speculative, and the liquidation value should be $0. The Final Regulations amend the partnership interest holding period rules under section 1223 to address profits interests. Specifically, the Final Regulations provide that if a partnership interest is comprised in whole or in part of one or more profits interests, then the portion of the holding period to which a profits interest relates is determined based on the fair market value of the profits interest upon the disposition of all, or part, of the interest (and not at the time that the profits interest is acquired).[134] The value of a profits interest is not included in determining the impact to the partner's holding period of a subsequent contribution of property – that is, the partner's holding period in its "capital interest" is determined without regard to its profits interests and the impact of any profits interests on the partner's holding period is only taken into account when the partner sells all or a portion of its overall partnership interest. The Final Regulations adopt the same definitions of capital interests and profits interest as the definition provided in Rev. Proc. 93-27.

I. Effective Date

The Final Regulations generally provide that they apply to taxable years of Owner Taxpayers and Passthrough Entities beginning on or after the date they are published in the Federal Register. Although the Final Regulations are not currently effective, the Preamble indicates that Owner Taxpayers and Passthrough Entities may rely on the Final Regulations for taxable years beginning after December 31, 2017, provided they follow the Final Regulations consistently and in their entirety for that taxable year and all subsequent taxable years.[135] As previously described, the Final Regulations provide that the rule excluding S Corporations from the corporate exception is effective for taxable years beginning after December 31, 2017, and the rule excluding PFICs making a QEF election is effective for taxable years of an Owner Taxpayer or Passthrough Entity beginning after August 14, 2020 (i.e., the date the Proposed Regulations were published in the Federal Register).

---

[133] Reg. §1.1223-3(b)(1).

[134] Reg. §1.1223-3(b)(5). The divided holding period rule for profits interest often will produce adverse results when LTIP unitholders in a REIT operating partnership exchange their LTIP units for REIT stock or sell their units to the REIT. Prior to the Proposed Regulations, there had been some hope that, because the liquidation value on issuance of a profits interest is always $0, there would be no new holding period created for annual LTIP issuances. The Proposed Regulations follow a different approach such that each LTIP issuance will have a different holding period. When LTIPs are converted, it is not possible to identify a holding period with specific units. Instead, each LTIP unit will have a divided holding period by reference to each LTIP issuance. Thus, upon the conversion of LTIP units, some portion of the converted units will have a holding period that relates to the most recent issuances, assuming that there is value associated with those recently issued LTIP units.

[135] Preamble, Part V.

IV. Conclusion

The Final Regulations under section 1061 contain some generally helpful changes, in particular in regard to the capital interest exception and section 1061(d), as well some simplifying changes (with regard to the Lookthrough Rule), but remain highly mechanical and complicated. In addition, as with the Proposed Regulations, the Final Regulations go beyond the language of the statute in many instances to import concepts from prior versions of the carried interest legislation that were never enacted into law. Parts of the Final Regulations are likely to be controversial and they do not appear to adequately address a number of circumstances that may arise in more complicated sponsor structures. One may question whether adequate time was taken to analyze the many complicated issues that were highlighted by commenters with respect to the Proposed Regulations prior to issuing the Final Regulations. The Preamble to the Final Regulations does indicate in a number of instances that issues remain under study, so there may be more to come.

□□□□