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Treasury and the IRS Issue Proposed Regulations on Partnership Interests Held in Connection with the Performance of Services under Section 1061

SUMMARY

On July 31, 2020, the U.S. Department of the Treasury (Treasury) and the Internal Revenue Service (IRS) published proposed regulations (REG-107213-18) under Section 1061 relating to the taxation of so-called carried interests.

Section 1061 generally provides that certain long-term capital gains may be recharacterized as short-term capital gain if the holding period associated with the property triggering the gain is less than three years. Thus, Section 1061 may operate to recharacterize long-term capital gain where the typical one-year holding period requirement has been satisfied, but the disposed property has been held for less than three years.

Section 1061 will apply only to certain capital gain allocations made with respect to an applicable partnership interest (API). Section 1061(c)(1) defines an API to mean any interest in a partnership which, directly or indirectly, is transferred to (or 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). Notwithstanding this general rule, an API does not include:

- A. Any interest in a partnership directly or indirectly held by a corporation (Corporate Exception), or
- B. Any capital interest in the partnership which provides the taxpayer with a right to share in partnership capital commensurate with the amount of capital contributed or the value of the partnership interest taxed under Section 83 (Capital Interest Exception).

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Further, under Section 1061(d), if a taxpayer transfers an API, directly or indirectly, to a related person, the taxpayer is required to immediately recognize gain in an amount equal to the excess, if any, of:

- A. The amount of gain attributable to partnership assets with a holding period of less than three years, over
- B. Any amount otherwise treated as short-term capital gain with respect to the transfer of the interest.

While the structure of the statute is relatively straightforward, implementation of these rules has proven challenging. The proposed regulations are intended to provide much needed guidance and address many open questions. Highlights of the proposed regulations are summarized below.

IMPORTANT DEFINITIONS & CALCULATIONS

Gains Subject to Section 1061. Capital gains subject to recharacterization under Section 1061 do not include long-term capital gains determined under Section 1231 or Section 1256, qualified dividends, and any other capital gain that is characterized as long-term or short-term without regard to the holding period rules under Section 1222, e.g., gains under the Section 1092(b) mixed straddle rules.

Recharacterization Amount. Section 1061(a) recharacterizes as short-term capital gain, the difference between a taxpayer's net long-term capital gain with respect to one or more APIs and the taxpayer's net long-term capital gain with respect to these APIs by using a three-year holding period for purposes of applying Sections 1222(3) and 1222(4). The proposed regulations define this amount as the API holder's Recharacterization Amount and specify that this amount may arise from both directly held APIs or APIs held indirectly through tiered partnership structures.

The proposed regulations generally provide that the Recharacterization Amount is the excess of the API holder's *One-Year Gain Amount* over the API holder's *Three-Year Gain Amount*. The proposed regulations create a series of defined terms needed to accurately calculate the Recharacterization Amount. These terms are summarized below:

- ▶ The **One-Year Gain Amount** is comprised of two components: (1) the combined net *API One-Year Distributive Share Amount* from all APIs held during the taxable year, and (2) the *API One-Year Disposition Amount*.
- ▶ The **Three-Year Gain Amount** is comprised of: (1) the combined net *API Three-Year Distributive Share Amount* from all APIs held during the taxable year, and (2) the *API Three-Year Disposition Amount*.

- ▶ The **API One-Year Distributive Share Amount** is determined by applying the following steps: (1) the partnership determines the long-term capital gains and losses that are allocated to the API holder under the partnership agreement under Sections 702 and 704, (2) the partnership reduces this amount by amounts that are not taken into account for purposes of calculating the Recharacterization Amount as listed in the previous section, and (3) the partnership reduces the amount determined under the second step by any amounts that are treated as Capital Interest Gains and Losses under §1.1061-3(c).
- ▶ The **API One-Year Disposition Amount** includes the long-term capital gains and losses that the API holder recognizes from the direct taxable disposition of an API that has been held for more than one year plus long-term capital gain or loss recognized on the disposition of Distributed API Property by an API holder.
- ▶ The **API Three-Year Distributive Share Amount** is generally equal to the API holder's One-Year Distributive Share Amount less amounts that would not be treated as long-term capital and loss if such amounts were computed by applying a three-year holding period.
- ▶ The **API Three-Year Disposition Amount** includes only the long-term capital gain or loss from the direct taxable disposition of an API held by the Owner Taxpayer for more than three years.

ATB Activity Test. Under the ATB Activity Test, the proposed regulations provide that an activity is conducted on a regular, continuous, and substantial basis if it meets the ATB Activity Test as defined in the proposed regulations. The ATB Activity Test is met if the total level of activity (conducted in one or more entities) meets the level of activity required to establish a trade or business for purposes of Section 162. In applying the ATB Activity Test, the proposed regulations provide that, in some cases, it is not necessary for both Raising or Returning Capital Actions and Investing or Developing Actions to occur in a single year for an ATB to exist in that year. Further, Raising or Returning Capital Actions and Investing or Developing Actions of related persons are aggregated together to determine if the ATB Activity Test is met. Consider the following examples illustrating the determination of an ATB:

Example 1. Combined Activities of Raising or Returning Capital Actions and Investing or Developing Actions.

During the taxable year, B takes a small number of actions to raise capital for new investments. B takes numerous actions to develop Specified Assets. B's actions with respect to raising capital and B's actions with respect to developing Specified Assets are combined for the purpose of determining whether the ATB Activity Test is satisfied.

Example 2. ATB Activity Test Not Satisfied. A is the manager of a hardware store. Partnership owns the hardware store, including the building in which the hardware business is conducted. In connection with A's services as the manager of the hardware store, a profits interest in Partnership is transferred to A. Partnership's business involves buying hardware from wholesale suppliers and selling it to customers. The hardware is not a Specified Asset. Although real estate is a Specified Asset if it is held for rental or investment purposes, Partnership holds the building for the purpose of conducting its hardware business and not for rental or investment purposes. Therefore, the building is not a Specified Asset as to Partnership. Partnership also maintains and manages a certain amount of working capital for its business, but actions with respect to working capital are not taken into account for the purpose of determining whether the ATB Activity Test is met. Partnership is not a Related Person with respect to any person who takes Specified Actions. Partnership is not engaged in an ATB because the ATB Activity Test is not satisfied. Although Partnership raises capital, its Raising or Returning Capital Actions alone do not satisfy the ATB Activity Test. Further, Partnership takes no Investing or Developing Actions because it holds no Specified Assets other than working capital. Partnership is not in an ATB and the profits interest transferred to A is not an API.

EXCEPTIONS TO SECTION 1061

Corporation Exception. Consistent with the position described in Notice 2018-18, Treasury and the IRS believe that S corporations are not treated as "corporations" for purposes of the exception to treatment of a partnership interest as an API. Additionally, the proposed regulations provide that the corporate exception does not apply to APIs held by passive foreign investment companies (PFICs) under Section 1295. Treasury and the IRS note in the preamble to the proposed regulations that Section 1061(f) grants authority as necessary or appropriate to carry out the purposes of Section 1061. Both the Conference Report and Bluebook direct Treasury and the IRS to issue regulations necessary to prevent abuse of the purposes of Section 1061.

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While this proposed rule seems overly broad, Treasury and the IRS appear to be relying on statutory authority to draft regulations that reflect Congressional intent. Consequently, the determination that S corporations and PFICs are not considered corporations subject to Section 1061 will likely elicit extensive comments from tax professionals. However, the proposed regulations are consistent with prior guidance published by Treasury and there has been no indication in a change in this position.

Capital Interest Exception. While the statute generally describes that capital gain allocations attributable to a capital interest are not subject to recharacterization, implementation of these rules can be challenging in all but the simplest allocation scenarios. The proposed regulations, therefore, provide rules for determining whether capital gains and losses allocated to the holder of an API are treated as allocations with respect to its capital investment and are excluded from application of Section 1061. As a general rule, the proposed regulations provide that allocations eligible to be excluded as capital interest allocations must be made to the partners based on the relative capital accounts (as determined under Section 704(b) or similar principles) of the partners (or owners in the case of a non-partnership entity) and the terms, priority, type, and level of risk, rate of return, and rights to cash or property distributions from operations and upon liquidation are the same. However, allocations that are subordinated to allocations made to partners who are not service providers will not be disqualified. Further, capital interest allocations never include any amounts that are treated as API gains and losses or unrealized API gains and losses that are allocated to the partnership by a lower-tier partnership.

Non-ATB Employee Exception. The proposed regulations are consistent with the statute in providing that an API does not include a partnership interest received by an employee who provides services to another entity that is conducting a trade or business other than an ATB and the person only provides services to such other entity. For example, if an employee of a corporation receives a profits interest in a partnership that holds the stock of the employer-corporation and the corporation does not operate an ATB, then the profits interest will not be treated as an API.

Exception for Third Party Investors & Family Offices. An acquiring taxpayer will not be treated as acquiring an API when purchased at fair market value in a taxable transaction if the taxpayer has not provided, and will not provide, services to the partnership, and is not related to any person who provides, or has provided services to the partnership or in a relevant ATB. Comments have suggested that the exception is intended to apply to family offices, that is, portfolio investments made on behalf of the service providers and persons related to the services providers. Treasury and the IRS generally agree with these comments and believe that the Section 1061 exception effectively is implemented in the proposed regulations. However, Treasury and the IRS request comments on the application of this provision and whether the proposed regulations adequately implement the exception.

SECTION 1061 GAIN RECHARACTERIZATION TRANSACTIONS

Transfers to Related Parties under Section 1061(d). Under Section 1061(d) the transfer of an API to a related person may trigger immediate recognition of short-term capital gain. The statute provides general rules for purposes of determining the amount of required gain recognized. The proposed regulations provide some clarifications around the required calculations and define the term “transfer” for these purposes. Specifically, the proposed regulations provide that the term “transfer” for purposes of Section 1061(d) includes, but is not limited to, contributions, distributions, sales and exchanges, and gifts. Further, a “related person” is defined to include only members of the taxpayer’s family within the meaning of Section 318(a) (1), the taxpayer’s colleagues (those who provided services in the ATB during certain time periods), and a passthrough entity, to the extent that a member of the taxpayer’s family or a colleague is an owner. Consider the following examples:

Example 1. Transfer to Child by Gift. A, an individual, performs services in an ATB and has held an API in connection with those services for 10 years. The API has a fair market value of \$1,000 and a tax basis of \$0. A transfers all of the API to A’s daughter as a gift. A’s daughter is a related person. Immediately before the gift, if the partnership that issued the API had sold all of its assets for fair market value, A would have been allocated \$700 of net long-term capital gain from assets held by the partnership for three years or less. A did not recognize any gain on the transfer for federal income tax purposes before application of this section. Consequently, A includes the difference between the \$700 and \$0, in gross income as short-term capital gain. Therefore, A includes \$700 in gross income as short-term capital gain. A’s daughter increases her basis in the API by the \$700 of gain recognized by A on the transfer.

Example 2. Contribution of an API to a Passthrough Entity Owned by Related Persons. A, B, and C are equal partners in GP. GP holds only one asset, an API in PRS1, which is an indirect API as to each A, B, and C. A, B, and C each provide services in the ATB in connection with which GP was transferred its API in PRS1. A and B contribute their interests in GP to PRS2 in exchange for interests in PRS2. Under the terms of the partnership agreement of PRS2, all unrealized API gain or loss allocable to A and B in the property held by GP and PRS1 as of the date of the contribution by A and B when recognized will continue to be allocated to each A and B by PRS2. As a result of the contribution by A and B of their interests in GP to PRS2, PRS1 and GP must revalue their assets under Section 704(b) principles. The contribution by A and B of their interest in GP to PRS2 is a potential transfer to a related person as to both A and B to the extent that the other is an owner of PRS2. However, because a contribution under Section 721(a) to a partnership is not a transfer to a related person for purposes of this section, Section 1061(d) does not apply to A and B’s contribution.

Taxable Disposition of an API. If an owner disposes of an API, any long-term gain recognized is presumed to be subject to Section 1061 recharacterization unless all or a portion of the long-term capital gain is determined to be attributable to a capital interest. The proposed regulations provide a series of steps to determine the portion of long-term capital gain or loss recognized on the disposition that is subject to recharacterization under Section 1061. Under the proposed regulations, taxpayers would perform the following steps:

- A. First, determine the amount of long-term capital gain or loss that would be allocated to the partner if the partnership’s assets were sold in a fully taxable transaction.
- B. Second, determine the amount of gain or loss that would be attributable to a capital interest held by the partner.
- C. Then, if the transferor recognized long-term capital gain on the disposition and only capital losses are allocated from the deemed liquidation, then all of the recognized gain is treated as API Gain. However, if the transferor recognized long-term capital loss on the disposition and only capital gain is allocated to the partner, the all of the long-term capital loss is treated as API Loss.
- D. If C does not apply, then the amount of long-term capital gain or loss not subject to Section 1061 recharacterization is determined by multiplying total long-term capital gain or loss recognized on the disposition by a percentage equal to the amount of capital interest gain determined in B divided by the total long-term capital gain determined under A.

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There has been some question regarding whether the disposition of an API could result in gain subject to recharacterization under Section 1061. The proposed regulations make it clear that Treasury and the IRS believe this to be the case. Further, the proposed regulations provide rules enabling taxpayers to accurately determine the amount of gain subject to Section 1061 recharacterization. From a practical perspective, however, implementation of this rule will require the partnership (or tiered partnerships) to provide information to the partner. Presumably, such information will be required via separate guidance including tax return form instructions.

Distribution of Property to an API Owner. Generally, the distribution of property with respect to an API does not accelerate the recognition of gain under Section 1061. However, if distributed API property is disposed of by the distributee-partner when the holding period is three years or less (inclusive of the partnership's holding period), gain or loss with respect to the disposition is subject to Section 1061 recharacterization. Further, distributed API property retains its character as it is passed from one tier to the next. However, at the time that distributed API property is held for more than three years, it is no longer subject to Section 1061 recharacterization. If distributed API property is distributed from a lower-tier partnership to an upper-tier partnership and upper-tier entity disposes of the property, the long-term capital gain or loss is subject to recharacterization included in the upper-tier entity's long-term capital gain or loss as API gain or loss.

Carried Interest Waivers. Taxpayers may seek to avoid Section 1061 recharacterization by waiving their rights to gains generated from the disposition of a partnership's capital assets held for three years or less and substituting for this amount any gains generated from capital assets held for more than three years. Alternatively, taxpayers may waive their rights to API gains and substitute other gains. Some arrangements also may include the ability for an API owner to periodically waive its right to an allocation of capital gains from all assets in favor of an allocation of capital gains from assets held for more than three years and/or a priority fill up allocation designed to replicate the economics of an arrangement in which the API owner shares in all realized gains over the life of the fund. These arrangements are often referred to as carry waivers or carried interest waivers. Treasury and the IRS note in the preamble to the proposed regulations that taxpayers should be aware that these and similar arrangements may not be respected and may be challenged under the disguised payment for service rules under Section 707 and the substantiality rules under Section 1.704-1(b)(2)(iii), as well as the substance over form or economic substance doctrines.

REPORTING RULES

Under the proposed regulations, both the partnership and partner are required to file specific information relating to Section 1061. The partner is required to file information with the IRS as may be required to demonstrate that the partner has complied with Section 1061. The proposed regulations do not provide further details, presumably these will be included in future instructions or other guidance.

The proposed regulations similarly do not provide partnerships with specific requirements regarding the form of information to be provided. However, the proposed regulations provide that the required information will include:

- i. The API One Year Distributive Share Amount and the API Three Year Distributive Share Amount.
- ii. Capital gains and losses allocated to the API holder that are excluded from Section 1061.
- iii. Capital Interest gains and losses allocated to the API holder.
- iv. API holder transition amounts.
- v. In the case of a disposition by an API holder of an interest in the Passthrough Entity during the taxable year, any information required by the API holder to properly take the disposition into account under Section 1061, including information to apply the look-through rule and to determine its Capital Interest Disposition Amount.

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