What's News in Tax

Analysis that matters from Washington National Tax

Proposed Regulations on Carried Interest

August 12, 2020

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, Matt Busta, and Rob Keller are managing directors; and Sarah Staudenraus is a partner 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://home.kpmg/us/en/home/insights/2019/08/tnf-kpmg-report-wyden-bill-new-approach-taxing-carried-interest.html.

[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").

© 2020 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved.

The KPMG name and logo are registered trademarks or trademarks of KPMG International.

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 July 31, 2020, the Treasury Department ("Treasury") and the Internal Revenue Service ("IRS") issued proposed regulations under section 1061 (the "Proposed Regulations"). The Proposed Regulations significantly expand on the statutory language and incorporate concepts reflected in earlier legislative proposals, in particular with respect to the exception for contributed capital.

II. The Proposed Regulations Generally

The Proposed Regulations are organized into six sections. The first section contains defined terms—37 defined terms, to be exact. The second section contains rules 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, and a large part of this section is spent on complicated rules 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 and provides for some very surprising results, including the override of nonrecognition provisions for certain gain in such transfers. Finally, the sixth section describes reporting rules applicable to section 1061.

III. Detailed Summary of Proposed Regulations

A. 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. Prior to issuance of the Proposed Regulations, there was some question regarding whether section 1061 would apply only at the level of the persons who would pay tax on the allocated capital gain or instead whether the rule might also apply to require a passthrough entity at a lower level in a structure (such as the general partner) to recharacterize capital gain as short-term prior to allocating that capital gain to its owners.

According to the Proposed Regulations preamble (the "Preamble"), the Proposed 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."[4] More specifically, under the Proposed 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"[5] that is treated as a taxpayer for purposes of determining the existence of an API. Each

---

[4] 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). Prop. Reg. §1.1061-4(a)(1).

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

© 2020 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved.

The KPMG name and logo are registered trademarks or trademarks of KPMG International.

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.[6] 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 and ultimately to any Owner Taxpayer.[7] 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.[8]

B. 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 Proposed 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.[9] Significantly, the Proposed 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.[10] The Proposed 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).[11]

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 Proposed Regulations, an ATB is any activity for which the "ATB Activity Test" with respect to "Specified Actions" is met.[12]

---

[6] Prop. Reg. §1.1061-1(a) (definitions).

[7] Prop. Reg. §1.1061-2(a)(1)(iii).

[8] If applicable, a passive partner may be excepted under the corporation exception or the unrelated purchaser exception, discussed *infra* at III.C.

[9] Prop. Reg. §1.1061-1(a) (definitions). Note, services performed as an employee are considered for these purposes.

[10] Prop. Reg. §1.1061-2(a)(1)(iv).

[11] Prop. Reg. §1.1061-2(a)(1)(i).

[12] Prop. Reg. §1.1061-1(a) (definitions).

© 2020 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved.

The KPMG name and logo are registered trademarks or trademarks of KPMG International.

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").[13]

Under the Proposed 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.[14] 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))[15] *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.[16] Actions of agents or delegates are included for this purpose.[17]

The Proposed 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.[18] 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.[19] The Proposed 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.[20] According to the Preamble, if the partnership interest is transferred before the ATB Activity arises, the partnership interest will become an API at the time when the ATB Activity test is satisfied.[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

---

[13] *Id.*

[14] 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.

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

[16] Prop. Reg. §1.1061-2(b)(1).

[17] Prop. Reg. §1.1061-2(b)(2).

[18] Prop. Reg. §1.1061-2(b)(1)(i)(A).

[19] Prop. Reg. §1.1061-2(b)(1)(i)(B).

[20] Prop. Reg. §1.1061-2(b)(1)(i)(A).

[21] Preamble, Part I, Section B.2.b.iv.

© 2020 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved.

The KPMG name and logo are registered trademarks or trademarks of KPMG International.

investment, cash or cash equivalents, and an interest in a partnership to the extent that the partnership holds other Specified Assets.[22]

Under the Proposed 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 Proposed 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 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]

C. 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 Proposed 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 Proposed Regulations but for convenience we will refer to them as the "one employer exception", the "corporation exception", the "capital interest exception", and "unrelated purchaser exception".

1. One Employer Exception

An API does not include any interest transferred to a person in connection with the 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]

---

[22] Prop. Reg. §1.1061-1(a) (definitions).

[23] Prop. Reg. §1.1061-2(b)(1)(ii).

[24] Prop. Reg. §1.1061-2(b)(1)(iii).

[25] Prop. Reg. §1.1061-1(a) (definitions).

[26] Levin Bill, §710(e).

[27] Prop. 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 provides no explicit guidance as to whether such a person can receive such interests in a manner that qualifies under the revenue procedures. The Preamble does, however, state in a different section addressing the interaction of the revenue procedures and section 1061: "[T]hese

© 2020 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved.

The KPMG name and logo are registered trademarks or trademarks of KPMG International.

2. Corporation Exception

Under the statute, an API does not include any interest held directly or indirectly by a corporation.[29] The Proposed 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 recharacterization under section 1061.[30] Consistent with Notice 2018-18[31], for these purposes the term "corporation" does not include an S Corporation, effective for taxable years beginning after December 31, 2017. The Proposed Regulations also provide that the term "corporation" does not include a PFIC for which the shareholder has made a QEF election.[32] This rule is effective for taxable years of an Owner Taxpayer or Passthrough Entity beginning after the date the Proposed Regulations are published in the Federal Register (anticipated to be on or around August 14, 2020).[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]

Rather than clarify or define what a "capital interest" means under the statute, the Proposed Regulations 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 satisfy certain requirements as well as certain gains and losses from the sale of a Passthrough Interest (i.e. an interest in a Passthrough Entity that represents in whole

---

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, *see* C. Kulish, J. Sowell & D. Fields, *I Spy an ISPI: Expansive Breadth of Carried Interest Proposals*, 2010 TNT 147-9 (Aug. 2, 2010).

[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 Proposed 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] Prop. Reg. §1.1061-3(b)(2)(ii). Note that the Preamble indicates 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, 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].

[35] Prop. Reg. §1.1061-3(c)(2).

[36] Prop. Reg. §1.1061-3(c)(1).

© 2020 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved.

The KPMG name and logo are registered trademarks or trademarks of KPMG International.

or in part an interest in an API).[37] 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.[38]

a) The Importance of Capital Accounts

Section 1061(d)(4)(B) describes the capital interest exception by reference to "contributed capital" 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 appear to be subject to recharacterization under section 1061(a), absent additional planning.

In contrast to the statutory language, the Proposed Regulations appear to exclude earnings on allocated but undistributed carry from recharacterization under section 1061 by applying the exception in reference to the partners' capital accounts rather than their capital contributions.[39]

For a partnership, the exception provided for in the Proposed Regulations generally requires that the partnership maintain capital accounts under Treas. Reg. 1.704-1(b)(2)(iv) or under similar principles. For a non-partnership Passthrough Entity, including S corporations and PFICs that are QEFs, or a partnership that does not maintain section 704(b) capital accounts, the entity must maintain and determine accounts for its owners using principles similar to those set forth in the section 704(b) regulations.[40]

The use of capital accounts as the starting point for determining whether allocations constitute Capital Interest Gains and Losses necessarily introduces complexity in accounting for gains and losses that are attributable to carry that has not yet been realized but has been reflected in a partner's capital account. In this regard, the Proposed Regulations introduce the term "Unrealized API Gains and Losses". This term is generally used to coordinate the application of section 1061 and the exception for Capital Interest Gains and Losses. Unrealized API Gains and Losses arise in connection with certain events, do not lose their character as such until they are recognized, and are required to be treated as API Gains and Losses when recognized.[41] As defined in the Proposed Regulations, Unrealized API Gains

---

37 Prop. Reg. §1.1061-1(a) (definitions).

38 Levin Bill, §710(d).

39 *But see* E. Yauch, *Legislative Past Could Be Carried Interest's Regulatory Prologue*, 2020 TNTF 152-1 (Aug. 7, 2020) [hereinafter *Legislative Past*] (quoting one of the IRS drafters of the regulation as stating that it was not intended that the holder of an API could receive exempt allocations on a capital account balance that is the result of revalued carry).

40 Prop. Reg. §1.1061-3(c)(3)(ii).

41 Prop. Reg. §1.1061-2(a)(1)(ii)(A).

© 2020 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved.

The KPMG name and logo are registered trademarks or trademarks of KPMG International.

and Losses in connection with a given event means all unrealized capital gains and losses (including both short-term and long-term) that would be allocated to the holder of an API with respect to its API if all relevant assets were sold for fair market value on the date of the event.[42] These include:

— Unrealized capital gains and losses that are allocated to an API holder with respect to an API pursuant to a capital account revaluation,

— In the case of a Passthrough Entity that contributes property to another Passthrough Entity, any unrealized capital gain or loss in the contributed property (i.e., any "forward" section 704(c) layer), and

— In the case of a tiered passthrough structure in which there is a revaluation of an upper-tier Passthrough Entity or in the case of a contribution of an API to a Passthrough Entity, the capital gains or losses that would be allocated directly or indirectly to the API Holder by the lower-tier Passthrough Entity if each lower-tier Passthrough Entity had sold its property for fair market value on the date of revaluation or contribution.[43]

The Proposed Regulations provide that, for purposes of section 1061, revaluations are mandatory (including for all property held by relevant partnerships through tiers) for purposes of determining and tracking an API holder's Unrealized Gains and Losses.[44] In addition, the Proposed Regulations are explicit that once Unrealized API Gains and Losses are recognized as API Gains and Losses, the API Gain or Loss must be allocated to the API Holder to whom the Unrealized API Gain or Loss had been allocated under principles similar to the "tiered partnership provisions" in section 1.704-3(a)(9).[45]

This requirement to revalue for purposes of section 1061 differs from the general revaluation rule in the section 704(b) capital account maintenance regulations which permit, but do not mandate, revaluations and which do not provide for revaluation through tiers of partnerships. This difference can potentially cause a conflict between the requirement in the Proposed Regulations to allocate API Gains and Losses to match the prior allocation of corresponding Unrealized API Gains and Losses and the allocation provisions under section 704(c) because section 704(c) allocations generally apply by reference to section 704(b) allocations. The Proposed Regulations seem to acknowledge this potential conflict and provide that if a partnership is required to revalue assets for purposes of section 1061, then it will be permitted to revalue its assets for purposes of section 704(b) as if an event under Reg. §1.704-1(b)(2)(iv)(f)(5) had occurred. [46] Unfortunately, it is not clear that a section 704(b) revaluation would eliminate all potential conflicts and uncertainties between allocations under section 704(c) and the rules relating to Unrealized API Gains and Losses and additional guidance is likely necessary in this area. Nevertheless, in practice, if a partnership is required to revalue for purposes of section 1061, it likely will also revalue for section 704(b) purposes as well. Otherwise, specifically in situations where there is a revaluation of an upper-tier Passthrough Entity or in the case of a contribution of an API to a

---

[42] Prop. Reg. §1.1061-1 (a) (definitions).

[43] *Id.*

[44] Prop. Reg. §1.1061-2(a)(1)(ii)(B).

[45] Prop. Reg. §1.1061-2(a)(1)(ii)(B).

[46] *Id.*

© 2020 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved.

The KPMG name and logo are registered trademarks or trademarks of KPMG International.

Passthrough Entity, it will be difficult to ensure that all recognized API Gains and Losses are allocated back to the API Holder under the provisions of section 704(c) as is required by the Proposed Regulations.[47]

b) Capital Interest Allocations and Passthrough Interest Capital Allocations

Under the Proposed Regulations, Capital Interest Gains and Losses include three types of qualifying allocations with respect to capital interests – Capital Interest Allocations, Passthrough Capital Allocations, and Passthrough Interest Direct Investment Allocations. (The latter two are collectively referred to as Passthrough Interest Capital Allocations.[48]) The rules relating to such allocations are complicated, and it is helpful to understand the purpose of the different allocation types before digging into the applicable rules.

"Capital Interest Allocations" are typically made at the fund or joint venture level to the general partner. That is because in order for allocations to qualify as Capital Interest Allocations, the allocations must correspond to allocations made to "Unrelated Non-Service Partners"[49] who serve as a benchmark. In this context, the allocations to the service partners must conform to the allocations made to the Unrelated Non-Service Partners.

"Passthrough Capital Allocations" are typically made at the general partner entity level (or by a Passthrough Entity further up the chain in a structure with multiple tiers). For an allocation by a Passthrough Entity to qualify as a Passthrough Capital Allocation, the allocation generally must be in proportion to its partners' capital accounts and must correspond to a Capital Interest Allocation received by the Passthrough Entity (or, in the case of a structure with multiple tiers, to a Passthrough Capital Allocation received from a lower-tier Passthrough Entity). The allocation rule here is different because Allocations at the general partner entity level, or through upper-tier partnerships, may not have Unrelated Non-Service Partners to provide a benchmark, but if the allocations at the lowest API level are confirmed as Capital Interest Allocations, a different approach for confirming upper-tier allocations can be used. That is, if an allocation has been confirmed at the lower level based on benchmarking to Unrelated Non-Service Partner allocations, allocations of those amounts through a chain of

---

[47] For example, under the Proposed Regulations, Unrealized API Gains or Losses seems to be contemplated as a static number – that is, Unrealized API Gains and Losses do not appear to be adjusted to reflect adjustments to the corresponding section 704(b) value of revalued property to reflect depreciation, amortization, etc. While the exclusion for section 1231 gain and loss from the definition of API Gains and Losses (discussed below) may mitigate some of this uncertainty, it is not clear that it eliminates all potential mismatches, including, e.g., mismatches that may arise with respect to Unrealized API Gains and Losses attributable to an investment in an operating partnership. In general, we believe that allocations made for purposes of section 1061 should be conformed to allocations made for purposes of section 704(b), so that any allocation of Unrealized API Gains and Losses should mirror the allocation of the corresponding items under section 704(b) and section 704(c).

[48] Prop. Reg. §1.1061-3(c)(5).

[49] "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." Prop. Reg. §1.1061-1(a) (definitions).

© 2020 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved.

The KPMG name and logo are registered trademarks or trademarks of KPMG International.

partnerships in proportion to capital accounts can be supported as proper without further benchmarking (i.e., Passthrough Capital Allocations).[50]

"Passthrough Interest Direct Investment Allocations" are conceptually distinct from Capital Interest Allocations and Passthrough Capital Allocations. Passthrough Interest Direct Investment Allocations generally relate to investments made by a Passthrough Entity on its own behalf separate and apart from any API it otherwise holds in a lower-tier entity and are subject to specific rules under the Proposed Regulations. As such, special rules are provided for permissible allocations related to those investments.[51]

Now for more detail. Subject to the allocation requirement and loan exclusion described below, Capital Interest Allocations are allocations of long-term capital gain or loss made under the partnership agreement to an API holder and to Unrelated Non-Service Partners based on their respective capital account balances, provided that:

- Allocations are made in the same manner to API holders and Unrelated Non-Service Partners,
- The allocations are made to Unrelated Non-Service Partners with a significant aggregate capital account balance (generally, 5% or more of the aggregate capital account balance of the partnership at the time the allocations are made), and
- The allocations to the API holders and Unrelated Non-Service Partners are clearly identified both under the partnership agreement and on the partnership's books and records as 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 clearly demonstrate that the additional allocation requirements described below have been met.[52]

Subject to the allocation requirements and the loan exclusion described below, Passthrough Interest Capital Allocations are generally allocations made by a Passthrough Entity that holds an API in a lower-tier Passthrough Entity. Passthrough Interest Capital Allocations can either be "Passthrough Capital Allocations", which are generally Capital Interest Allocations made by the lower-tier Passthrough Entity to the upper-tier Passthrough Entity, or "Passthrough Interest Direct Investment Allocations", which are generally allocations comprised of long-term capital gain or loss derived from assets (other than an API) directly held by the Passthrough Entity.[53]

---

[50] Prop. Reg. §1.1061-3(c)(5)(i).

[51] Prop. Reg. §1.1061-3(c)(5)(ii).

[52] Prop. Reg. §1.1061-3(c)(4).

[53] Note that Passthrough Interest Direct Investment Allocations must relate to assets that are directly held by the partnership. Thus, these allocations presumably must satisfy the requirements of a different rule in order to qualify for allocation through an upper-tier partnership. Prop. Reg. §1.1061-3(c)(5)(iii)(A). If there are no Unrelated Non-Service Partners in the upper-tier partnership, the further allocation cannot qualify as a Capital Interest Allocation. Prop. Reg. §1.1061-3(c)(4). A Passthrough Capital Allocation makes reference only to further allocations of Capital Interest Allocations, so it does not appear that this rule will permit further allocation of a Passthrough Interest Direct Investment Allocation. Prop. Reg. §1.1061-3(c)(5)(ii). This

© 2020 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved.

The KPMG name and logo are registered trademarks or trademarks of KPMG International.

In addition to the above requirements, Capital Interest Allocations and Passthrough Interest Capital Allocations must be made in the same manner to all partners in the partnership. In general, allocations are considered to be made in the same manner if, under the partnership agreement, the allocations are based on the relative capital accounts of the partners receiving the allocation and the terms, priority, type and level of risk, rate of return, and rights to cash or property distributions during the partnership's operations and on liquidation are the same.[54] An allocation will not fail to qualify solely because the allocation is subordinated to allocations made to Unrelated Non-Service Partners.[55] Further, an allocation will not fail to qualify because it is not reduced by the cost of services provided to the partnership.[56] This provision clearly provides that an allocation will not fail because the partner bears reduced or no management fees. It is not entirely clear that the carried interest represents a cost of services for these purposes, given that carried interest embodies allocations and not a cost or expense,[57] but it seems that the provision must be intended to include carried interests, since otherwise this relaxation of the allocation rule would be largely useless.[58]

In a tiered structure, Passthrough Capital Allocations (i.e., allocations by an upper-tier Passthrough Entity that is attributable to a Capital Interest Allocation or Passthrough Capital Allocation from a lower-tier Passthrough Entity) generally must be allocated among the upper-tier Passthrough Entity's owners based on each owner's share of the upper-tier Passthrough Entity's capital account in the lower-tier Passthrough Entity.[59] Passthrough Interest Direct Investment Allocations by a Passthrough Entity generally must be based on each owner's relative capital account balance in the Passthrough Entity, *excluding* any portion of the owner's capital account balance that is attributable to the Passthrough Entity's capital account in a lower-tier Passthrough Entity.[60] Alternatively, a Passthrough Entity can make all Passthrough Interest Capital Allocations (i.e., both Passthrough Capital Allocations and

---

result is strange, given that a separate rule in the Proposed Regulations makes reference to a Passthrough Interest Direct Investment Allocation being made to a Passthrough Taxpayer. Prop. Reg. §1.1061-3(c)(3)(ii)(B)(2).

[54] Prop. Reg. §1.1061-3(c)(3)(i).

[55] *Id.*

[56] *Id.*

[57] *See* E. Yauch, *'Carry-Free' Treatment Remains Unclear in Carried Interest Rules*, 2020 TNTF 150-3 (Aug. 5, 2020).

[58] Note that the Levin Bill had a statutory provision that provided similar relief. Levin Bill, §710(d)(5). That provision also used the phrase "cost of services", and the heading for the provision is "exception for no self-charged carry and management fee provisions".

[59] Prop. Reg. §1.1061-3(c)(3)(ii)(B). A partner may have a different indirect share of capital account in different lower-tier entities making Capital Interest Allocations. Prop. Reg. §1.1061-3(c)(3)(ii)(B)(1) (references "each owner's share of the Passthrough Entity's capital account *in the entity making the Capital Interest Allocations*"). Note that this rule is similar to the tiered partnership for qualified capital interest allocations in the Levin Bill. Levin Bill, §710(d)(4).

[60] The Preamble indicates that Passthrough Entity Direct Investment Allocations may still qualify even if more beneficial allocations are made to Unrelated Non-Service Partners with respect to such investments if allocations to the API Holders are all the same. The Preamble also provides that allocations will not fail to qualify if made in the same manner to some API Holders if a service provider/API Holder with respect to that partnership receives a different allocation (e.g., the service partner receives a carry with respect to the directly held investment). Preamble, Part II, Section C.3.b.

© 2020 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved.

The KPMG name and logo are registered trademarks or trademarks of KPMG International.

Passthrough Interest Direct Investment Allocations) based on each owner's relative capital account balance in the Passthrough Entity.[61]

For purposes of the section 1061 regulations, "a capital account does not include the contribution of amounts directly or indirectly attributable to any loan or other advance made or guaranteed, directly or indirectly, by any other partner or the partnership (or any related person with respect to any such other partner or the partnership)." Repayments will be included so long as the repayment is not funded with another such loan.[62] This rule is similar, although not identical, to the debt rule in the Levin Bill.[63] The rule will present a problem for most employee co-invest entities, as a portion of the capital contributed by such entities typically will be funded with sponsor-guaranteed debt.[64]

c) Capital Interest Disposition Amounts

In addition to the allocations above, 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.[65] 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.[66] Second, determine the Capital Interest Gain or Loss that would be allocated to the interest as Capital Interest Allocations or Passthrough Interest Capital Allocations if all assets were sold at fair market value immediately before the disposition. [67] (For these purposes, assets are deemed sold at the lowest tier in the structure.)[68] The seller's Capital Interest Disposition Amount is generally equal to the product of the long-term capital gain or long-term

---

[61] Prop. Reg. §1.1061-3(c)(3)(ii)(B)(3). This provision seems to anticipate simple arrangements where the partners contribute all capital for direct investments and capital investment in funds and joint ventures in the same proportions. If the partners share in different investments based on different capital ratios, it would not seem possible to allocate based on blended capital accounts and still reflect the economic arrangement of the partners.

[62] Prop. Reg. §1.1061-3(c)(3)(ii)(C).

[63] Levin Bill, §710(d)(8)(A). The Levin Bill only gave credit for payments made on the debt on or prior to the date of enactment of the bill. For a discussion of problems caused by the debt provision in the Levin Bill, s*ee* J. Sowell, *Carried Interest: Line Drawing and Fairness (or Lack Thereof), Part 2*, 2013 TNT 224-8 (Nov. 20, 2013).

[64] If a partner contributes capital that is only partially funded with sponsor-guaranteed debt, it is unclear under the Proposed Regulations to what extent allocations made to that partner may qualify as Capital Interest Allocations or Passthrough Interest Allocations. It is arguable that all allocations would be treated as API Gains or Losses because under the partnership agreement the partner's non-carry allocations will be made in proportion to the partner's entire capital account, including the portion funded by sponsor-guaranteed debt, and not in proportion to the partner's capital account as determined without regard to contributions funded by sponsor-guaranteed debt.

[65] Note the preamble emphasizes that the principles of Rev. Rul. 84-53 apply in determining the basis of a partial interest sold even if the partner disposes of solely a capital interest or an API. *See also* Prop. Reg. §1.1061-3(c)(7)(v), Ex. 5(C).

[66] Prop. Reg. §1.1061-3(c)(6)(ii)(A). Note this calculation includes amounts referenced in Prop. Reg. §1.1061-4(b)(6) – 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.

[67] Prop. Reg. §1.1061-3(c)(6)(ii)(B). Note this calculation does not include amounts referenced in Prop. Reg. §1.1061-4(b)(6).

[68] Prop. Reg. §1.1061-3(c)(6)(ii)(A) & (B).

© 2020 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved.

The KPMG name and logo are registered trademarks or trademarks of KPMG International.

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).[69]

d) Unrelated Purchaser Exception

Under the Proposed 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 each of following 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, directly or indirectly, or any lower-tier partnership in which the partnership directly or indirectly holds an interest.[70]

The Proposed Regulations require that the acquisition by the unrelated taxpayer constitute a taxable purchase. Accordingly, the Proposed 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.[71] 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.

---

[69] Prop. Reg. §1.1061-3(c)(6)(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 not Capital Interest Disposition Amount. Prop. Reg. §1.1061-3(c)(6)(ii)(C).

[70] Prop. Reg. §1.1061-3(d).

[71] Prop. Reg. §1.1061-3(e); Preamble, Part II, Section E (providing that “…the exception does not apply to an unrelated non-service provider who becomes a partner by making a contribution to a Passthrough Entity that holds an API and in exchange receives an interest in the Passthrough Entity’s API”).

© 2020 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative (“KPMG International”), a Swiss entity. All rights reserved.

The KPMG name and logo are registered trademarks or trademarks of KPMG International.

The Proposed Regulations do not implement section 1061(b) but instead reserve on the provision.[72] The Preamble states:

> 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 service providers. The Treasury Department and IRS generally agree with these comments and believe that the section 1061(b) exception effectively is implemented in the proposed regulations with the exception to section 1061 for Passthrough Interest Direct Investment Allocations.

Section 1061(b) is similar to a provision in the Levin Bill that limited application of that bill to "investment partnerships."[73] The Levin Bill provision was intended, at least in part, to address the "enterprise value" issue (i.e., goodwill associated with sponsor organization).[74] The Levin Bill provided a separate rule for family partnerships.[75] The issue with regard to enterprise value does not seem to be taken care of with the exception for Passthrough Interest Investment Allocations in the same way that family offices might be.

D. Section 1061 Computations

The Proposed 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 Proposed Regulations refer to as the "Recharacterization Amount".

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 Proposed 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.[76]

---

[72] Prop. Reg. §1.1061-3(e).

[73] Levin Bill, §710(c)(3).

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

[75] Levin Bill, §710(d)(9).

[76] Prop. Reg. §1.1061-4(b)(6).

© 2020 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved.

The KPMG name and logo are registered trademarks or trademarks of KPMG International.

The Proposed Regulations also include a set of provisions that are intended to simplify the application of section 1061 to partnership interests that comprised a mix of invested capital, carried interest, and reinvested carry prior to the enactment of section 1061 (the "Transition Rule"). According to the Preamble,

> Prior to the enactment of section 1061, taxpayers had no reason to track what portion of the unrealized appreciation in partnership assets was attributable to capital interests. Therefore, the Treasury Department and the IRS are aware that partnerships may not have information readily available to enable them to comply with these regulations with respect to property that the partnership held more than three years as of the effective date of section 1061.[77]

At a general level and subject to certain exceptions, the Transition Rule essentially allows taxpayers to elect to treat capital gains and losses from the sale of assets held by the partnership for more than three years as of December 31, 2017, as being excluded from API Gains and Losses without regard to whether such capital gains and losses would qualify as Capital Interest Gains and Losses.[78]

More specifically, the Transition Rule applies with respect to a given partnership only if the partnership was in existence as of January 1, 2018, and the partnership irrevocably elects to treat all long-term capital gains and losses recognized from the disposition of all assets held by the partnership for more than three years as of January 1, 2018, as "Partnership Transition Amounts."[79]

If a partnership makes this election, then holders of an API in that partnership can exclude their "API Holder Transition Amount"[80] in a given taxable year when determining their Recharacterization Amount

---

[77] Preamble, Part III, Section E.2.

[78] The following example illustrates a situation when election under the Transition Rule may be beneficial. The Potential One Year Gain Amount of $100 comprises (1) $100 gain from sale of a potential transition asset, (2) $75 gain from sale of 2-year asset, and (3) ($75) loss from the sale of a 3-year non-transition asset. The potential Three Year Gain Amount of $25 comprises (1) $100 gain from sale of potential transition asset, (2) ($75) loss from the sale of a 3-year non-transition asset. If the partnership can exclude the $100 gain from the sale of the potential transition asset, the One Year Gain Amount is $0 and section 1061(a) does not apply under Prop. Reg. §1.1061-4(b)(1).

[79] To make such an election, the partnership must: (1) attach a signed and dated copy of a statement that the partnership is making the election to the timely filed return (including extensions) filed by the partnership with the IRS for the first taxable year the partnership treats amounts as Partnership Transition Amounts, (2) maintain a copy of the election and by the due date of the election must clearly and specifically identify the assets held for more than three years as of January 1, 2018 in the partnership's books and records, (3) keep sufficient books and records to demonstrate to the satisfaction of the Secretary of the Treasury or his delegate that the identified assets had been held by the partnership for more than three years as of January 1, 2018 and that long-term capital gain or loss on the disposition of each asset has been treated as a Partnership Transition Amount, and (4) keep an executed copy of its partnership agreement in effect as of March 15, 2018 and must have sufficient books and records to demonstrate that the "API Holder Transition Amounts" (as defined below) allocated to an API holder in any taxable year do not exceed the amounts that would have been allocated to the API holder with respect to its API under the partnership agreement in effect as of March 15, 2018 for the year ending December 31, 2017. Prop. Reg. §1.1061-4(b)(7)(iii).

[80] An "API Holder Transition Amount" is the amount of long-term capital gain or loss that is treated as a "Partnership Transition Amount" and that is included in the allocation of long-term capital gains and losses under section 702 and 704 to the API Holder for the taxable year with respect to the API Holder's interest in the Passthrough Entity. Prop. Reg. §1.1061-4(b)(7)(ii).

© 2020 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved.

The KPMG name and logo are registered trademarks or trademarks of KPMG International.

for that taxable year. An API Holder's API Holder Transition Amount for any taxable year cannot exceed the amount of Partnership Transition Amount that would have been allocated to the API Holder with respect to its interest in the partnership under the partnership agreement in effect on March 15, 2018, with respect to the calendar year ending December 31, 2017.[81] Thus, the partners cannot amend the partnership agreement to allocate more API Holder Transition Amount to an API Holder.

2. Determining Recharacterization Amount

As described in the Preamble, for purposes of determining the relevant holding period in analyzing a transaction under section 1061, "[t]he proposed regulations adopt the approach that the holding period of the owner of the assets sold controls."[82] The Preamble notes that this approach is consistent with the application of section 702(b) and Rev. Rul. 68-79.[83] The Proposed Regulations provide for three exceptions to this general rule. The first is the related-party transfer rule in section 1061(d). The other two relate to a non-statutory "Lookthrough Rule" introduced in the Proposed 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.[84] 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.[85] The Proposed Regulations also include a rule 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.[86]

In general, the Proposed Regulations utilize a formula that 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 Proposed Regulations, the Recharacterization Amount equals the Owner Taxpayer's "One Year Gain Amount" less the Owner Taxpayer's "Three Year Gain Amount.[87] The One Year Gain Amount is the sum of the Owner Taxpayer's combined net "API One Year Distributive Share Amount" from all APIs

[81] *Id.*

[82] Preamble, Part III, Section E.6.; *see also* Prop. Reg. §1.1061-4(b)(8)(ii).

[83] 1968-1 C.B. 310.

[84] Prop. Reg. §1.1061-4(a)(1).

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

[86] Prop. 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).

[87] Prop 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. Prop. 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. Prop. Reg. §1.1061-4(b)(2).

© 2020 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved.

The KPMG name and logo are registered trademarks or trademarks of KPMG International.

held during the taxable year and the Owner Taxpayer's "API One Year Disposition Amount".[88] 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".[89] 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.[90]

The Proposed Regulations provide that the API One Year Distributive Share Amount equals the "API holder's distributive share of *net long-term capital gain* from the partnership, including capital gain or loss on the disposition of all or a part of an API,[91] 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.), the API holder's Transition Amount for the taxable year, and Capital Interest Gains and Losses. [92] If the computation results in a net long-term capital gain, it constitutes the API One Year Distributive Share Amount. It appears that, if the computation results in a net long-term capital *loss*, there will not be an API One Year Distributive Share Amount with respect to that particular API.[93]

The API Three Year Distributive Share Amount is the API One Year Distributive Share Amount[94] 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.[95]

The API One Year Disposition Amount equals the combined net amount of four items. First, long-term capital gains and losses recognized during the taxable year by an Owner Taxpayer on the disposition of

---

[88] Prop. Reg. §1.1061-4(a)(2)(i).

[89] Prop. Reg. §1.1061-4(a)(2)(ii).

[90] Prop. Reg. §1.1061-6(b)(1)(i).

[91] 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.

[92] Prop. Reg. §1.1061-4(a)(3)(i) (emphasis added).

[93] If this is the result intended in the Proposed Regulations, an Owner Taxpayer seemingly does not have the ability to offset a net capital loss from one API against a net capital gain derived through another API. This result is surprising, and possibly not intended. Note that the Preamble indicates that the Proposed Regulations adopt a "partial entity approach," and "amounts subject to section 1061 flow through those entities and are netted at the Owner Taxpayer Level to determine the Recharacterization Amount." Preamble, Part I, Section A.1.a. Note also that the ABA Report, s*upra* note 34, described the partial netting approach as allowing a netting of long-term capital gain and long-term capital loss from separate APIs at the Owner Taxpayer level. Separately, it is not clear whether a capital loss from an API recognized in a prior year, but limited pursuant to section 1211, impacts the Owner Taxpayer's computation of its Recharacterization Amount.

[94] 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.

[95] Prop. Reg. §1.1061-4(a)(3)(ii).

© 2020 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved.

The KPMG name and logo are registered trademarks or trademarks of KPMG International.

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.[96] 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.[97] Third, long-term capital gains and losses recognized on the disposition of Distributed API Property during the taxable year that has a holding period of more than one year but nor more than three years on the date of disposition.[98] Fourth, long-term capital gain or loss recognized as a result of the application of section 751(b).[99]

The API Three Year Disposition Amount equals the combined net amount of four 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.[100] 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.[101] 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) (and section 752(b) if applicable) as gain or loss from the sale or exchange of a partnership interest held for more than three years.[102] Fourth, long-term capital gains and losses recognized as a result of the application of section 751(b) that is treated as derived from an asset held for more than three years.[103]

The Proposed 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[104] and the Three Year Amounts Disclosure,[105] 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

---

96 Prop. Reg. §1.1061-4(a)(4)(i)(A).

97 Prop. Reg. §1.1061-4(a)(4)(i)(B).

98 Prop. 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.

99 Prop. Reg. §1.1061-4(a)(4)(i)(D). Presumably this reference is to section 751(b) gain or loss recognized at the partner level, rather than section 751(b) exchange gain recognized at the partnership level and allocated to the Owner Taxpayer or with respect to the API, since the latter gain should be included in the API One Year Distributive Share Amount. The Proposed Regulations do not contain a provision for including section 737(a) gain in the Three Year Disposition Amount.

100 Prop. Reg. §1.1061-4(a)(4)(ii)(A).

101 Prop. Reg. §1.1061-4(a)(4)(ii)(B).

102 Prop. Reg. §1.1061-4(a)(4)(ii)(C).

103 Prop. Reg. §1.1061-4(a)(4)(ii)(D).

104 *See infra* text accompanying note 142.

105 *See infra* text accompanying note 143.

© 2020 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved.

The KPMG name and logo are registered trademarks or trademarks of KPMG International.

Distributive Share Amount.[106] 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.[107] 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.[108] 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).[109] 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.[110]

3. Installment Sale Gain

The Proposed 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.[111]

4. Lookthrough Rule

The Proposed Regulations include a rule 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").[112] The Lookthrough Rule does not apply to any transfer subject to the Related-Party Transfer Rule described below.[113]

In general, the Lookthrough Rule applies to the direct sale of an API if the API holder held the API for more than three years, recognized capital gain, and 80% or more of the underlying assets of the partnership are assets that would produce capital gain or loss (not otherwise excluded from the application of section 1061) if disposed of by the partnership and in which the partnership has a holding

---

[106] Prop. Reg. §1.1061-4(b)(4)(i) & (ii).

[107] Prop. Reg. §1.1061-4(c)(2), Ex. 6.

[108] Prop. Reg. §1.1061-4(b)(4)(i) & (ii).

[109] Prop. Reg. §1.1061-4(b)(4)(iii).

[110] Prop. Reg. §1.1061-4(b)(5). 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 Prop. Reg. §1.1061-3(b)(2)(ii).

[111] Prop. Reg. §1.1061-4(b)(3).

[112] Prop. Reg. §1.1061-4(b)(9).

[113] Prop. Reg. §§1.1061-4(b)(9)(i).

© 2020 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved.

The KPMG name and logo are registered trademarks or trademarks of KPMG International.

period of three years or less (the "Substantially All Test").[114] For purposes of the Substantially All Test, the numerator is equal to the fair market value of the assets that would produce non-excluded capital gain or loss and have a holding period of less than three years and the denominator is equal to the fair market value of all of the assets of the partnership, excluding cash, cash equivalents, unrealized receivables under section 751(c) and inventory items under section 751(d).[115]

In a tiered structure in which the API holder holds its API through one or more Passthrough Entities,[116] the Lookthrough Rule applies if an API holder disposes of a Passthrough Interest held for more than three years in a taxable transaction, recognizes capital gain, and either (1) the Passthrough Entity which is sold has a holding period in a directly or indirectly held API of three years or less[117] or (2) the assets of the partnership in which the API is held meet the Substantially All Test.[118] For purposes of applying the Substantially All Test, an upper-tier partnership that has a holding period in a lower-tier partnership of more than three years must look through to the lower-tier partnership's assets in determining how much of the fair market value of the lower-tier partnership to include in the numerator (i.e., the fair market value of the lower-tier partnership's less-than-three-year non-excluded capital assets).[119]

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 or (in the case of a sale by a Passthrough Entity) in the API One Year Distributive Share Amount.[120] This same amount, as reduced by the following adjustment, is included in the API Three Year Disposition Amount or the API Three Year Distributive Share Amount, as applicable.[121] The required adjustment in the case of a sale of a Passthrough Interest in a Passthrough Entity that has a holding period in an API of less than three years is equal to the gain attributable to the API directly or indirectly held by the Passthrough

---

[114] Prop. Reg. §§1.1061-4(b)(9)(i)(A) & (C).

[115] Prop. Reg. §1.1061-4(b)(9)(i)(C)(1)(i) & (ii).

[116] A Passthrough Entity includes an S corporation or a PFIC with respect to which a shareholder has made a QEF election. If the S corporation or the QEF holds an API, a disposition of its stock constitutes a disposition of a Passthrough Interest, bringing the Lookthrough Rule into play with respect to the disposition.

[117] Note that this provision will impact a situation there the sponsor entity through which the principals invest receive GP interests in newly-formed funds on a periodic basis. If a principal disposed of its interest in the sponsor entity which it has held for more than three years, but the sponsor entity has received new GP interests within three years prior to the sale of the principal's interest in the sponsor entity, the Lookthrough Rule will apply with respect to those GP interests.

[118] Prop. Reg. §1.1061-4(b)(9)(i)(B).

[119] Prop. Reg. §1.1061-4(b)(9)(i)(C)(2). In the case of a partnership that has held an interest in a lower-tier Passthrough Entity for more than three years, the partnership increases its numerator by its "share" of the value of the relevant assets held by the lower-tier Passthrough Entity that would be included in the numerator by the lower-tier Passthrough Entity if it was calculating the numerator. The Proposed Regulations do not provide guidance on how to determine an upper-tier Passthrough Entity's share of a lower-tier Passthrough Entity's assets. This determination could be uncertain where the upper-tier's share of profits, loss, and capital in the lower-tier varies. In addition, the Proposed Regulations make no provision to disregard assets of a lower-tier entity that an upper-tier partnership may not have an economic share in, such as situations with tracking interests in some but not all partnership assets.

[120] Prop. Reg. §1.1061-4(b)(9)(ii)(A).

[121] Prop. Reg. §1.1061-4(b)(9)(ii)(B).

© 2020 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved.

The KPMG name and logo are registered trademarks or trademarks of KPMG International.

Entity.[122] When the Substantially All Test applies, the adjustment is equal to the capital gain recognized in the disposition that is attributable to assets included in the numerator in the Substantially All Test. This amount is calculated by multiplying the capital gain recognized on the sale of the API by a fraction, the numerator of which is net capital gain that would be recognized by the partnership in a sale of all assets included in the numerator of the Substantially All Test and the denominator of which is the net capital gain that would be recognized in a sale of all assets by the partnership included in the denominator of the Substantially All Test.[123]

5. Carry Waivers

Following the enactment of section 1061, many fund sponsors began to consider a concept known as "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 do not address these arrangements, but the Preamble contains 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."[124]

E. Related-Party Transfer Rule

The Proposed Regulations interpret the section 1061(d) related-party transfer rule[125] to do two things – (1) 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 (taking into account all assets producing capital gain, including section 1231 gain, section 1256 gain, etc.), and (2) cause the transferor of the API to recognize gross income as short-

---

[122] Prop. Reg. §1.1061-4(b)(9)(ii)(C)(2).

[123] Prop. Reg. §1.1061-4(b)(9)(ii)(C)(1). If such numerator is zero or less, then the adjustment is zero. If the numerator is more than zero and the denominator is zero or less, then the adjustment is the entire amount of gain recognized on the sale of the API. The adjustment amount is equal to the capital gain recognized on the disposition of the API that is "attributable to the assets" included in the numerator of the Lookthrough Rule formula. The use of the words "attributable to" could lead one to infer that the Proposed Regulations are employing a pure aggregate approach to the sale of the partnership interest that is based on the gain or loss that would be allocable to the seller on a hypothetical sale of all the assets of the partnership (similar to the operation of section 751(a)). However, this does not appear to be the case. The formula that the Proposed Regulations proscribes to determine the adjustment amount is a percentage that is calculated based on the net capital gain that would be generated by the underlying partnership from the relevant capital gain assets, without provision for the *share* of the net capital gain from such assets that would be allocated to the Owner Taxpayer of the Passthrough Entity. The examples in the Proposed Regulations that illustrate the application of this Lookthrough Rule involve factual situations where the partner's share of capital and profits is the same; so they are not instructive as to situations where a particular API Holder's share of the gain may be proportionately more (or less) than its share of capital. Compare, for example, the operation of the section 1061(d) related party transfer rule (discussed below).

[124] Preamble, Part I, Section A.1.f.

[125] 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).

© 2020 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved.

The KPMG name and logo are registered trademarks or trademarks of KPMG International.

term capital gain by reference to the net gain associated with the underlying assets producing capital gain with less than a three-year holding period where gain otherwise would not be recognized (e.g., contribution, distribution, exchange, gift, etc.).

The Proposed Regulation interpreting section 1061(d) is extremely important and potentially quite broad. The general rule reads as follows:

> If an Owner Taxpayer transfers any API, or any Distributed API Property, *directly or indirectly*, 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 Internal Revenue Code, the Owner Taxpayer shall include in gross income as short-term capital gain, the excess (if any) of–
>
> (1) The Owner Taxpayer's net long-term capital gain with respect to such interest for such taxable year determined as provided in paragraph (c) of this section, over
>
> (2) Any amount treated as short-term capital gain under §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).[126]

A Section 1061(d) Related Person is any person that is 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.[127]

The parties defined as "related" are 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. Two examples illustrate the difficulty in the analysis and the potential breadth of the rules.

First, consider an irrevocable transfer of an API to a non-grantor trust for the current benefit of the transferor's children. At a gut level, this transaction feels like a related-party transaction, but the result under the Proposed Regulations is unclear. As an initial matter, the family relationship is defined strictly by reference to section 318(a)(1). Note that this section is not a related-party provision, but instead is an attribution provision. For purposes of section 1061(d), the family members to whom shares of stock would be attributed under section 318 are themselves treated as related. Section 318 contains attribution rules causing a beneficiary to own assets that are owned by a trust (i.e., section 318(a)(2)) and a trust to own assets that are owned by a beneficiary (i.e., section 318(a)(3)), but those rules are

---

[126] Prop. Reg. §1.1061-5(a). For purposes of section 1061(d), the term transfer includes but is not limited to contributions, distributions, sale and exchanges, and gifts. Prop. Reg. §1.1061-5(b). The Related Party Transfer Rule does not apply to a transfer that is a contribution to a partnership under section 721(a). Prop. Reg. §1.1061-5(e)(2). Note, however, that section 1061(d), as interpreted by the Proposed Regulations, provides no exception for distributions under section 731 and appears to apply to a pro rata distribution of APIs held by a partnership to its partners.

[127] Prop. Reg. §1.1061-5(e)(1).

© 2020 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved.

The KPMG name and logo are registered trademarks or trademarks of KPMG International.

not referenced in section 1061(d) or the Proposed Regulations. This fact may cause one to believe that a transfer to a trust for the benefit of the transferor's children should not be treated as a related party transfer. Note, however, that the operative rule applies by reference to a "direct or indirect" transfer. There is some authority in the gift tax context that treats certain transfers to a trust as an indirect transfer to the trust beneficiary.[128] But transfers in trust can be complicated. The transfer in some instances will be revocable, and even if irrevocable, the ultimate beneficiary may not be identifiable with certainty or may not have a present interest in the API. If the analysis in the gift tax authority applies for purpose of section 1061(d), the related party analysis for indirect family transfers could be fact-dependent and quite cumbersome.

As a separate example, consider a public REIT executive who is converting operating partnership LTIP units into stock of the REIT. The REIT executive provides services in connection with the ATB Activity of the operating partnership and thus is an API Holder with respect to the LTIP units. The REIT is the general partner of the operating partnership and thus is a person who is performing services with respect to the ATB Activity. As a result, the LTIP conversion transaction appears to be a related-party transaction captured by section 1061(d). While the conversion transaction is a taxable transaction, the application of section 1061(d) has the potential to convert significantly more long-term gain associated with the API into short-term capital gain.

Note the implications if the taxable transfer in the LTIP conversion transaction is subject to section 1061(d). If the Related Party Transfer Rule applies, then the Owner Taxpayer must determine two amounts. The first is the amount of net long-term capital gain from assets held for three years or less (taking into account remedial allocations) that would have been allocated to the partner in respect of the portion of the API that is sold if the underlying partnership had sold all of its property for fair market value immediately prior to the transfer of the API.[129] This amount includes not just gain from the sale of capital assets, but gain from all assets that produce capital gain, including section 1231 assets, etc. In addition, the gain relates to assets held for zero to three years, rather than the one- to three-year period that generally applies in recharacterizing capital gain under section 1061.[130] The second determination is the amount otherwise included in the Owner Taxpayer's API One Year Disposition Gain Amount but not in the Owner Taxpayer's API Three Year Disposition Gain Amount with respect to the transfer, i.e. the amount the Owner Taxpayer would otherwise be required to recharacterize as short-term capital gain in respect of the transfer.

---

[128] *See, e.g.*, *Helvering v. Hutchings*, 312 U.S. 393 (1941); *Hackl v. Commissioner*, 118 T.C. 279 (2002), *aff'd*, 335 F.3d 664 (7th Cir. 2003). *Cf.* Reg. §25.2503-2(a) (for purposes of applying the annual exclusion, "[i]n the case of a gift in trust the beneficiary of the trust is the donee"); Reg. §25.2511-1(a) ("The gift tax applies to a transfer by way of gift whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible." The inclusion of a transfer in trust, followed by reference to direct or indirect transfers, may imply that a transfer in trust is not an indirect transfer).

[129] If such amount is negative or zero, then section 1061(d) does not apply.

[130] Oddly, the statute is drafted differently for the related-party rule under section 1061(d) than is the case for the general rule under section 1061. Section 1061(d)(1)(A) references the "taxpayer's long-term capital gain with respect to [its API] for such taxable year attributable to the sale or exchange *of any asset held for not more than 3 years* as is allocable to such interest." (emphasis added).

© 2020 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved.

The KPMG name and logo are registered trademarks or trademarks of KPMG International.

If the first amount is greater than the second amount, then the Owner Taxpayer must include the excess in gross income as short-term capital gain. If the transfer is otherwise a taxable event, the Owner Taxpayer must recharacterize the capital gain otherwise recognized as short-term capital gain to the extent of such excess. If the capital gain otherwise recognized is less than such excess, the Owner Taxpayer must include the difference in gross income as short-term capital gain.

For the LTIP owner, this rule produces a very surprising result. In determining the gain recognized upon the exchange of its LTIP operating partnership units for REIT stock that is subject to recharacterization as short-term capital gain (and potentially determining gross income in excess of the gain that is recognized by reference to the amount realized and adjusted basis for the partnership interest), the LTIP unitholder must consider gain related section 1231 assets held by the operating partnership (or lower-tier partnerships) for three years or less even though the allocation of such gain to the LTIP unitholder while a partner would not have invoked the general rule in section 1061(a).

If the transferee's basis in the interest transferred is determined in whole or in part by reference to the transferor's basis, then the transferor's basis is increased by the amount included in gross income solely by reason of the Related Party Transfer Rule immediately prior to the transfer.[131]

The Related Party Transfer Rule also potentially applies to a transfer of Distributed API Property by a Taxpayer Owner to a section 1061(d) related party.[132] This rule is operative, for example, to a situation where property that had been previously distributed to a Taxpayer Owner with respect to an API is subsequently contributed to a Passthrough Entity where related family members also hold interests. In this case, the Passthrough Entity in which the family members hold interests is treated as a section 1061(d) related person to the extent that such related persons hold interests.[133] There is an exception from the gain recognition rule of section 1061(d) for contributions under section 721(a) to a partnership that is a Passthrough Entity, however there is no such exception for transfers to other Passthrough Entities, such as S corporations or PFICs for which a QEF election has been made.[134]

F. Reporting Requirements

Under the Proposed 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,

[131] Prop. Reg. §1.1061-5(d).

[132] Prop. Reg. §1.1061-5(a).

[133] The Proposed Regulations do not provide rules defining the term "to the extent" held by section 1061(d) related persons. However, this rule appears to look to the portion of the Passthrough Entity is owned by the other related party. *See* Prop. Reg. §1.1061-5(f), Example 3.

[134] *See* Prop. Reg. §1.1061-5(e)(2).

© 2020 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved.

The KPMG name and logo are registered trademarks or trademarks of KPMG International.

- Capital Interest Gains and Losses allocated to the API holder,
- API Holder Transition Amounts, and
- 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 Lookthrough Rule and to determine its Capital Interest Disposition Amount.[135]

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.[136] 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.[137] A Passthrough Entity receiving a request for information must retain a copy of the request and the date received in its books and records.[138] Failure to provide the information required under the Proposed Regulations is subject to penalties under section 6722.[139]

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.[140]

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

---

[135] Prop. Reg. §1.1061-6(b)(1).

[136] Prop. Reg. §1.1061-6(b)(2)(iii)(A).

[137] Prop. Reg. §1.1061-6(b)(2)(iii)(B)(1). Note, Prop. 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.

[138] Prop. Reg. §1.1061-6(b)(2)(v).

[139] Prop. Reg. §1.1061-6(b)(2)(vii).

[140] Prop. Reg. §1.1061-6(b)(2)(vi).

© 2020 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved.

The KPMG name and logo are registered trademarks or trademarks of KPMG International.

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.[141]

1. RIC, REIT, and QEF Reporting

As noted above, the Proposed 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.[142] 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.[143] 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.[144] 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.[145]

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.[146]

G. 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

---

[141] Prop. Reg. §1.1061-6(a)(2).

[142] Prop. Reg. §1.1061-6(c)(1)(i).

[143] Prop. Reg. §1.1061-6(c)(1)(ii).

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

[145] Prop. Reg. §1.1061-6(c)(3).

[146] Prop. Reg. §1.1061-6(d).

© 2020 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved.

The KPMG name and logo are registered trademarks or trademarks of KPMG International.

property transferred at the same time but resulting in different holding periods.[147] 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 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.[148]

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 Proposed Regulations include amendments to the partnership interest holding period rules under section 1223 to address profits interests. Specifically, the Proposed 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).[149] 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 Proposed Regulations adopt the same definition of a profits interest as the definition provided in Rev. Proc. 93-27.

H. Effective Date

The Proposed Regulations generally provide that final regulations will apply to taxable years of Owner Taxpayers and Passthrough Entities beginning on or after such final regulations are published in the Federal Register. Although the Proposed Regulations are not currently effective, the Preamble indicates that Owner Taxpayers and Passthrough Entities may rely on the Proposed Regulations for taxable years beginning before the final regulations if they follow the Proposed Regulations in their entirety and in a consistent manner.[150] One exception to the "follow in their entirety" requirement is carved out for the Proposed Regulations regarding Partnership Transition Amounts and API Holder Transition Amounts. As previously described, the Proposed Regulations provide that the rule excluding

---

[147] Reg. §1.1223-3(a).

[148] Reg. §1.1223-3(b)(1).

[149] Prop. 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.

[150] Preamble, Part VII.

© 2020 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved.

The KPMG name and logo are registered trademarks or trademarks of KPMG International.

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 6, 2020 (i.e., the date the Proposed Regulations were published in the Federal Register).

IV. Conclusion

The Proposed Regulations under section 1061 are highly mechanical and quite complicated. In addition, in many instances, the Proposed Regulations go beyond the language of the statute to import concepts from prior versions of the carried interest legislation that were never enacted into law. The Proposed Regulations are sure to be controversial, and numerous and detailed comments with respect to these regulations can be expected. One can hope that Treasury and the IRS will give reasoned consideration to the comments so that some of the problems identified will be moderated or eliminated.

□ □ □ □

The information in this article is not intended to be "written advice concerning one or more federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230 because the content is issued for general informational purposes only. The information contained in this article is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the author or authors only, and does not necessarily represent the views or professional advice of KPMG LLP.

© 2020 KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative (“KPMG International”), a Swiss entity. All rights reserved.

The KPMG name and logo are registered trademarks or trademarks of KPMG International.