



November 23, 2020

The Honorable David J. Kautter
Assistant Secretary for Tax Policy
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable Charles P. Rettig
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

RE: Comments on REG-107213-18, Proposed Regulations Under Section 1061

Dear Messrs. Kautter and Rettig:

The American Institute of CPAs (AICPA) appreciates the efforts of the Department of the Treasury (“Treasury”) and the Internal Revenue Service (IRS) in developing and issuing regulations under section 1061.¹ The purpose of section 1061 is to prevent the transmutation of ordinary income into long term capital gain. However, instead of recharacterizing (improper) long term capital gain as ordinary income, section 1061 recharacterizes certain long term capital gain of a partner that holds an applicable partnership interest into short term capital gain. These comments are in response to the proposed regulations issued on July 31, 2020. There are general concerns regarding the applicability and statutory authority under some of the proposed provisions, as well as principles of fairness and effective administration which are bedrocks of sound tax policy.² Our comments and recommendations cover the following topics:

- I. Definition of Specified Assets – Widely Held Partnerships
- II. Capital Interest Exception
 - i. In General
 - A. Provide Definition for an Interest that is Commensurate with Capital Contributed
 - B. Remove Capital Interest Exception Loan Rule
 - ii. Alternative Specific Comments if the Recommendation to Remove the Capital Interest Exception Loan Rule is Not Adopted
 - A. Removal of a Guarantee Increases Capital Accounts
 - B. Certain Repayments Included in the Capital Interest Exception
 - C. Transition Rule
- III. Expand the Unrelated Purchaser Exception
- IV. Correct Recharacterization Amount Calculation
- V. Eliminate Mandatory Revaluations Through Tiered Partnership Structures

¹ Unless otherwise indicated, references to a “section” are to a section of the Internal Revenue Code of 1986, as amended (the “Code”), and references to a “Treas. Reg. §” are to the Treasury regulations promulgated under the Code.

² [AICPA Principles of Good Tax Policy](#).

- VI. Transfers of Applicable Partnership Interests to Related Parties
 - i. Application to General Nonrecognition Transactions
 - ii. Alternative Exceptions in Limited Circumstances
- VII. Ease and Clarify Reporting Requirements
- VIII. Transition Rules

Our comments, if adopted in final regulations, would decrease the complexity and increase the practicality of the proposed regulations in applying section 1061.

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We appreciate your consideration of these comments and welcome the opportunity to discuss these issues further. If you have any questions, please contact Sarah Allen-Anthony, Chair, AICPA Partnership Taxation Technical Resource Panel, at (574) 235-6818, or Sarah.Allen-Anthony@crowe.com; Alexander Scott, AICPA Senior Manager – Tax Policy & Advocacy, at (202) 434-9204, or Alexander.Scott@aicpa-cima.com; or me at (612) 397-3071 or Chris.Hesse@CLAconnect.com.

Sincerely,



Christopher W. Hesse, CPA
Chair, AICPA Tax Executive Committee

cc: Hon. Michael J. Desmond, Chief Counsel, Internal Revenue Service
Roger Pillow, Attorney-Advisor, Office of Tax Legislative Counsel, Dept. of the Treasury
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AMERICAN INSTITUTE OF CPAs

Proposed Regulations Under Section 1061

November 23, 2020

BACKGROUND

The compensation a taxpayer receives for performing services is generally taxed as ordinary income. A general partner manager of an investment fund typically receives two types of compensation: (1) an annual 2% management fee; and (2) a carried interest (i.e., a share of partnership profits) equal to 20% of the profits of the fund.³ The management fee is properly ordinary income. The taxation of the carried interest is more complicated.

The IRS has taken the position that the receipt of a carried interest is not a taxable event to the recipient.⁴ Instead, the service provider takes into account the provider's distributive share of income and gains (which were commonly actually distributed immediately to the manager) of the partnership. In particular to the extent that the gains are generated by assets held for more than one year, the profits interest holder recognizes long term capital gain and qualified dividend income, which are taxed at 23.8% (20% capital gains rate plus 3.8% on net investment income), which is typically less than the ordinary income rate. Due to Congressional concern that these investment managers were therefore transmuted ordinary income into long term capital gain income, section 1061 was enacted under legislation commonly referred to as the Tax Cut and Jobs Act of 2017 ("TCJA") to curtail this perceived abuse.⁵

It did so, very generally, by requiring the fund to hold assets for more than three years, instead of one year, in order to achieve long-term status. Although the concept is seemingly straightforward, there is nevertheless complexity lurking in the details. We respectfully submit the recommendations below to further refine and clarify certain aspects of the proposed regulations.

I. Definition of Specified Assets – Widely Held Partnerships

Overview

Section 1061 applies to certain net long term capital gains recognized in connection with an applicable partnership interest (API). An API is defined to include certain partnership interests transferred to a taxpayer in connection with the performance of services in an applicable trade or business (ATB). An ATB means any activity conducted on a regular, continuous, and substantial basis which consists of:

- (1) raising or returning capital; and
- (2) either,

³ These are typical percentages in fund structures used as examples for simplicity, but they are not the only real-world arrangements.

⁴ Rev. Proc. 93-27. There are three exceptions in the Rev. Proc. not relevant here.

⁵ P.L. 115-97.

- (i) investing in or disposing of specified assets; or
- (ii) developing specified assets.

Section 1061(c)(3) provides that the term specified asset includes securities,⁶ commodities,⁷ real estate held for rental or investment, cash or cash equivalents, options or derivative contracts with respect to any of the foregoing, and an interest in a partnership to the extent of the partnership's proportionate interest in any of the foregoing. Proposed Reg. § 1.1061-1(a) clarifies that securities include partnership interests qualifying as securities.

Section 475(c)(2) includes the following assets: (1) share of stock in a corporation; (2) partnership or beneficial ownership interest in a widely held or publicly traded partnership or trust; (3) note, bond, debenture, or other evidence of indebtedness; (4) interest rate, currency, or equity notional principal contract; (5) evidence of an interest in, or a derivative financial instrument in, any security described above, or any currency, including any option, forward contract, short position, and any similar financial instrument in such a security or currency; and (6) position which: (i) is not a security described above; (ii) is a hedge with respect to such a security; and (iii) is clearly identified in the dealer's records as being described in this subparagraph before the close of the day on which it was acquired or entered into.

Based on the statute and proposed regulations, an interest in a partnership will be considered a specified asset in three situations:

- To the extent the partnership holds assets that are defined as specified assets;⁸
- The partnership is a publicly traded partnership which under section 7704(b) means any partnership if interests in such partnership are traded on an established securities market or readily tradeable on a secondary market (or substantial equivalent thereof); and
- The partnership is a widely held partnership.

Existing guidance is generally sufficient to determine whether a partnership interest will be considered a specified asset under the first two categories described above. However, there is no definitive guidance to assist in determining when a partnership may be considered widely held for purposes of section 1061. For example, there is a lack of guidance indicating whether a specific number of direct or indirect owners is required to establish that a partnership is widely held. Additionally, there is uncertainty as to whether a widely held fund will cause any partnership held by the fund to be considered widely held.

⁶ Under section 475(c)(2) without regard to the last sentence thereof.

⁷ Under section 475(e)(2).

⁸ For example, an interest in a partnership whose assets consist solely of corporate stock will be considered a specified asset.

Recommendation

The AICPA recommends that the final regulations clarify and provide that:

1. An interest in a lower-tier partnership that is not itself widely held, a publicly traded partnership, or otherwise holds specified assets will not be considered a specified asset solely as a result of one of its partners being widely held or a publicly traded partnership.
2. A partnership is considered widely held for purposes of section 1061 if: (i) the partnership has in excess of 250 direct partners; and (ii) interests are required to be registered under federal or state laws regulating securities or have been sold under an exemption from registration requiring the filing of a notice with a federal or state agency regulating the offering or sale of securities.

Analysis

The Conference Report accompanying the TCJA contains the following illustration concluding that an operating partnership is considered a specified asset:

A partnership interest, for purposes of determining the proportionate interest of a partnership in any specified asset, includes any partnership interest that is not otherwise treated as a security for purposes of the provision (for example, an interest in a partnership that is not widely held or publicly traded). For example, assume that a hedge fund acquires an *interest in an operating business conducted in the form of a non-publicly traded partnership that is not widely held*; the partnership interest is a specified asset for purposes of the provision [emphasis added].

Based on the facts provided in this illustration, the operating partnership itself is not a publicly traded partnership, does not hold specified assets, and is not widely held. However, the illustration nonetheless concludes that the operating partnership is a specified asset. Since the hedge fund is likely widely held, the implication of this illustration that a fund holding a partnership interest will be treated as widely held if one of its partners is itself widely held.

This indirect tainting of an operating partnership is not consistent with the statute and leads to an incorrect result. Under section 1061(c), an interest in a partnership can only be considered an API if the partnership operates an ATB. An ATB requires that the partnership invests in, disposes of, or develops specified assets. The plain language of the statute requires a determination that the partnership which issued the API invests in, disposes of, or develops specified assets.

For example, Fund LP may issue an interest to its manager in connection with the performance of services provided by the manager to Fund LP. This partnership interest will be considered an API only if Fund LP conducts an ATB. In order for Fund LP to conduct an ATB, Fund LP itself must operate an “activity conducted on a regular, continuous, and substantial basis which, regardless of whether the activity is conducted in one or more entities, consists, in whole or in part of raising or

returning capital, and either investing in (or disposing of) specified assets (or identifying specified assets for such investing or disposition), or developing specified assets.”⁹

Whether or not Fund LP is itself widely held should have no bearing on whether a partnership interest held by Fund LP is a specified asset. Rather, the only time an investment in a lower-tier partnership interest held by Fund LP should be considered a specified asset is when the lower-tier partnership interest is: (1) a publicly traded partnership; (2) holds specified assets; or (3) is widely held.

Importantly, the General Explanation of Public Law 115-97 (the Blue Book) modified the example contained in the Conference Report as follows:

A partnership interest, for purposes of determining the proportionate interest of a partnership in any specified asset, includes any partnership interest that is not otherwise treated as a security for purposes of the provision (for example, an interest in a partnership that is not widely held or publicly traded). For example, assume that a hedge fund acquires an interest in a partnership that is neither publicly traded nor widely held and whose assets consist of *stocks, bonds, positions that are clearly identified hedges with respect to securities, and commodities*; the partnership interest is a specified asset for purposes of the provision [emphasis added].

The Blue Book appears to more accurately conform to the statutory language specifically referencing partnerships that either hold specified assets or are themselves considered a publicly traded partnership or widely held. In other words, the illustration in the Blue Book would appear to support the belief that regardless of whether Fund LP is widely held, the determination of an interest in a lower-tier partnership will be determined based on direct ownership.

However, the Blue Book contains a confusing example describing application of the corporate exception under section 1061(c)(4)(A). Specifically, page 201 of the Blue Book notes that if two corporations form a partnership to conduct a joint venture for developing and marketing a pharmaceutical product, the partnership interests held by the two corporations are not applicable partnership interests. While this result is clear because the partners are corporations, one may infer that the operating partnership could somehow be considered a specified asset. The partnership in this example would be a specified asset only if the partnership is a publicly traded partnership or is widely held.

Given the inclusion of widely held partnerships as specified assets for purposes of section 1061, taxpayers require guidelines that can be consistently applied. There is no statutory or regulatory guidance establishing a minimum number of partners needed for a partnership to be considered widely held. However, the concept of widely held partnership is not new.

A report submitted to Congress by Treasury in March 1990, “Widely Held Partnerships: Compliance and Administration Issues” (the “1990 Report”)¹⁰ indicates that a non-service

⁹ See section 1061(c)(2).

¹⁰ A copy of the report may be found at: <https://home.treasury.gov/system/files/131/Report-Partnerships-1990.pdf>.

partnership with at least 250 partners is considered widely held. This report was the product of a directive contained in the Omnibus Budget Reconciliation Act of 1987 to study the issues of compliance and administration with respect to publicly traded partnerships and other large partnerships. In this report, the IRS noted that the definition of a widely held partnership should satisfy three criteria:

1. First, it should cover partnerships with numerous partners;
2. Second, it should provide a bright line; and
3. Third, the definition should exclude service partnerships such as law or accounting firms.

The IRS then proposed that a widely held partnership would include “any partnership (i) with 250 or more partners during the taxable year; and (ii) in which interests are required to be registered under federal or state laws regulating securities or have been sold under an exemption from registration requiring the filing of a notice with a federal or state agency regulating the offering or sale of securities.”

Additionally, beginning with the 1991 tax year, the Form 8804, *Annual Return for Partnership Withholding Tax (Section 1446)*, instructions defined a widely held partnership, for purposes of foreign partner withholding, as a partnership that has more than 200 partners, including publicly traded partnerships. The Form 8804 instructions included this definition until the 2005 tax year when the special reliance rule applicable to widely held partnerships was expanded to all partnerships.

Given the existing history surrounding the meaning of the term “widely held partnership” dating back to the Omnibus Budget Reconciliation Act of 1987, a definition consistent with the 1990 Report is an appropriate standard to be applied for purposes of section 1061.

II. Capital Interest Exception

i. In General

Overview

Section 1061(c)(4)(B) provides that an API does not include any capital interest in the partnership that provides the taxpayer with a right to share in partnership capital commensurate with: (i) the amount of capital contributed (determined at the time of receipt of the partnership interest); or (ii) the value of the interest subject to tax under section 83 upon the receipt or vesting of such interest (the “Capital Interest Exception”).

Section 1061 and its legislative history do not address capital contributions funded by loans for purposes of the Capital Interest Exception. However, the Capital Interest Exception mechanism under Prop. Reg. § 1.1061-3 excludes capital contributions made from certain loans. In relevant part, the preamble states that:

For purposes of section 1061, 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 person related to any such other partner or the partnership). However, the repayments on the loan are included in capital accounts as those amounts are paid (unless the repayments are funded with a similar loan from the partners or the partnership or any person related to such partners or the partnership).¹¹

Proposed Reg. § 1.1061-3(c)(3)(ii)(C) includes this rule, which is subject to the general effective date of the proposed regulations.¹² Although the proposed regulations provide that repayments on a loan that are within the scope of Prop. Reg. § 1.1061-3(c)(3)(ii)(C) are included in capital accounts for purposes of the Capital Interest Exception, it is not entirely clear what impact the timing of a repayment has on the Capital Interest Exception, as discussed below.

A. Provide Definition for an Interest that is Commensurate with Capital Contributed

Overview

Section 1061(c)(4)(B) excludes from the definition of an API “any capital interest in the partnership which provides the taxpayer with a right to share in partnership capital commensurate with the amount of capital contributed (determined at the time of receipt of such partnership interest)...” The proposed regulations do not provide a definition of an interest that is commensurate with the amount of capital contributed but rather rely on complex rules defining a partner’s share of Capital Interest Gains and Losses to determine what amounts should be excluded from the Recharacterization Amount. The approach in the proposed regulations does not appropriately consider many common economic arrangements and may result in over-recharacterization or taxable income acceleration in certain scenarios that should be excepted from the application of section 1061 pursuant to the statute.

Recommendation

The AICPA recommends that, rather than relying on complex Capital Interest Gain and Loss definitions, Treasury and the IRS provide a definition of an interest that is commensurate with capital contributed to the partnership, ensuring that the statutory exception provided in section 1061(c)(4)(B) is appropriately implemented.

Analysis

Section 1061(c)(4)(B) provides that an API does not include “any capital interest in the partnership which provides the taxpayer with a right to share in partnership capital commensurate with - (i) the amount of capital contributed (determined at the time of receipt of such partnership interest); or (ii) the value of such interest subject to tax under section 83 upon the receipt or vesting of such

¹¹ REG-107213-18, 85 Fed. Reg. 49,754 at 49,762.

¹² Prop. Reg. § 1.1061-3(f). The proposed rule also incorporates the general definition of Related Person under Prop. Reg. § 1.1061-1(a) (a person or entity who is treated as related to another person or entity under sections 707(b) or 267(b)).

interest.” In a common fund structure, the carry-partner typically contributes 1% of the capital to the fund and is allocated profits and losses on that 1% capital interest similar to the limited partners in the fund, except the carry-partner’s interest may not be subject to management fees or bear the burden of incentive allocations. Additionally, the carry-partner typically receives a disproportionate 20% share of the net profits of the fund. In this common scenario, and disregarding the effect of the management fee or carried interest allocations, the statutory language provides that any allocations with respect to the 1% capital interest are not subject to recharacterization under section 1061 because such allocations are commensurate with the capital contributed by the carry partner as compared to the capital contributed by the limited partners.

Rather than attempting to define an interest that is commensurate with capital contributed, the proposed regulations assume the entire partnership interest issued to the carry partner is an API and excepts certain allocations of gains and losses from the Recharacterization Amount calculation with respect to the interest. Relevant to this discussion is the Capital Interest Exception provided under Prop. Reg. § 1.1061-3(c). These rules have very complex defined terms and contain numerous requirements whereby standard allocations made on a capital interest could fail to meet the strict definitions provided. In order to qualify for the Capital Interest Exception, allocations must be based on each partner’s respective capital account balances,¹³ must be made in the same manner to the API Holder as to Unrelated Non-Service Partners with an aggregate capital account balance of 5% or more and must be clearly identified in the partnership agreement and on the books and records. Proposed Reg. § 1.1061-(3)(c)(1) states that allocations are made in the same manner to the extent the allocations are made based on relative capital accounts and the terms, priority, type and level of risk, rate of return, and rights to cash or property distributions during operations and upon liquidation are the same. However, an allocation to an API Holder does not fail the “in the same manner” test if the allocation is subordinated to allocations to Unrelated Non-Service Partners or if the allocation is not burdened by cost of services provided by the API Holder.

The complexities with the Capital Interest Exception approach in the proposed regulations can be illustrated with a common private equity fund structure for which allocations to the partners are initially, prior to any incentive allocations, apportioned among the partners pro rata to each partner’s investment contributions with respect to each investment. This mechanism allows for different allocations with respect to different investments to account for situations in which the partners do not participate equally in each investment. In this simple case, the Capital Interest Exception does not appear to apply to the API Holder’s capital interest because the allocations are not made pro rata to the capital account balances of the partners. Similarly, any fund with non-pro rata tax distributions would have the same issue because future allocations will be made pro rata to each partner’s investment contributions that are not in accordance with each partner’s relative capital account balance after the tax distribution.

In addition to the issues in complying with the mechanical rules of the proposed regulations, the reporting rules in Prop. Reg. § 1.1061-6 could result in an otherwise qualified allocation failing to qualify for the Capital Interest Exception simply because of a reporting deficiency. In this way, the approach in the proposed regulations is overly broad as it applies to qualifying allocations.

¹³ Generally, Passthrough Entities that do not maintain section 704(b) capital account may determine capital accounts using principles similar to section 704(b).

Further, the approach in the proposed regulations is not comprehensive. For example, Prop. Reg. § 1.1061-5¹⁴ provides that certain related partner transfers may cause an otherwise non-taxable transaction to become a taxable event. Under section 1061(d), the related party transfer rules only apply to the transfer of an API. If a carry-partner transfers an interest that when issued was commensurate with capital contributed, it is not by definition the transfer of an API. Accordingly, under the statute the carry-partner's transfer of its capital interest should not be subject to the related party transfer rules. However, it is unclear how gains attributable to the capital interest are excepted from the section 1061(d) calculation provided in Prop. Reg. § 1.1061-5(a).

The preamble to the proposed regulations states that “the disposition of a capital interest will be treated as such under section 1061 and the gain or loss on the disposition is treated as Capital Interest Gain or Loss if the interest being disposed of is clearly identified as a capital interest.” Given the extraordinary complexity involved in the definition of Capital Interest Gains and Losses, it is not certain that a pure capital interest will always escape recharacterization as is provided in the statute. Further, the application of the Capital Interest Disposition Amount definition through tiered partnership structures will be difficult to apply in practice, and it is not clear if a failure to gather all of the required information from lower-tier entities would taint the entire gain or loss from the disposition of the capital interest.

We suggest the final regulations abandon the mechanical rules of the proposed regulations in favor of a simplified approach that defines an interest that is commensurate with the capital contributed by a service provider. In many fact patterns, it is easy to delineate a partner's capital interest and incentive interest. In less certain fact patterns, there may be some complexities that could result in attempting to define an interest that is commensurate with capital contributed. The complexities can best be managed by providing a simple general rule aimed at ensuring a service provider's capital interest is outside the scope of section 1061 in accordance with the statute while addressing a few specific items outlined below:

1. If a service provider does not withdraw its incentive allocation (i.e., the partner reinvests its incentive allocation) resulting in a greater sharing percentage moving forward, are the earnings on the reinvested incentive allocation eligible for the Capital Interest Exception? We believe, consistent with the proposed regulations, that allocations on reinvested incentive allocations should qualify for the Capital Interest Exception.
2. To the extent a service provider receives a distribution from the partnership, how should the partnership bifurcate the distribution between the partner's incentive interest and capital interest?

If our recommended approach is not adopted, we recommend clarification of the Capital Interest Exception in the proposed regulation for the following points:

1. Modify the requirement for pro rata allocations to capital account balances to account for the many fund structures that do not and cannot allocate profits and losses pro rata to capital accounts;

¹⁴ See IV, below, for further analysis of section 1061(d).

2. Are both management fees and carried interest allocations considered costs of services provided by the API Holder? For the current Capital Interest Exception to have any applicability, a service provider's capital interest that is not subject to carry allocations nor management fees should qualify as long as the other requirements are met; and
3. Please provide further details on what differences in rights between the interests of an API Holder and non-service provider could cause the allocations to not be considered made in the same manner. It is generally the case that the capital interest held by most API Holders will have slightly different legal rights and it is currently unclear what differences run afoul of the proposed regulations.

B. Remove Capital Interest Exception Loan Rule

Recommendation

The AICPA recommends removing Prop. Reg. § 1.1061-3(c)(3)(ii)(C).

Analysis

The AICPA recommends removal of Prop. Reg. § 1.1061-3(c)(3)(ii)(C) from the final regulations because there is no specific indication in section 1061 and legislative history suggesting that the Capital Interest Exception should be turned on or off depending on how a partner funds its capital contribution. Moreover, the general federal income tax principles and the substance over form doctrine should already apply to recharacterize certain abusive loan transactions negating the need for a specific section 1061 regulatory rule. Also, such a rule may be unnecessarily burdensome (e.g., depending on how the rule is applied, a significant amount of tracking may be required for reporting purposes in the case of a series of loans and a series of repayments, even when the loan amounts are immaterial to the overall capital invested in the partnership).

If the final regulations retain Prop. Reg. § 1.1061-3(c)(3)(ii)(C), specific comments are needed regarding the operation of the rule as stated below.

ii. Alternative Specific Comments if the Recommendation to Remove the Capital Interest Exception Loan Rule is Not Adopted

A. Removal of a Guarantee Increases Capital Accounts

Recommendation

The AICPA recommends that the removal of a guarantee described in Prop. Reg. § 1.1061-3(c)(3)(ii)(C) increases capital accounts for purposes of the Capital Interest Exception (i.e., clarify that amounts included in the Capital Interest Exception are not limited solely to "repayments" of loans).

Analysis

Under the proposed regulations, a third-party bank loan made to fund the capital contribution of an Owner Taxpayer does not give rise to a capital account eligible for the Capital Interest Exception if the loan is guaranteed by the partnership, another partner, or a person related to the partnership or another partner.¹⁵ Depending on how other terms of a loan are affected, the removal of the guarantee may or may not result in a “significant modification” and a deemed exchange of the original debt instrument under Treas. Reg. § 1.1001-3(b).

However, if a guarantee described in Prop. Reg. § 1.1061-3(c)(3)(ii)(C) caused exclusion of the capital account funded by the loan proceeds from the Capital Interest Exception under the policy rationale of the rule, it appears that the removal of the guarantee should give capital account credit for purposes of the Capital Interest Exception regardless of repayment or exchange of the loan (either actual or deemed).

B. Certain Repayments Included in the Capital Interest Exception

Recommendation

The AICPA recommends including repayments in the Capital Interest Exception with respect to any gains recognized by the partnership and allocated to the partners after the date of the repayment (i.e., clarify that partnerships need not bifurcate Unrealized API Gains and Losses in the periods before versus periods after each repayment on loans described in Prop. Reg. § 1.1061-3(c)(3)(ii)(C)).

Analysis

A repayment of a loan described in Prop. Reg. § 1.1061-3(c)(3)(ii)(C) appears to give capital account credit with respect to the operation of the Capital Interest Exception for any gains recognized and allocated by the partnership after the date of the repayment. There appears to be no requirement in the proposed regulations for the partnership to bifurcate Unrealized API Gains and Losses economically accrued before and after the repayment. This is the correct approach, and any approach that requires a bifurcation based on specific repayment dates and amounts is not administrable given that repayments typically occur over a long series of payments.

C. Transition Rule

Recommendation

The AICPA recommends that the final regulations include a transition rule for loans described in Prop. Reg. § 1.1061-3(c)(3)(ii)(C) that entered into before the proposed regulations were published.

¹⁵ Prop. Reg. § 1.1061-3(c)(3)(ii)(C).

Analysis

The AICPA's understanding is that it is relatively common for the general partner or management company of an investment management partnership to provide loans or loan guarantees to allow individual service providers in the ATB (for example, new members) to make capital contributions to the partnership. Many of these arrangements were entered into as a general business practice before the enactment of section 1061. Neither section 1061 nor its legislative history address the loan arrangements described in Prop. Reg. § 1.1061-3(c)(3)(ii)(C). Assuming these existing arrangements were not entered into with a principal purpose of circumventing section 1061(a) and qualifying for the capital interest exception of section 1061(c)(4)(B)(i), a limited transition rule is appropriate.

III. Expand the Unrelated Purchaser Exception

Overview

The proposed regulations added a non-statutory exception from section 1061 for interests in a partnership purchased by an unrelated taxpayer that is otherwise an API. This helpful exception only applies with respect to partnership interests purchased for fair market value in a transaction to which section 1061(d) does not apply. Contributions to a partnership are not covered by this exception.

Recommendation

The AICPA recommends expansion of the unrelated purchaser exception in Prop. Reg. § 1.1061-3(d) to include interests acquired by an unrelated taxpayer through a contribution.

Analysis

The additional exception added by Treasury and the IRS for unrelated purchasers provided clarity and better targets the effect of section 1061 to service providers. It is our understanding that it is common for investment fund managers to seek outside capital for purposes of operating their trade or business. These transactions often involve a contribution to or sale of interests in an upper-tier partnership that holds the carried interest in various lower-tier investment funds. To the extent the requirements of Prop. Reg. § 1.1061-3(d) are met, the proposed regulations provide that the allocations to these unrelated third parties are not subject to section 1061. This is a reasonable result as the purpose of section 1061 is to ensure taxation of service providers at ordinary rates, rather than at the beneficial long-term capital gains rates.

The proposed regulations, however, require purchase of an interest in a partnership for fair market value to qualify for the exception. A contribution to a partnership by an unrelated third party is an equivalent transaction to the purchase of a partnership interest for these purposes. Such contribution should be excepted from the application of section 1061 under the same policy reasons as a taxable purchase.

IV. Correct Recharacterization Amount Calculation

Overview

The proposed regulations' definition of API One Year Distributive Share Amount reported to an Owner Taxpayer or API Holder includes net long-term capital gains, but not net long-term capital losses, with the result that the Owner Taxpayer's Recharacterization Amount is overstated. This result is inconsistent with the partial entity approach described in the preamble to the proposed regulations.

Recommendation

The AICPA recommends that Treasury and the IRS modify the definition of API One Year Distributive Share Amount to include an API Holder's distributive share of net long-term capital gain or loss from the partnership with respect to the API [emphasis added].

Analysis

The preamble to the proposed regulations describes various approaches considered by Treasury and the IRS to define "taxpayer" for purposes of section 1061, including the aggregate approach, the partial entity approach, and the full entity approach. The preamble identifies various benefits and detriments of each approach before concluding that the partial entity approach is the appropriate methodology utilized in the proposed regulations. Under the partial entity approach, the existence of an API is determined at the entity level but the recharacterization calculation is done only at the individual, estate, or trust level (i.e., the Owner Taxpayer level). The preamble states that by allowing the recharacterization to happen at the Owner Taxpayer level, an Owner Taxpayer that owns multiple APIs indirectly through one or more Passthrough Entities can net the amounts that are subject to section 1061 from the various APIs to determine the Recharacterization Amount. The economic analysis included in the proposed regulations states that a full entity approach (where recharacterization would happen at the passthrough entity level) would lead to increased recharacterizations because individuals would not be able to net gains and losses across multiple APIs.

Proposed Reg. § 1.1061-4(a)(1) provides that an Owner Taxpayer's Recharacterization Amount is equal to such Owner Taxpayer's One Year Gain Amount less its Three Year Gain Amount. An Owner Taxpayer's One Year Gain Amount is the Owner Taxpayer's combined net API One Year Distributive Share Amount from all APIs held during the taxable year plus any API One Year Disposition Amounts. An Owner Taxpayer's API One Year Distributive Share Amount includes the "API Holder's distributive share of net long-term capital gain from the partnership for the taxable year." As such, this definition omits an Owner Taxpayer's distributive share of net long-term capital loss from an API.

Example

Owner Taxpayer owns two separate APIs through separate Passthrough Entities and has no API One Year Disposition Amount. Both Passthrough Entities are partnerships.

Assume that the Owner Taxpayer's distributive share from the first partnership is a \$(100) long-term capital loss from an asset held less than three years, and that his distributive share from the second partnership is a \$100 long-term capital gain from an asset held less than three years.

Under the partial entity approach described in the preamble, the Owner Taxpayer should be able to combine the \$100 net capital gain from one API against the \$(100) net capital loss from the other API, resulting in no section 1061 recharacterization. However, under the proposed regulations the first partnership would report an API One Year Distributive Share Amount of \$0 and the second partnership would report an API One Year Distributive Share Amount of \$100. The Owner Taxpayer's One Year Gain Amount in this case would accordingly be \$100, and the Owner Taxpayer's Three Year Gain Amount would be nil resulting in a \$100 Recharacterization Amount. The resulting recharacterization is greater than should happen under a partial entity approach.

Section 1061(a) provides that if a taxpayer holds one or more APIs, its net long-term capital gain with respect to those interests is subject to recharacterization. The partial entity approach's goal of the preamble is consistent with the statute in allowing full netting of gains and losses from all APIs held by an Owner Taxpayer. As such, we recommend modification of the definition of API One Year Distributive Share Amount to include an API Holder's distributive share of net long-term capital gain or loss from an API.

V. Eliminate Mandatory Revaluations Through Tiered Partnership Structures

Overview

The proposed regulations' framework utilizing the section 704(b) capital accounts to determine Capital Interest Gains and Losses also requires tracking any Unrealized API Gains and Losses that have adjusted the capital accounts to ensure that those gains and losses, when ultimately realized, are allocated to the API Holder as API Gains and Losses subject to recharacterization. The proposed regulations require tracing these unrealized gains and losses to the lowest asset level by requiring mandatory revaluations for section 1061 purposes through tiered partnership structures in certain circumstances. These circumstances include a revaluation of property of a partnership that owns a tiered structure of partnerships and the contribution of an API to another Passthrough Entity. The revaluation required for section 1061 purposes identifies the API Holder's Unrealized API Gains and Losses allocated directly or indirectly to the API holder by the lower-tier partnerships as if a taxable disposition of the property of each lower-tier partnership also occurred on the date of the revaluation or transfer. If a revaluation is required for section 1061 purposes, the partnership is permitted to revalue property for purposes of section 704(b).

Recommendation

The AICPA recommends that Treasury and the IRS eliminate the mandatory section 1061 revaluation rules for tiered partnership structures. If Treasury and the IRS are concerned that upper-tier partnerships will attempt to circumvent section 1061 using lower-tier partnerships,

create an anti-abuse rule whereby section 1061 revaluations are mandatory solely in the case of controlled partnership structures.

If the regulations maintain a mandatory section 1061 revaluation regime, guidance is needed on the effect of a lower-tier partnership's failure to revalue its assets. In this case, Treasury and the IRS should provide general rules under section 704(c) allowing taxpayers to use any reasonable approach in allocating gains and losses allocated from a lower-tier partnership that was previously revalued by the upper-tier partnership.

Analysis

The mandatory nature of the section 1061 revaluation is overly burdensome and is generally not feasible in structures where an upper-tier partnership does not control each lower-tier partnership. Additionally, it is unclear how a revaluation made only for section 1061 purposes is intended to coordinate with the actual tax allocations made under sections 704(b) and 704(c) upon the gain or loss recognition.

The proposed regulations provide that an Owner Taxpayer includes its distributive share of net long-term capital gain from the partnership less its Capital Interest Gains and Losses (among other adjustments) in determining its Recharacterization Amount. Capital Interests Gains and Losses do not include API Gains and Losses and Unrealized API Gains and Losses.¹⁶ The proposed regulations also provide that long-term Unrealized API Gains and Losses are API Gains and Losses subject to section 1061 when the gains and losses are recognized.¹⁷ The proposed regulations further provide that if a partnership that owns a tiered structure of partnership revalues its property, or an API is contributed to another passthrough entity, a revaluation must be done for section 1061 purposes through the chain of partnerships to ensure that any Unrealized API Gains and Losses ultimately become API Gains and Losses allocable to the API Holder.¹⁸ The proposed regulations permit a partnership that is required to revalue its assets for purposes of section 1061 to also revalue its assets for purposes of section 704(b).

There are two stated reasons for the mandatory section 1061 revaluations. The first is to ensure that API Gains and Losses are not converted to Capital Interest Gains and Losses by virtue of a revaluation or a contribution. The second is to ensure that Unrealized API Gains and Losses of a partnership when recognized are properly allocated to the correct API Holder in a tiered partnership structure.

To illustrate the significant complexity and administrative burden of these rules, consider an example of an investment fund partnership that solely invests in other investment fund partnerships (i.e., a "fund of funds"). It is not uncommon for a fund of funds to own hundreds or thousands of minority interests in lower-tier partnerships. A fund of funds also typically has a general partner that may have a carried interest entitlement, and thus there is a partner that holds an API in the fund of funds. If the fund of funds revalues its assets and there is an Unrealized API Gain or Loss allocated to the general partner's interest, the section 1061 mandatory revaluation rules would

¹⁶ Prop. Reg. § 1.1061-3(c)(3)(iii).

¹⁷ Prop. Reg. § 1.1061-2(a)(1)(ii)(A).

¹⁸ Prop. Reg. § 1.1061-2(a)(1)(ii)(B).

require each of the lower-tier partnerships to revalue its assets solely for section 1061 purposes. Each lower-tier partnership could own several other lower-tier partnership interests requiring each to revalue its assets for section 1061 purposes. It is quite possible that none of the lower-tier partnerships in the structure would have otherwise revalued its property under the section 704(b) regulations. As a result, one indirect fund of funds partner in a tiered structure could cause numerous cascading revaluations to effectuate an anti-abuse regulation. In this situation, however, the fund of funds is not attempting to circumvent the application of section 1061 using tiered partnerships, but rather is operating in the normal course of business.

It is also unclear how the section 1061-only revaluations and the requirement to allocate Unrealized API Gains and Losses back to the API Holder for purposes of section 1061 would operate with the allocation rules of section 704(b) in the case of a lower-tier partnership that revalues for purposes of section 1061 but not for section 704(b). A section 1061 revaluation could lock in certain Unrealized API Gains and Losses to an API Holder. If the same gains are not locked in for section 704(c) purposes, allocation to the API Holder of such specific gains and losses would not occur upon recognition. This disconnect between tax allocations and requirement under section 1061 to allocate Unrealized API Gains and Losses back to the API Holder when recognized may be difficult to reconcile.

Example

An API Holder holds an interest in an upper-tier partnership (UTP) that revalues its assets under section 704(b). The revaluation results in a \$20 revaluation gain allocable to the API Holder, and an \$80 gain allocable to other UTP partners, all of which is attributable to an interest in a lower-tier partnership (LTP). Under the proposed regulations, this transaction results in a section 1061 revaluation at LTP. Assume further, that if there was a hypothetical sale of LTP's assets on the revaluation date, the API Holder would have been indirectly allocated a \$20 gain from LTP Asset A and the other UTP partners allocated \$80 of gain from LTP Asset A. Also assume that LTP did not revalue its assets under section 704(b) at the time of the section 1061 revaluation. In the following year, Asset A is sold by LTP and the section 704(b) allocations at LTP for that year result in only \$10 of the gain on Asset A allocated to UTP, with \$2 of that gain allocated by UTP to API Holder.

This fact pattern is common and raises the following questions on application of the rules in the proposed regulations:

- Does the earmarking of \$20 of the revaluation gain as an Unrealized API Gain or Loss taint the \$10 allocation by LTP to UTP, in a circumstance where LTP's section 704(b) allocations would not have allocated more gain to UTP?
- Does the failure to allocate the Unrealized API Gain and Loss to UTP in full taint UTP's ability to comply with the proposed regulation's requirements, and taint any Capital Interest Gain and Loss allocations?
- At the UTP level, must all the \$10 of gain allocated by LTP to UTP be allocated to API Holder, even though the API Holder partner and the other partners at UTP should have shared in that gain 20% and 80%?

- What mechanisms are to be put into place to identify specific Unrealized API Gains and Losses by LTP such that UTP can identify them?

The section 704(c) regulations discuss tiered partnerships but only provide specific tiered allocation rules in situations where a partnership contributes section 704(c) property to a lower-tier partnership or when a partner that contributed section 704(c) property to a partnership contributes that partnership interest to a section partnership. In general, these tiered partnership scenarios require allocation of the gain or loss attributable to the section 704(c) property back to the original contributor through the tiered structure. Outside of these scenarios, tiered partnership structures lock in revaluation gain to the lower-tier partnership interest, and the section 704(c) regulations provide no specific rules for “looking through” the interest to the assets of the lower-tier partnership in order to apply section 704(c) to the gain from the asset when realized. Some upper-tier partnerships may treat the section 704(c) as only in the interest, and others may adopt a reasonable method of allocating tax gains from the lower-tier to the section 704(c) layer in the partnership interest.

Outside of controlled partnership scenarios created for section 1061 purposes, it is unclear why significantly more complex and burdensome rules are required for the allocation of certain types of long-term capital gains and losses to a limited subset of partners under section 1061 than the actual allocation of taxable income items under section 704(c). Treasury and the IRS could minimize section 1061 concerns and enhance the application of section 704(c) by providing general rules under section 704(c) allowing taxpayers to use any reasonable approach in allocating gains and losses allocated from a lower-tier partnership that was previously revalued by the upper-tier partnership. The proposed regulations should rely on the current, longstanding section 704(c) rules to ensure that gains and losses are not inappropriately shifted among partners for both section 704(c) and section 1061 purposes.

VI. Transfers of Applicable Partnership Interests to Related Parties

Overview

Section 1061(d) provides that if a taxpayer transfers an API, directly or indirectly, to a related person described in section 1061(d)(2), the taxpayer is required to include in gross income (as short-term capital gain) the excess of: (1) the net built-in long-term capital gain in assets attributable to the transferred interest with a holding period of three years or less; over (2) the amount of long-term capital gain treated as short-term capital gain under section 1061(a) at the time of the transfer. A related person is defined, in part, as a person that is a member of the taxpayer’s family within the meaning of section 318(a)(1).¹⁹

The proposed regulations define and clarify certain key terms and provisions associated with the application of section 1061(d). For example, Prop. Reg. § 1.1061-5(b) provides that the term “transfer” includes (but is not limited to) contributions, distributions, sales and exchanges, and gifts.²⁰ The proposed regulations also provide that gain recognition in this context is required

¹⁹ Section 1061(d); Prop. Reg. § 1.1061-5(e)(1).

²⁰ Prop. Reg. § 1.1061-5(a).

regardless of recognition of the gain upon the transfer.²¹ Further, Prop. Reg. § 1.1061-2(a)(1)(v) confirms that grantor trusts and disregarded entities will be disregarded for purposes of section 1061 (including with respect to section 1061(d)).²²

Despite the welcome clarification for the treatment of grantor trusts, the proposed regulations do not clearly address a few areas related to transfers to trusts and estates under section 1061(d). For example, it is unclear whether an API that passes to an estate by reason of the taxpayer's death should trigger gain under section 1061(d) and Prop. Reg. § 1.1061-5(b). In addition, while gain recognition is not required for transfers made to grantor trusts, the tax treatment of transfers made to non-grantor trusts (including conversions from grantor to non-grantor status) remains uncertain.

i. Application to General Nonrecognition Transactions

Recommendation

The AICPA recommends that the application of section 1061(d) should remain limited to taxable transfers, and that nonrecognition continue for contributions, gifts, death and otherwise nontaxable transfers of an API. In this respect, a nontaxable transfer also includes the deemed transfer of assets pursuant to a trust's conversion from a grantor trust to a non-grantor trust (due to the death of the grantor or other event).

Analysis

If the application of section 1061(d) is not limited to taxable transfers, this provision would convert some otherwise nontaxable transfers to taxable events, contrary to the legislative intent of section 1061. While most taxpayers are compensated with wages in exchange for their services, investment fund managers in the financial services industry are typically compensated with the grant of a profits interest in a partnership, thereby entitling them to a disproportionate share of the future profits of the funds that they manage. Because the fund manager's distributive share of the partnership's income in this context is typically received in the form of long-term capital gains, this compensation is taxed at preferential long-term capital gains rates, rather than ordinary income tax rates. Congress enacted section 1061 to address this result, and it appears that section 1061 was not intended to accelerate income recognition; rather, the provision aimed to eliminate the tax rate discrepancy between traditional forms of compensation (such as wages and other earned income derived from the performance of services), and the carried interest derived by fund managers in their capacity as partners.

Furthermore, if an API is transferred to a section 1061(d) Related Person, the operational rules of section 1061 will apply to the transferee since an API remains an API in the hands of the holder (unless or until an exception applies).²³ Because a contribution, gift, or other transfer of an API will not cleanse its taint in the hands of the transferee, Treasury and the IRS are not disadvantaged by permitting such transfers to remain nontaxable to the transferor.

²¹ Prop. Reg. § 1.1061-5(a).

²² Prop. Reg. § 1.1061-2(a)(1)(v).

²³ Prop. Reg. § 1.1061-2(a)(1)(i).

ii. Alternative Exceptions in Certain Circumstances

Recommendation

Alternatively, the AICPA recommends that a transfer²⁴ should specifically exclude a transfer to an estate by reason of the taxpayer's death (or upon conversion of a grantor trust to a non-grantor trust based on the grantor's death), to the extent a beneficiary of an estate (or trust) is considered a related party under section 318(a)(1). Upon the distribution of the API from the estate or trust to a beneficiary, section 1061(d) would apply. Additionally, exclude transfers to non-grantor trusts (or conversions of a grantor trust to a non-grantor trust) from the application of section 1061(d). Section 1061(d) would apply upon the distribution of the API from the trust to a beneficiary.

Analysis

Proposed Reg. § 1.1061-5(b) provides that the term "transfer" includes, but is not limited to, contributions, distributions, sales and exchanges, and gifts. The proposed regulations do not explicitly address whether a transfer to an estate by reason of the taxpayer's death is considered a transfer requiring the taxpayer to accelerate the recognition of capital gain. Further, because this provision applies to both direct and indirect transfers,²⁵ it is unclear whether the mere transfer of an API to an estate with related party beneficiaries, and/or a distribution of an API from the taxpayer's estate to a related party beneficiary, is an indirect transfer covered under section 1061(d). If the transfer of an API to an estate is considered an indirect transfer, decedents would be required to recognize short-term capital gain of their proportionate share of the API's net long-term capital gain from assets held for three years or less, upon death. The basis step-up provided by section 1014(a) would also not apply because the section 1061(d) recognition event is deemed to occur "immediately prior to the [taxpayer's] transfer of the API."²⁶

It has long been held that no income or gain is recognized at death upon the transfer of property to the decedent's estate and beneficiaries. Based upon this fundamental income tax principle, the final regulations should explicitly exclude API transfers to an estate by reason of death from the definition of transfer under Prop. Reg. § 1.1061-5(b). Excluding transfers to an estate by reason of death from the provisions of section 1061(d) is consistent with the exception for contributions to partnerships under section 721(a).²⁷ This result is also consistent with a similar provision found within the final Opportunity Zone regulations,²⁸ which provide that the transfer of a qualifying investment by reason of the taxpayer's death to the deceased owner's estate is not considered an inclusion event triggering gain recognition.²⁹

Additionally, the final regulations should clarify that the term "Section 1061(d) Related Person"³⁰ does not include an estate. The preamble to the proposed regulations indicates that a related person

²⁴ Under Prop. Reg. § 1.1061-5(b).

²⁵ Prop. Reg. § 1.1061-5(a).

²⁶ Prop. Reg. § 1.1061-5(c).

²⁷ Prop. Reg. § 1.1061-5(e)(2).

²⁸ T.D. 9889.

²⁹ Treas. Reg. § 1.1400Z2(b)-1(c)(4)(A).

³⁰ Under Prop. Reg. § 1.1061-5(e).

in this context is defined “more narrowly” than a related person for purposes of section 1061(c)(1), and only includes members of the taxpayer’s family within the meaning of section 318(a)(1).³¹ While attribution from an estate to its beneficiaries is covered by section 318(a)(2), and not section 318(a)(1), it is unclear whether the conveyance of an API to an estate with related party beneficiaries is considered an indirect transfer under this provision. If the final regulations explicitly clarify that an estate is not considered a Section 1061(d) Related Person, it would eliminate any ambiguity arising from whether an indirect transfer supersedes the intended “more narrow” definition of a related party.

Section 1061 treatment does not apply to the extent a taxpayer’s capital gains derived from an API are attributable to property held for more than three years. In other words, taxpayers who hold an interest in an API can circumvent the application of this provision to the extent they defer the recognition of capital gains from certain assets, unless or until they meet the relevant holding period requirements. For this reason, requiring a decedent to recognize income at death (by treating a transfer to an estate as a transfer to a related party) both undermines the purpose of section 1061.

In addition, the definition of transfer under section 1061(d) should not include transfers to non-grantor trusts and conversions of grantor trusts to non-grantor trusts. The proposed regulations as currently drafted would place an undue administrative burden on both taxpayers and tax practitioners and would also present enforcement challenges for the IRS. For example, taxpayers routinely make gifts to grantor and non-grantor trusts for legitimate non-income tax reasons as part of routine estate and gift tax planning. However, Prop. Reg. § 1.1061-5(a) provides that gain recognition is required whenever a taxpayer transfers an API to a section 1061(d) Related Person either directly or indirectly. Because a non-grantor trust is not considered a member of the taxpayer’s family within the meaning of section 318(a)(1),³² the application of section 1061(d) is dependent upon the question of whether a transfer in trust is considered an indirect transfer to the beneficiaries, as well as whether those beneficiaries are considered section 1061(d) Related Persons.

Based on analogous guidance in the gift tax context, transfers in trust can be considered indirect transfers to the trust beneficiaries.³³ However, the underlying terms of the trust agreement may call into question whether a transfer has occurred, leading to both confusion and uncertainty for advisors trying to determine whether section 1061(d) applies to a particular situation. For example, the transfer of an API to a non-grantor trust with multiple beneficiaries might represent a gift of a present interest, depending upon whether the trust agreement contains a *Crummey* right of withdrawal.³⁴ If the beneficiaries of the trust do not have the unrestricted right to use, possess, or enjoy income from the API,³⁵ the beneficiaries will not have a present interest in the API property, and arguably no indirect transfer has occurred.

³¹ Section 318(a)(1)(A) provides that an individual is deemed to own stock owned (directly or indirectly) by his or her spouse, children, grandchildren, and/or parents.

³² Attribution from trusts to beneficiaries is covered under section 318(a)(2), and attribution from beneficiaries to trusts is covered under section 318(a)(3).

³³ Treas. Reg. § 25.2503-2(a) (“In the case of a gift in trust the beneficiary of the trust is the donee”).

³⁴ Section 2503(b).

³⁵ Treas. Reg. § 25.2503-3(b).

Similarly, fully discretionary trusts present another unique set of issues. If trust distributions are to be made entirely at the discretion of the trustee, it will be inherently uncertain when, if, and to whom those distributions may or may not be made. This is especially true for non-grantor trusts with a mix of beneficiaries who are both related and unrelated to the transferor. Common examples of unrelated beneficiaries include the grantor's friends, siblings, and charitable beneficiaries, none of whom would be considered a related party under section 318(a)(1). In those cases, the ultimate recipient of the API property may not be determinable upon transfer.

Addressing these questions for each taxpayer would add time, complexity, and inefficiency to the compliance process. Providing in the final regulations that any interest in an API transferred to a non-grantor trust will retain its character as an API, with immediate gain recognition required by the trust only if the API is actually distributed to a section 1061(d) Related Party beneficiary, alleviates these administrative burdens and eliminates the inherent ambiguity in the proposed regulations.

Consider the transfer of an API to a fully discretionary non-grantor trust with beneficiaries who are both related (under section 318(a)(1)) and unrelated to the original API holder (i.e., grantor). Because this transaction is not considered a transfer under Prop. Reg. § 1.1061-5(b), no gain is recognized by the transferor, and the transferred interest remains an API to the non-grantor trust.³⁶ If the trust subsequently recognizes any gain attributable to API property with a holding period of three years or less, the trust is required to characterize such gain as short-term. To alleviate any concerns that these gains are offset by capital losses or other deductions from non-API property at the trust level, Treasury and the IRS could also adopt rules for trusts holding an interest in an API similar to those that apply to electing small business trusts holding shares of S corporation stock.³⁷ This rule would ensure that capital gains from the API property are subject to the top marginal tax rate, and prevent such gains from inclusion in the trust's distributable net income (allowing inclusion in the income of lower tax bracket beneficiaries). Further, the trust would recognize short-term capital gain if the non-grantor trust distributes API property with a holding period of three years or less to a beneficiary considered a section 1061(d) Related Person. This result maintains the integrity of section 1061(d) by requiring income recognition upon the transfer of the API, but only when the amount so transferred to a related party becomes fixed and determinable.

VII. Ease and Clarify Reporting Requirements

Overview

The proposed regulations introduce significant reporting requirements for passthrough entities that issue an API, including the imposition of a substantial burden on passthrough entities that are part of a tiered partnership structure. These new reporting requirements are intended to assist an API Holder with computing the One Year and Three Year Gain Amounts. The failure of a passthrough entity to gather and report all required information punitively results in the Owner Taxpayer losing the benefit of various exceptions provided in the statute and regulations and effectively requires short-term capital gain or loss treatment for the distributive share of items of capital gain or loss.

³⁶ Prop. Reg. § 1.1061-2(a).

³⁷ Treas. Reg. § 1.641(c)-1.

Recommendation

The AICPA recommends that Treasury and the IRS ease the reporting burden on passthrough entities, provide further details on actions required to otherwise substantiate unreported amounts, and clarify that only amounts that are adequately substantiated are taken into account in the Owner Taxpayer's Recharacterization Amount.

We suggest that Treasury and the IRS provide that an upper-tier Passthrough Entity may use any reasonable approach to estimate the amounts generated by a lower-tier Passthrough Entity, provided that the reasonable approach is used consistently. Further, we suggest allowing inclusion of information provided by a lower-tier Passthrough Entity within 60 days of the extended due date of the upper-tier Passthrough Entity's tax return in the following tax year's disclosures.³⁸ We also suggest allowing real estate investment trusts (REITs) and regulated investment companies (RICs) to supplement capital gain disclosures made to shareholders by the extended tax return due date.

Analysis

Proposed Reg. § 1.1061-6(b)(1) requires each passthrough entity that has issued an API to furnish to the API holder and the IRS the following information:

- The API One Year Distributive Share Amount and the API Three Year Distributive Share Amount;
- Capital gains and losses allocated to the API holder that are excluded from section 1061;
- Capital Interest Gains and Losses allocated to the API holder;
- API Holder Transition Amounts; and
- If an API Holder of an interest in a passthrough entity disposes of the interest during the taxable year, any information required by the API holder to properly take the disposition into account under section 1061, including information to apply the Look-through Rule and to determine its Capital Interest Disposition Amount.

To the extent a passthrough entity requires information from a lower-tier entity to meet its reporting requirements, it must request such information from the lower-tier passthrough entity by the later of the 30th day after the close of the taxable year or 14 days after the date of a request for the information from an upper-tier passthrough entity. If a passthrough entity receives a request, it must furnish the information generally no later than its extended tax return due date. Failure to provide the information required under the proposed regulations is subject to penalties under section 6722.

If an upper-tier passthrough entity does not receive the required or requested information, the upper-tier passthrough entity must take actions to otherwise determine and substantiate the missing

³⁸ We note the same issue exists with tiered partnership structures and the issuance of Schedules K-1. Tiered partnership structures are prevalent in the modern business landscape for significant non-tax reasons. As such, it would be helpful if Treasury and IRS were to provide reasonable relief to enable upper-tier partnerships to utilize estimates in preparing tax returns to enable the timely provision of tax information to partners.

information. To the extent that the upper-tier passthrough entity is not able to otherwise substantiate and determine the missing information, the upper-tier passthrough entity (and Owner Taxpayer) must treat the amounts as described below and is required to provide notice to the API holder and the IRS regarding the inability.

If an Owner Taxpayer is not furnished with the required information from a passthrough entity, and the Owner Taxpayer is not otherwise able to substantiate all or part of certain amounts to the satisfaction of the government, 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. Also, for purposes of determining an Owner Taxpayer's API Three Year Distributive Share Amount, no items in the API One Year Distributive Share Amount are treated as items that would be long-term capital gain or loss if three years is substituted for one year.

Similar reporting requirements apply to REITs, RICs, and passive foreign investment company (PFICs) for which a qualified electing fund (QEF) election has been made. However, the regulations generally permit rather than require those entities to report the information outlined in the regulations. REITs and RICs are generally required to make the disclosures when the capital gain dividend is reported or designated. The timing considerations for REITs and RICs are exacerbated compared to those of other passthrough entities because capital gain disclosures are generally required to be provided within 30 days of the end of the taxable year.

The requirement for an upper-tier passthrough entity to request information from lower-tier entities that are not required to provide such information until the extended due date will make it difficult for upper-tier passthrough entities to timely comply with the required disclosures. While the regulations provide that an upper-tier passthrough entity may otherwise substantiate various items in order to take advantage of those amounts in determining its required disclosures, there are no details on what this substantiation entails or the manner presented to Owner Taxpayers. Further, there is no discussion on the effect of untimely disclosures from lower-tier passthrough entities, including whether the untimely disclosures can be taken into account in the upper-tier passthrough entity's disclosures.

VIII. Transition Rules

Overview

Before the enactment of section 1061, partnerships did not typically track, nor have reason to track, unrealized appreciation in partnership assets attributable to capital interests. The proposed regulations contain a transition rule whereby a partnership that was in existence on or before January 1, 2018 may irrevocably elect to treat all long-term capital gains and losses from the disposition of all assets as Partnership Transition Amounts, regardless of whether they would be API Gains or Losses in prior periods, that were held by the partnership for more than three years. Partnership Transition Amounts that are allocated to an API holder are not taken into account in determining the Recharacterization Amount.

Recommendation

The AICPA recommends allowing a revocation of the transition amount election upon publication of the final regulations and recalculation of the Partnership Transition Amounts under the final rules. We also request that Treasury and the IRS provide further details on the simplification intended by this election and to provide flexibility with respect to the election.

Analysis

We appreciate Treasury and the IRS recognizing the need for a transition rule for taxpayers in order to simplify calculations and comply with these new rules. However, the Partnership Transition Amount election is situationally fact-dependent to such an extent that taxpayers and practitioners are unclear of the effect of the election. The potential changes published in final regulations only exacerbate this uncertainty. The section 1061 calculations in the proposed regulations are complicated and taxpayers' projections on the benefit or harm of this election may depend on future facts not known to the taxpayer. Their determination may not be correct based on any interim changes before final publication. Transparency and fairness are essential to a well-administered tax system. While the transition rule would likely simplify certain calculations regarding basis, recharacterization amounts, and certain dispositions of interests regarding the look-through rule, taxpayers may unintentionally be whipsawed by an irrevocable election.