The “Carried Interest” Rules of Section 1061: Proposed Regulations Resolve Several Ambiguities Under the Statute

Ronald E. Creamer, Jr., Zachary W. Feldman, Andrew B. Motten, David C. Spitzer, Davis J. Wang, and Isaac Wheeler*

The recently released proposed regulations under Code Section 1061 are a mixed bag for taxpayers. Certain aspects of Section 1061 are interpreted narrowly, but the proposed regulations are broad in other respects. And the proposed regulations provide detailed—and in some cases very complex—rules on how taxpayers should calculate the amount of long-term capital gain recharacterized as short-term capital gain under Section 1061 and the application of certain exceptions. Affected taxpayers, particularly hedge funds and private equity industries, and their advisors should closely review the proposed regulations.

Introduction

On July 31, the Internal Revenue Service (IRS) and the Treasury Department released proposed regulations (the “Proposed Regulations”) under Section 1061 of the Internal Revenue Code (the “Code”),[1] a section which extends the holding period required for long-term capital gain treatment for holders of certain partnership interests from one year to three years.[2] This rule is particularly important to the hedge fund and private equity industries.

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* Ronald E. Creamer, Jr., David Spitzer, Davis Wang, and Isaac Wheeler are partners at Sullivan & Cromwell LLP. Zachary Feldman and Andrew Motten are associates at the firm. They may be reached at creamerr@sullcrom.com, spitzerd@sullcrom.com, wangd@sullcrom.com, wheeleri@sullcrom.com, feldmanz@sullcrom.com, and mottena@sullcrom.com, respectively.

[1] References herein to a “Section” are to sections of the Code and the Treasury regulations (“Treasury Regulations” or “Treas. Reg.”) promulgated thereunder.

[2] See “Guidance Under Section 1061,” REG-107213-18, 85 Fed. Reg. 49754 (Aug. 14, 2020).

The Proposed Regulations are a mixed bag for taxpayers. Certain aspects of Section 1061 are interpreted narrowly, including the three-year holding period requirement, which is generally measured by reference to the partnership's holding period in its assets irrespective of a partner's holding period in its partnership interest. Similarly, the Proposed Regulations provide that amounts eligible for long-term capital gain rates under special rules (such as qualified dividend income, gains from the sale of assets used in a trade or business, and gains from so-called "Section 1256 contracts") are not subject to Section 1061. But the Proposed Regulations are broad in other respects, and would apply the extended holding period requirement to property distributed by the partnership to its partners, as well as to partnership interests held through S corporations and certain passive foreign investment companies (PFICs). Finally, the Proposed Regulations provide detailed—and in some cases very complex—rules on how taxpayers should calculate the amount of long-term capital gain recharacterized as short-term capital gain under Section 1061 and the application of certain exceptions.

The Proposed Regulations would generally apply to taxable years beginning on or after the date final regulations are published in the *Federal Register*, although taxpayers may currently rely on them. The rule treating certain PFICs as non-corporations for purposes of Section 1061 is proposed to apply for taxable years beginning after the date the Proposed Regulations are published in the *Federal Register*.[3]

Background

A taxpayer who is paid for services is generally taxed at ordinary income rates on the compensation received. In the case of a typical hedge fund or private equity fund structured as a partnership, the manager usually receives an interest in the profits of the fund (commonly referred to as "carried interest") in exchange for services. Under general principles of partnership taxation, the character of the fund's gains flow through to these partners. As a result, historically, when a fund recognized long-term capital gain, a portion of that gain was allocated to the manager and was subject to tax at preferential long-term capital gains rates. In response to criticism of the "carried interest" treatment common in these industries, in 2017 Congress enacted Section 1061 as part of the Tax Cuts and Jobs Act.[4]

Section 1061 extends the holding period requirement for long-term capital gain treatment on specified assets—generally securities, certain real estate, and cash—from one year to three years, and operates by recharacterizing net gains recognized with respect to capital assets held for more than

[3] See id. at 49769–49770.

[4] P.L. 115-97, tit. I, § 13309(a)(2), 131 Stat. 2053, 2130.

one year but not more than three years as short-term capital gains (the "Recharacterization Amount").[5] The rule applies to gain in respect of applicable partnership interests (APIs) received in connection with the performance of substantial services by the taxpayer (or a related person) in an applicable trade or business (ATB).[6] An ATB is any activity conducted on a regular, continuous, and substantial basis which consists of (1) raising or returning of capital, and (2) either (a) investing in (or disposing of) specified assets (or identifying specified assets for such investing or disposition) or (b) developing specified assets (collectively, "Specified Actions").[7]

Section 1061 applies both to APIs held directly by the taxpayer and to APIs held indirectly through one or more tiers of passthrough entities. The rule also applies to the transfer of an API, and, under the Proposed Regulations, generally requires recognition of gain regardless of whether the transfer is otherwise taxable (except in the case of a tax-free contribution to another partnership).

Before the Proposed Regulations were released, several aspects of the application of Section 1061 were unclear. For example, was the relevant holding period the partner's holding period in its API, the partnership's holding period in the underlying asset, or both? Other ambiguities included the types of long-term capital gains subject to potential recharacterization under Section 1061 and whether PFICs were subject to the rules.[8]

The Proposed Regulations

Key Takeaways. The Proposed Regulations would resolve many of the uncertainties under the statute. As discussed more fully below, key takeaways of the Proposed Regulations include:

- If a partnership disposes of an asset, the partnership's holding period controls. As a result, if a partnership sells an asset held for more than three years, a partner is generally permitted long-term capital gain treatment even when such partner has a short-term holding period in its partnership interest.

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[5] See IRC § 1061(a).

[6] IRC § 1061(c)(4) provides several statutory exclusions from these rules, including: (1) certain partnership interests held by employees of entities that are not engaged in an ATB; (2) any interest in a partnership held directly or indirectly by a corporation; (3) certain capital interests in a partnership; and (4) to the extent provided by regulations, income or gain attributable to an asset not held for portfolio investment on behalf of third-party investors.

[7] IRC § 1061(c)(2).

[8] In Notice 2018-18, 2018-12 IRB 443, the IRS indicated that S corporations would be subject to IRC § 1061.

- If a partner disposes of an API, the partner's holding period in its partnership interest generally controls. Under a lookthrough rule, however, gain from the sale of an API (or an interest in a lower-tier partnership) may be recharacterized as short-term gain to the extent attributable to assets of the partnership held for less than three years, even if the API is held for more than three years.

- Determination of the amount recharacterized as short-term capital gain is made at the taxpayer level. Capital gains and losses (both one-year and three-year) are netted across all APIs of the taxpayer, meaning that losses with respect to one API can offset gains with respect to another API.

- Once a partnership interest is treated as an API, it remains an API unless sold to a bona fide third-party purchaser.

- In determining whether a particular profits interest is an API, activities of the holder and related persons are aggregated across all entities.

- Amounts taxed at long-term capital gain rates without regard to the holding period rules of Section 1222 (such as qualified dividends, Section 1231 amounts, and Section 1256 amounts) are excluded from potential recharacterization under Section 1061.

- S corporations and PFICs with respect to which a taxpayer has a qualified electing fund election in effect (QEF-PFICs) are treated as "passthrough entities" for purposes of Section 1061.

- Regulated investment companies (RICs) and real estate investment trusts (REITs) may specify what portion of a capital gain dividend is attributable to three-year property. If the RIC or REIT does not provide this information, the entire amount of such dividend is treated as attributable to one-year property.

- Gain allocated to a capital interest in a partnership is exempt from recharacterization only if the partnership has certain non-service partners with a significant aggregate capital account balance. *Caution:* In a potential trap for the unwary, a capital contribution of appreciated property to a partnership that fails this requirement could result in the gain from disposition of such property being subject to recharacterization.

- The transfer of an API to a related party triggers gain for purposes of Section 1061, even if the transaction would otherwise qualify for nonrecognition. Section 721 contributions are exempt from this rule, but Section 731 distributions are not. As a result, most distributions of an API from a lower-tier partnership to an upper-tier partnership would require gain recognition under Section 1061.

- Partnerships will be required to provide additional information relating to Section 1061 on schedule K-1. Failure to provide this information could subject the partnership to penalties.

Applicable Partnership Interest. The definition of an API under the Proposed Regulations largely tracks the language of the statute, though the Proposed Regulations add that an interest in a partnership also includes any financial instrument or contract the value of which is determined in whole or in part by reference to the partnership.[9] Additionally, to the extent an interest would otherwise be an API, the Proposed Regulations treat such an interest as an API regardless of whether the holder has made an election under Section 83(b).[10]

However, while Section 1061 refers only to the "taxpayer," the Proposed Regulations use two different definitions depending on the context:

1. *For purposes of determining whether an interest is an API at all*, the Proposed Regulations look to the entity or person receiving the partnership interest (the "API Holder"), which may be a lower-tier partnership (a "Passthrough Taxpayer").

2. *For purposes of determining the Recharacterization Amount*, the Proposed Regulations look to the person ultimately subject to federal income tax on net gain with respect to the API (the "Owner Taxpayer").[11] Long-term capital gains and losses recognized with respect to an API ("API Gains and Losses") retain their character as they are allocated through tiers of passthrough entities up to the Owner Taxpayers.

Once an interest is determined to be an API, it remains an API unless and until an exception to API treatment applies.[12] For example, if a partner ceases to provide services but continues to hold its partnership interest, the

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[9] See Prop. Treas. Reg. § 1.1061-1(a).

[10] See Prop. Treas. Reg. § 1.1061-4(b)(10). The interest may be eligible for the capital interest exception (discussed below) to the extent the service provider recognizes compensation income on the transfer or vesting of the interest.

[11] See Prop. Treas. Reg. § 1.1061-1(a).

[12] See Prop. Treas. Reg. § 1.1061-2(a)(1)(i).

interest will remain an API subject to Section 1061.[13] Similarly, if the partner instead continues to provide services but later flunks the ATB Activity Test (as defined below), the interest also retains its API character.[14] However, if a partnership interest is transferred in connection with services to be provided in a future ATB that does not exist at the time of the transfer, the interest will be treated as an API only once services are provided in the ATB.[15]

Applicable Trade or Business. As described above, Section 1061 applies only to partnership interests received in respect of substantial services performed in an ATB.[16] The Proposed Regulations clarify that an ATB will only exist for these purposes if the total level of Specified Actions would be sufficient to establish a trade or business for purposes of Section 162 (the "ATB Activity Test").[17] A taxpayer must aggregate the Specified Actions of all "Related Persons" across multiple entities to determine whether the ATB Activity Test is satisfied. For these purposes, a Related Person is any person or entity treated as related under Section 707(b) or 267(b). If the aggregate Specified Actions satisfy the ATB Activity Test, then each Related Person is deemed to be engaged in the relevant ATB.[18]

The Proposed Regulations also create a presumption that services are substantial with respect to the partnership interest transferred in exchange for such services.[19]

Recharacterization Amount. As described above, while the existence of an API is determined at the entity level, the Recharacterization Amount is determined at the Owner Taxpayer level. The Recharacterization Amount—the amount the Owner Taxpayer must treat as short-term capital gain as a result of these rules—is equal to the excess of the Owner Taxpayer's "One Year Gain Amount" over the Owner Taxpayer's "Three Year Gain Amount."[20] If the One Year Gain Amount is zero or less than zero, Section 1061 does not apply, and no gain is recharacterized.

As described in greater detail below, the One Year Gain Amount and Three Year Gain Amount each consist of the sum of the net amounts taken into account as distributive shares of partnership income and amounts

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[13] See "Guidance Under Section 1061," supra note 2, at 49759.

[14] See id.

[15] See id. at 49760.

[16] See supra text accompanying note 6.

[17] See Prop. Treas. Reg. § 1.1061-2(b)(1).

[18] See id.

[19] See Prop. Treas. Reg. § 1.1061-2(a)(1)(iv).

[20] See Prop. Treas. Reg. § 1.1061-4(a)(1).

recognized on the disposition of an API. Because these amounts are determined on a net basis, losses in respect of property held for more than one year but not more than three years can offset gains on such property from other entities.

Distributive Share Amounts. Each passthrough entity must calculate an “API One Year Distributive Share Amount” for each API Holder that owns a direct interest in such entity. The API One Year Distributive Share Amount is generally equal to the API Holder’s distributive share of net long-term capital gain from the partnership, but excludes items of income taxed at long-term capital gains rates under special rules (rather than under the general holding period rule of Section 1222).[21] Accordingly, the API One Year Distributive Share Amount is calculated without regard to: (1) long-term capital gains and losses computed under Sections 1231 and 1256; (2) qualified dividends; (3) any other capital gain that is characterized as long-term or short-term without regard to the holding period rules of Section 1222; and (4) Capital Interest Gains and Losses (as discussed below).[22]

The “API Three Year Distributive Share Amount” is then calculated by subtracting from the API One Year Distributive Share Amount amounts that would not have been treated as long-term capital gains and losses if a three-year holding period had been required for long-term treatment.[23]

As discussed below, an Owner Taxpayer’s distributive share of gains from S corporations and QEF-PFICs is not excluded from application of Section 1061 under the Proposed Regulations.[24]

Disposition Amounts. Calculation of the “API One Year Disposition Amount” and the “API Three Year Disposition Amount” takes into account not only gains and losses from the disposition of an API, but also gains and losses from the disposition of certain property distributed with respect to an API. The API One Year Disposition Amount is generally the combined net amount of long-term capital gains and losses recognized by the Owner Taxpayer upon the disposition of (1) all or part of an API (including gain or loss recognized in respect of distributions in excess of basis[25] or a reduction in the partner’s liabilities)[26] held for more than one year, and (2) “Distributed API Property” that has a holding period of more than one year but not more

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[21] See Prop. Treas. Reg. § 1.1061-4(a)(3)(i).

[22] See infra notes 34–41 and accompanying text.

[23] See Prop. Treas. Reg. § 1.1061-4(a)(3)(ii).

[24] See infra note 45 and accompanying text.

[25] See IRC § 731(a).

[26] See IRC § 752(b).

than three years.[27] Distributed API Property is any property distributed by a passthrough entity to an API Holder with respect to an API if the holding period of the asset in the API Holder's hands is three years or less at the time the API Holder disposes of the asset.[28] The preamble to the Proposed Regulations makes clear that Distributed API Property is included in the API One Year Disposition Amount specifically to prevent circumvention of Section 1061 through a distribution to an API Holder of appreciated property held for less than three years.[29] However, Distributed API Property loses its character as such and is no longer subject to Section 1061 once the aggregate holding period of the asset exceeds three years.

The API Three Year Disposition Amount generally includes the long-term capital gain or loss from an Owner Taxpayer's disposition of an API (including gain or loss recognized in respect of distributions in excess of basis or a reduction in the partner's liabilities) held for more than three years.[30]

Additionally, Section 1061 requires recognition of gain upon the transfer of an API to a related person, even if the transfer would not otherwise be a taxable event. The Proposed Regulations provide that a "transfer" to a related person includes contributions, distributions, sales, exchanges, and gifts.[31] The definition of a related person for these purposes is also expanded to include any passthrough entity to the extent that (1) a member of the taxpayer's family (as defined in Section 318(a)), or (2) a person that performs services in the current calendar year or the preceding three calendar years in the ATB owns, directly or indirectly, an interest in the passthrough entity.[32] The Proposed Regulations provide that a contribution to a partnership under Section 721(a) is not treated as a transfer to a related person for these purposes.[33] *Caution:* Since this exception does extend to distributions under Section 731, it appears that under the Proposed Regulations an Owner Taxpayer immediately recognizes gain on most distributions of an API from a lower-tier partnership to a related upper-tier partnership, notwithstanding that Section 731 generally does not require gain recognition when a partner receives a distribution of non-cash property.

Holding Period. Prior to the guidance provided by the Proposed Regulations, the application of the holding period rules under Section 1061 was unclear. Under the Proposed Regulations, the relevant holding period is the owner's

[27] See Prop. Treas. Reg. § 1.1061-4(a)(4)(i).

[28] See Prop. Treas. Reg. § 1.1061-1(a).

[29] See "Guidance Under Section 1061," supra note 2, at 49764.

[30] See Prop. Treas. Reg. § 1.1061-4(a)(4)(ii).

[31] See Prop. Treas. Reg. § 1.1061-5(b).

[32] See Prop. Treas. Reg. § 1.1061-5(e)(1).

[33] See Prop. Treas. Reg. § 1.1061-5(e)(2).

holding period in the asset disposed of.[34] Therefore, where a partnership disposes of an asset (including an API), the relevant holding period is the partnership's. Thus, where a partnership has held relevant property for more than three years, gain on the disposition of that property allocated to an Owner Taxpayer can be long-term capital gain, even if the Owner Taxpayer held its partnership interest for less than one year. This result also applies to distributions of capital gain property because the holding period of an Owner Taxpayer in Distributed API Property includes the holding period of the distributing partnership.[35]

In contrast, where a partner disposes of an API, the relevant holding period is the partner's. Therefore, the entire gain on a partner's sale of an API is generally subject to recharacterization as short-term capital gain if the partner has held the API for three years or less. Additionally, under a special "Lookthrough Rule," a portion of the gain recognized on the disposition of an API may be subject to recharacterization, even though the Partner has held the API for more than three years.[36]

The Lookthrough Rule applies in two situations. First, in the case of an Owner Taxpayer that directly disposes of an API held for more than three years, the Lookthrough Rule applies if at least 80 percent of the assets (by value) of the partnership have a holding period of three years or less (the "Substantially All Test").[37] Second, the Lookthrough Rule applies to the disposition of an interest in a lower-tier passthrough entity if that entity was held for more than three years, and either (1) the passthrough entity has a holding period in an API of three years or less, or (2) the passthrough entity has a holding period in the API of more than three years but the assets of the entity in which the API is held meet the Substantially All Test.[38] As with a direct API disposition, if the Lookthrough Rule applies to a tiered structure, a portion of the gain on such a disposition may be subject to recharacterization.[39]

In situations where a taxpayer owns both a profits interest and a capital interest, the Proposed Regulations provide for a divided holding period between such interests based on the relative fair market value of each interest.[40] A similar rule applies with respect to a partnership interest comprised of more than one profits interest.[41]

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[34] See Prop. Treas. Reg. § 1.1061-4(b)(8).

[35] See IRC § 1223(2).

[36] See Prop. Treas. Reg. § 1.1061-4(b)(9).

[37] See Prop. Treas. Reg. § 1.1061-4(b)(9)(i)(B)(2), (i)(C).

[38] See Prop. Treas. Reg. § 1.1061-4(b)(9)(i)(B)(1).

[39] See Prop. Treas. Reg. § 1.1061-4(b)(9)(i)(C)(2).

[40] Prop. Treas. Reg. § 1.1223-3(b)(5)(i). The fair market value of a profits interest is measured at the time of its disposition, rather than its acquisition.

[41] Id.

Exceptions. Section 1061 itself provides for four exceptions from the application of these rules, and the Proposed Regulations added one additional exception.

Non-ATB Employee. An API does not include a partnership interest held by a person who is employed by another entity that is not conducting an ATB and who provides services only to such other entity.[42] This exception would presumably capture a situation where a private equity fund issues a profits interest to an employee of one of its portfolio companies in connection with the employee's services to such company, perhaps based on the rationale that the services are provided to a trade or business that is not an ATB.

Corporations. Under the statute, a corporation cannot be an API Holder.[43] Although the IRS had stated prior to the release of the Proposed Regulations that S corporations would not be excepted under this rule,[44] it remained unclear whether QEF-PFICs would be treated as passthrough entities. The Proposed Regulations clarify that both S corporations and QEF-PFICs are not treated as corporations for this purpose and thus can hold APIs subject to Section 1061.[45] Therefore, the distributive share amounts allocated to owners of an S corporation or QEF-PFIC with respect to an API are subject to potential recharacterization.

Capital Interests. The statute provides that Section 1061 does not apply to certain capital interests.[46] While the statute simply provides that capital interests are not APIs, the Proposed Regulations apply this exception by identifying gains and losses in respect of capital interests that are excluded from the Recharacterization Amount calculations. In general, if an allocation is made to a partner in proportion to the relative value of the API Holder's capital account, then such gain or loss is excluded from the application of Section 1061.[47]

Capital interest allocations can be made only by a partnership that has both API Holders and "Unrelated Non-Service Partners" (defined as partners who have never (1) provided services in the relevant ATB, or (2) been related to any API Holder in the partnership or any person who has ever provided services in the relevant ATB). Generally, capital interest allocations to the API

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[42] See IRC § 1061(c)(5).

[43] See IRC § 1061(c)(4)(A).

[44] See Notice 2018-18, supra note 8.

[45] See Prop. Treas. Reg. § 1.1061-3(b)(2).

[46] See IRC § 1061(c)(4)(B).

[47] See Prop. Treas. Reg. § 1.1061-3(c)(1); Prop. Treas. Reg. § 1.1061-3(c)(4).

Holder and Unrelated Non-Service Partners based on their respective capital account balances will not be subject to recharacterization if: (1) allocations are made in the same manner to API Holders and Unrelated Non-Service Partners; (2) the allocations are made to Unrelated Non-Service Partners with a "significant" combined capital account balance; (3) the terms of the allocations are identified both in the partnership agreement and on the partnership's books and records; and (4) the allocations are clearly separate and apart from allocations made with respect to the API. For these purposes, an aggregate capital account balance of 5 percent or more of the aggregate capital account balance of the partnership is deemed to be "significant."[48]

Gains allocated from a lower-tier partnership will be treated as gains with respect to a capital interest only if such amounts are allocated to each of the partnership's owners in the same manner based on each owner's share of the capital account in such lower-tier entity.[49]

Similarly, in the case of allocations consisting solely of long-term capital gains and losses derived from assets (other than an API) directly held by the partnership, such allocations must be made in the same manner to each of the owners of the passthrough entity based on each owner's relative investment in the assets held by the passthrough entity. The preamble to the Proposed Regulations states that this rule is meant to include the third-party investor exception described below, which commenters suggested was meant to apply to family offices.[50]

While not entirely clear, it appears that a capital contribution of appreciated property by an API Holder would not cause the built-in gain on such property to become subject to recharacterization, assuming the requirements described above are satisfied. However, the rule requiring significant Unrelated Non-Service Partners creates a trap for the unwary in this context: A capital contribution to a partnership without such partners would evidently make gain on the property subject to recharacterization. For example, suppose an individual creates a fund structure and intends to seed the fund with appreciated securities. If the individual contributes the property directly to the fund and the fund has third-party investors, the interest received for the appreciated securities will be eligible for the capital interest exception. On the other hand, if the individual contributes the appreciated securities first to an upper-tier entity all the partners of which provide services (for example, the general partner of the fund, owned by the individual and other service providers), and then the appreciated securities are contributed to the fund, the individual's interest in the upper-tier entity would not be eligible for the

[48] See Prop. Treas. Reg. § 1.1061-3(c)(4).

[49] See Prop. Treas. Reg. § 1.1061-3(c)(5)(ii).

[50] See "Guidance Under Section 1061," supra note 2, at 49763.

capital interest exception. However, allocations of gain from the lower-tier may be eligible for the exception.

Additionally, the preamble to the Proposed Regulations makes clear that a contribution of an API to a partnership's capital should not convert gains on such interest into capital interest gains that are exempt from Section 1061.[51] Moreover, a capital contribution funded by a loan made or guaranteed by any other partner or the partnership will not increase a partner's capital account for purposes of determining whether an interest satisfies the capital interest exception.[52] Furthermore, because a capital interest allocation must be based on the API Holder's capital account, an interest may fail to qualify for the capital interest exception even if such interest is not necessarily a "carried interest." For example, if the partnership uses special allocations with respect to certain assets, allocations of gain to an API Holder with respect to such assets would not be pro rata based on the API Holder's capital account and could be subject to potential recharacterization. The preamble to the Proposed Regulations notes that the IRS is continuing to study allocation arrangements not covered by the Proposed Regulations that could appropriately be treated as capital interest gains and losses.[53] While the Proposed Regulations do not address so-called "carry waivers" under which an API Holder is allocated capital gains only from property held for more than three years, the preamble indicates that these and similar arrangements may be challenged under current law.[54]

Importantly, the Proposed Regulations preserve the character of any unrealized gains allocated to an API Holder and thereby prevent taxpayers from avoiding Section 1061 by converting an API to a capital interest. Any unrealized capital gains and losses that would be allocated to an API Holder with respect to its API if all relevant assets of the partnership were disposed of for fair market value in a taxable transaction ("Unrealized API Gains and Losses") are treated as API Gains and Losses subject to Section 1061 when recognized.[55]

Assets Not Held for Portfolio Investment. Section 1061 does not apply to any income or gain attributable to an asset not held for portfolio investment on behalf of third-party investors, but only to the extent provided by regulations. The Proposed Regulations reserve guidance with respect to this exception.

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[51] See "Guidance Under Section 1061," supra note 2, at 49758.

[52] See Prop. Treas. Reg. § 1.1061-3(c)(3)(ii)(C).

[53] See "Guidance Under Section 1061," supra note 2, at 49762–49763.

[54] Id. at 49758. See, e.g., IRC § 707(a)(2)(A); Treas. Reg. § 1.701-2; Treas. Reg. § 1.704-1(b)(2)(iii).

[55] See Prop. Treas. Reg. § 1.1061-2(a)(1)(ii)(A).

Bona Fide Purchaser. The Proposed Regulations add one new exclusion to the definition of an API to cover third-party purchasers of an API. While the general rule is that once a partnership interest is treated as an API it retains that character, an interest will not be treated as an API with respect to a buyer if it is purchased by an unrelated buyer for fair market value and such buyer (1) has never provided services in the relevant ATB, (2) does not expect to provide services in the future, and (3) is not related to a person who has ever provided services.[56] For purposes of this exception, a related person is any person or entity who is treated as related under Section 707(b) or 267(b).

Capital Gain Inclusions From PFICs, RICS, and REITS. Any QEF-PFIC, and any RIC or REIT that designates all or part of a dividend as a capital gain dividend, is permitted but not required to furnish additional information to its shareholders to allow API Holders to determine their distributive share amounts that would be included in the API One Year Distributive Share Amount and API Three Year Distributive Share Amount.[57] Without such information, an Owner Taxpayer may not include in its API Three Year Distributive Share Amount any long-term capital gains with respect to the QEF-PFIC or capital gain dividends with respect to the RIC or REIT. Thus, if this information is not provided, the entire amount of such dividends would be subject to recharacterization.

Reporting and Bookkeeping Requirements. Owner Taxpayers must report any information the IRS may require to evidence compliance with Section 1061.[58] To that end, passthrough entities through which an Owner Taxpayer holds an API must furnish information necessary for the Owner Taxpayer to comply with Section 1061 and compute the Recharacterization Amount on schedule K-1.[59] Failure to provide this information is subject to penalties.

The Proposed Regulations also require revaluations of partnership property—solely for purposes of Section 1061—at each relevant passthrough entity upon the occurrence of a revaluation or contribution in order to determine Unrealized API Gains and Losses.[60] While Unrealized API Gains and Losses are included in an API Holder’s capital account, as noted above they are treated as API Gains and Losses subject to Section 1061 when recognized.

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[56] See Prop. Treas. Reg. § 1.1061-3(d).

[57] See Prop. Treas. Reg. § 1.1061-6(c); Prop. Treas. Reg. § 1.1061-6(d).

[58] See Prop. Treas. Reg. § 1.1061-6(a)(1).

[59] See Prop. Treas. Reg. § 1.1061-6(b)(1).

[60] See Prop. Treas. Reg. § 1.1061-2(a)(1)(ii)(B).

If a partnership is required to revalue its assets for purposes of Section 1061, then the partnership is also permitted to revalue its assets for general capital account purposes under Section 704.[61]

Applicability Date and Request for Comments. The Proposed Regulations generally provide that the final regulations apply to taxable years of Owner Taxpayers and passthrough entities beginning on or after the date final regulations are published in the *Federal Register*.[62] With the exception of certain transition rules (which may be separately relied upon), Owner Taxpayers and passthrough entities may generally rely on the Proposed Regulations for taxable years beginning before the publication of final regulations, provided they follow the Proposed Regulations in their entirety and in a consistent manner.[63]

The IRS and Treasury specifically invited comments on several aspects of the Proposed Regulations, including (1) whether Section 1061 revaluations are necessary to ensure that API Gains and Losses are allocated to API Holders when there is a revaluation event in one or more tiers of entities; (2) the substantial services presumption and the types of arrangements in which insubstantial services might be performed in connection with the receipt of a profits interest; (3) application of the ATB Activity Test with respect to Specified Assets held by the partnership; and (4) how to calculate gain under Section 1061(d) when a passthrough entity is only partially a Related Person.

Conclusion

The new proposed regulations under Code Section 1061 would resolve a range of uncertainties that have existed up to now, but they are also detailed and often extremely complex. Affected taxpayers and their advisors should closely review these proposed regulations to ensure that they understand how they may be affected by these changes.

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[61] Id.

[62] See Prop. Treas. Reg. § 1.1061-5(e).

[63] See "Guidance Under Section 1061," supra note 2, at 49769.