FRIED FRANK

To Our Clients and Friends

Memorandum

August 3, 2020

Treasury Releases Carried Interest Guidance

On July 31, 2020, the U.S. Treasury Department and the IRS released long-awaited proposed regulations on the three-year carried interest holding period rule enacted in 2017 (the "Proposed Regulations").[1] The guidance answers some questions, but it also raises significant issues for many carried interest arrangements and potentially certain employee investment programs.

EXECUTIVE SUMMARY: KEY TAKEAWAYS

1. Basic Rule: Capital gain allocated in respect of, or generated upon the sale of, a carried interest is generally treated as long-term capital gain only if the holding period for the underlying asset or interest is more than three years (as compared to the generally applicable rule of more than one year). The relevant holding period is generally that of the direct owner of the asset or interest in question. However, a special lookthrough rule may apply to the sale of a carried interest held for more than three years. A carried interest generally retains its status as such, regardless of change in ownership or circumstances, unless and until an exception applies.

2. Exempt Gain: Section 1231 gain, qualified dividend income and gain from Section 1256 contracts and certain mixed straddles are not subject to the three-year holding period rule.

3. Limited Corporate Exception: The three-year holding period rule cannot be avoided by holding a carried interest through an S corporation or a passive foreign investment company with a QEF election.

4. Capital Interest Exception: Under complex rules, the three-year holding period rule does not apply to "capital interests," which term is narrowly defined in a way that could implicate many types of common arrangements, including employee co-investments that benefit from more favorable terms than are applicable to other investors or which are funded through a loan program.

5. Limited Purchaser Exception: The three-year holding period rule does not apply to a carried interest purchased (in a secondary transaction) by an unrelated buyer who does not perform services.

6. Related Party Transfers: If a carried interest is transferred to a related party (generally, family or colleagues), gain on the transfer may be recharacterized as short-term capital

[1] Capitalized terms used but not defined herein have the meanings ascribed to them in the Proposed Regulations.

gain, and additional gain may be triggered, even if the transfer is otherwise nontaxable (*e.g.*, a gift). Common carried interest forfeiture arrangements may be implicated by this rule.

7. Certain Mitigation Strategies: Parties may seek to structure real estate transactions as asset sales in order to achieve certain favorable gain characterization. In-kind distributions in respect of a carried interest do not restart the holding period.

8. Applicability of Proposed Regulations: The Proposed Regulations are generally not effective until after they are finalized, although the corporate exception limitations noted above are effective sooner. Taxpayers may generally rely on the Proposed Regulations before finalization, if applied consistently.

OVERVIEW OF THE REGIME

Under Section 1061(a),[2] for taxable years beginning after 2017, with respect to a taxpayer's applicable partnership interests ("APIs"),[3] the excess of (i) the net long-term capital gain ("LTCG") determined under the general rule for LTCG, which requires the applicable capital assets to be held for more than one year, over (ii) the net LTCG determined by substituting three years for one year (the "Recharacterization Amount") is recharacterized as short-term capital gain ("STCG"). Under this rule, in respect of an API, capital gain from the sale of property held for more than one year but not more than three years, which would otherwise be subject to tax at capital gains rates, is instead subject to tax at ordinary income tax rates.

The LTCGs and long-term capital losses ("LTCLs") recognized with respect to all of a taxpayer's APIs ("API Gains and Losses") are aggregated for purposes of determining the taxpayer's Recharacterization Amount. This calculation is generally made by looking through tiers of partnerships, S corporations and passive foreign investment companies ("PFICs") with respect to which a QEF election has been made (collectively, "Passthrough Entities")[4] through which the taxpayer holds its API (or certain other property).

API Gains and Losses include gains and losses allocated to an API, gains and losses from the disposition of an API, and gains and losses from the disposition of certain property distributed in respect of an API. API Gains and Losses exclude Section 1231 gain (from the sale of real property or depreciable personal property used in a trade or business and held for more than one year), qualified dividend income, and gain from Section 1256 contracts and certain mixed straddles. RIC and REIT capital gain dividends are included in the calculation of the Recharacterization Amount unless they are attributable to properly identified excluded gain (and certain requirements are met).

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[2] References to "Sections" are to sections of the Internal Revenue Code of 1986, as amended, and references to "Regulations Sections" are to sections of the final, temporary and proposed U.S. Treasury regulations promulgated under the Internal Revenue Code of 1986, as amended.

[3] The most typical API is popularly known as a "carried interest" (or simply "carry"), and this memorandum uses those terms. However, as discussed below, certain interests that are not commonly considered to be "carried interests" may be treated as APIs, and certain interests that are commonly considered to be "carried interests" may not be treated as APIs.

[4] All three types of Passthrough Entities generally permit income recognized by such entity to pass through to its owners, and such income generally retains its character as ordinary income or capital gain.

An API is a partnership interest held by a taxpayer in connection with the performance of substantial services by the taxpayer, or by any other related person, in any applicable trade or business ("ATB"). An ATB is any business that consists of raising or returning capital and investing in or developing certain specified assets, which generally include securities, commodities, derivatives and real estate. An API does not include an interest held by a corporation, a "capital interest" (as specifically defined for this purpose), an interest held by an employee of an entity not engaged in an ATB received in connection with the performance of substantial services by that person as employee of such entity, and certain interests acquired for fair market value ("FMV") by an unrelated purchaser who does not provide services.

Under Section 1061(d), if an API is transferred to certain related parties, the transferor (for this purpose, looking through Passthrough Entities) must include in income, as STCG, the excess of (i) the net LTCG from assets held for three years or less that would have been allocated to the transferor in respect of the API on a hypothetical liquidation of the partnership at FMV over (ii) any amount otherwise recharacterized as STCG on the transfer of the API under Section 1061(a).

APPLICABLE TRADE OR BUSINESS (ATB)

Under the Proposed Regulations, an ATB is any activity that satisfies the "ATB Activity Test," which will be satisfied if certain actions ("Specified Actions") are conducted at a level that constitutes a "trade or business" under U.S. federal income tax principles. For this purpose, all Specified Actions conducted by persons who are related under applicable rules (*i.e.*, Section 707(b) or Section 267(b), which, in the case of business entities, generally require a greater than 50% overlap in ownership) ("Related Persons"), including all agents or delegates thereof, and combining activities conducted in separate partnership tiers, are combined and attributed to each such Related Person. Specified Actions include both (i) actions involving raising or returning capital and (ii) actions involving either (a) investing in (or disposing of) Specified Assets (or identifying Specified Assets for such investing or disposition) or (b) developing Specified Assets. Specified Actions described in clause (i) and clause (ii) do not necessarily need to occur in the same year in order to satisfy the ATB Activity Test. The Proposed Regulations include detailed discussions about actions taken, or not taken, contemporaneously with each other and how they are, or are not, aggregated for purposes of determining whether there is an ATB. Of note, the Proposed Regulations specify that if a service provider represents to certain 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 (*e.g.*, in its marketing or offering materials), it can be considered to be in an ATB if it has previously taken actions involving raising or returning capital. However, merely exercising voting power of shares owned does not constitute development for this purpose.

Specified Assets include securities (including all corporate stock and interests in publicly traded or widely held partnerships or trusts), commodities, real estate held for rental or investment, cash or cash equivalents, any interest in a partnership to the extent that the partnership holds Specified Assets, and options or derivatives with respect to any of the foregoing. Interests in closely held operating partnerships do not, however, appear to constitute "Specified Assets," except to the extent any such operating partnership itself holds Specified Assets.

APPLICABLE PARTNERSHIP INTEREST (API)

Financial Instrument or Contract

The Proposed Regulations clarify that 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, the value of partnership assets, or the results of partnership operations), which presumably includes an option to acquire a partnership interest. Accordingly, any capital gain associated with such an instrument or contract may be subject to potential recharacterization under this regime. Furthermore, the transfer of any such instrument or contract to a related party may result in gain recognition under the related party transfer rules discussed below.

Performance of Services

To be an API, the partnership interest must be, directly or indirectly, transferred to (or held by) a taxpayer (for this purpose, including a Passthrough Entity) in connection with the performance of substantial services by the taxpayer, or by any Related Person, including services performed as an employee, in any ATB.

The Proposed Regulations include a presumption that a partnership interest transferred in connection with the performance of services is transferred in connection with the performance of substantial services. In many cases, this effectively removes the substantiality requirement from the API definition. The presumption suggests that any carried interest which qualifies as a profits interest under Revenue Procedure 93-27 will meet the “substantial services” requirement since Revenue Procedure 93-27 only applies if the partner provides services “to or for the benefit of the partnership.” However, the preamble to the Proposed Regulations (the Preamble) states in this context that the status of a partnership interest as a profits interest for purposes of Revenue Procedure 93-27 and the status of a partnership interest (or financial instrument or contract) as an API are different, and do not implicate each other. It should also be noted that the definition of an API is not limited to a profits interest within the meaning of Revenue Procedure 93-27.

“Once an API, Always an API,” Unless a Specific Exception Applies

Once an interest becomes an API, it does not lose its status as such unless and until the requirements of one of the exceptions to API treatment set forth below are met. Thus, the interest’s status as an API does not depend on whether an ATB is conducted in each taxable year or whether the API Holder (or a Related Party) continues to provide services in connection with the Relevant ATB, and an API does not lose its status if it is transferred by gift or (apparently) at death.

API Exception: Capital Interest (Including Application to Certain Equity Co-Investments)

In addition to receiving a carried interest, service providers often invest their own capital alongside third-party investors in the same assets as to which they receive carry. The Proposed Regulations include rules exempting certain capital gains generated from the capital invested by a holder of an API (*e.g.*, an equity co-investment) from the recharacterization regime of Section 1061(a). The Proposed Regulations, however, raise some significant uncertainties and interesting questions regarding capital investments by service providers.

Generally speaking, the rules exempt equity co-investments that are made on terms consistent with those to which third-party investors are subject, whether such investments are made directly or in a Passthrough Entity with third-party investors.

Under Section 1061, an API does not include a capital interest in a partnership 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 interest. The Preamble points out that the “reference to the amount of capital contributed in Section 1061(c)(4)(B)(i) and a similar reference in the Conference Report[5] indicate that the exception for capital interests should apply only to the extent that a service provider's rights with respect to its contributed capital matches the rights of other non-service partners with respect to their shares of contributed capital." The Proposed Regulations clarify, however, that an API will not fail to be treated as a capital interest solely because its capital interest allocation is subordinated to an allocation to an Unrelated Non-Service Partner (*i.e.*, partners who have not and do not provide services in the Relevant ATB and who are not related to an API Holder in the partnership (or any person that provides services in the Relevant ATB)).

The excluded amounts are referred to in the Proposed Regulations as Capital Interest Gains and Losses, and include (i) Capital Interest Allocations, (ii) Passthrough Interest Capital Allocations and (iii) Capital Interest Disposition Amounts.

When an equity co-investment is made in the same entity in which third-party investors invest, the Proposed Regulations require that to qualify as Capital Interest Allocations, allocations must be made under the partnership agreement to an API Holder and an Unrelated Non-Service Partner based on their respective capital account balances and meet certain additional requirements. These include: (i) that the allocations are made in the same manner to all partners, (ii) that the allocations are made to Unrelated Non-Service Partners with a significant aggregate capital account balance (5% or more of the aggregate capital account balance of the partnership at the time the allocation is made will be treated as significant), and (iii) that the allocations to the API Holder and the 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.

Passthrough Interest Capital Allocations are either (i) Capital Interest Allocations made by a lower tier entity and allocated by the Passthrough Entity to its owners in the same manner as each owner's share of the capital account in the lower-tier entity making the allocation (a "Passthrough Capital Allocation") or (ii) allocations solely comprised of LTCG and LTCL from assets (other than an API) held directly by the Passthrough Entity based on each direct owner's capital account ("Passthrough Interest Direct Investment Allocations"). A Passthrough Interest Direct Investment Allocation may include allocations in respect of Distributed API Property (as defined below) from a lower-tier entity provided that such property is no longer Distributed API Property because it had been held for more than three years.

The Proposed Regulations provide apportionment rules for determining the Capital Interest Disposition Amount in a case where only a portion of gain or loss on a sale or disposition of all or a portion of a Passthrough Interest[6] may be treated as Capital Interest Gain or Loss. In such a case, the Capital Interest Disposition Amount is determined based on the amount of gain or loss that, on a hypothetical liquidation of the Passthrough Entity following a FMV sale of all of its assets, would be allocable to the sold portion of the Passthrough Interest as a result of Capital Interest Allocations or Passthrough Interest Capital Allocations. These rules exclude amounts that are not included in determining LTCG or LTCL (*e.g.*, amounts treated as ordinary income under Section 751(a)). The partner's basis and holding period, however, will be split between the transferred and retained interests as provided under general

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5 The referenced conference report pertains to the Tax Cuts and Jobs Act, which added Section 1061 in 2017.

6 A "Passthrough Interest" is an interest in a Passthrough Entity that represents an API, in whole or in part; *e.g.*, an interest in a general partner or special limited partner entity that in turns holds an API in an investment fund.

partnership tax principles (*e.g.*, basis will be allocated to the transferred and retained interests based on the relative FMVs of the interests, without regard to status of the retained or transferred portion as an API, non-API, capital interest and/or profits interest).

As noted above, the Proposed Regulations provide that in order for Capital Interest Allocations and Passthrough Interest Capital Allocations to satisfy this capital interest exclusion rule, allocations must be based on relative capital account balances (maintained in accordance with applicable Regulations under Section 704(b)) and, subject to certain exceptions, made in the same manner to all partners. The Proposed Regulations interpret “allocations made in the same manner” to mean allocations that are based on relative capital account balances “and the terms, priority, type and level of risk, rate of return and rights to cash or property distributions during the partnerships operations and liquidation are the same.” This requirement may raise issues for partnerships utilizing special allocations (*i.e.*, where economic entitlements do not necessarily follow capital accounts).

The Proposed Regulations request comments on “other allocation arrangements that appropriately could be treated as Capital Interest Gains and Losses under the regulations without inappropriately expanding the capital interest exception, taking into account the statutory requirement that the API Holder’s right with respect to its capital interest be commensurate with other partners’ rights with respect to their contributed capital.”

Certain Considerations for Employee Co-Investments: Fee-Free/Carry-Free Class

The rule requiring all capital interests to have the same terms raises a question of whether a typical fee-free/carry-free equity co-invest represents a capital interest for this purpose when other partners (either third-parties or other API holders) are subject to management fees and/or carried interest. With regard to “fee-free” equity co-investment, the Preamble states that an interest “will not fail to qualify because it is not reduced by the cost of services provided by the API Holder or a Related Person to the partnership,” which appears to allow for interests that are not subject to management fees. It is unclear, however, whether “carry-free” equity co-investment similarly qualifies for this exception. The Preamble further provides an example that may shed some light on this question, although its scope is unclear:

> Further, allocations made in the same manner to some API Holders by a partnership will not fail to qualify to be treated as a Passthrough Interest Direct Investment Allocation as to those partners despite allocations being made to one or more service providers (or related parties) that are treated as APIs issued by the Passthrough Entity. For example, if (1) all of the partners of the Passthrough Entity are API Holders and one partner manages the Passthrough Entity’s direct investments and receives a 20 percent interest in the net long-term capital gains from those investments that is treated as an API as to that partner and (2) the other API Holders share the remaining 80 percent of gain from those investments based on their relative investments in the Passthrough Entity, then (3) the allocation of the 80 percent of net long-term capital gain is a Passthrough Interest Direct Investment Allocation to those partners.

Certain Considerations for Employee Co-Investments: Loan Programs

In some circumstances, the Proposed Regulations may also impact the tax treatment of gains that would otherwise qualify as LTCG if they are attributable to certain employer sponsored loan programs. The Proposed Regulations provide that, for purposes of the capital interest rules, “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).” By way of example, this could impact loans provided by an asset manager to its employees to co-invest in their funds, as well as third-party loans guaranteed by an asset manager, and potentially in other cases. These loans or other advances do get included in capital accounts under these provisions once repayments “are paid by the partner, provided that the loan is not repaid with the proceeds of another loan described in this paragraph.”

API Exception: Unrelated Purchaser

The Proposed Regulations add an important exception for unrelated taxpayers who purchase an interest that would otherwise be considered an API in a taxable transaction at FMV, but the exception applies only if, immediately before the purchase, the unrelated purchaser (i) has not provided, does not provide, and does not anticipate providing services in the future to or for the benefit of the target partnership, directly or indirectly, or any partnership in which the target partnership is (directly or indirectly) invested, (ii) is not a Related Person with respect to a person who provides services in the Relevant ATB or to or for the benefit of the target partnership, or any partnership in which the target partnership is (directly or indirectly) invested, and (iii) the transaction is not covered by the related party transfer rules of Section 1061(d) and corresponding provisions of the Proposed Regulations. This exception could apply to purchasers of interests in publicly traded partnerships (commonly known as “PTPs”) that are engaged in an ATB, or to purchasers of “stakes” in fund managers (and related carry vehicles) that are engaged in an ATB. However, the Proposed Regulations exclude from this relief purchasers who acquire their interest in a primary transaction, as opposed to a secondary transaction, which would prevent many “stakes” and “seed” deals from fitting within this exclusion. It is not clear what the basis is for this distinction, and is not entirely clear what the intent is with regard to transactions that are structured as primary investments but treated for tax purposes as secondary purchases, such as disguised sale transactions, which are common structuring techniques in “stakes” deals. On a more technical level, it is not clear what the “fair market value” standard adds to this rule, given that taxable transactions between unrelated parties are almost always at FMV, but it may be intended to exclude transactions that are not on arm’s-length terms, such as a sale by an employer to an employee. Moreover, a revenue share arrangement, which is also common in “stakes” and “seed” deals, may be subject to these rules (in particular, as relates to a disposition of such a right) because, as noted above, the definition of an API includes a financial instrument or contract the value of which is determined (in whole or in part) by reference to a partnership. “Stakes” and “seed” investors should take into account the potential impact of these rules on their traditional structures for acquisitions of interests in fund sponsors and whether any alternative structuring can be implemented to mitigate this impact.

Other API Exceptions

There are two other exceptions to the definition of an API which are generally similar to the exceptions provided under the statute. The first exception is the non-ATB employee exception, which excludes from the definition of API an interest held by a person who is employed by another entity that is conducting a trade or business other than an ATB and provides services only to such other entity. Because this exception does not apply to entities engaged in an ATB, it generally cannot be utilized by owners of investment managers and because it is limited to employees, it generally cannot be utilized by people who receive interests in such entities in a non-employee capacity (*e.g.*, directors and consultants). The second exception is the corporate exception, which provides that an API does not include any partnership interest held by a corporation. The Proposed Regulations clarify (as previously provided in Notice 2018-18) that partnership interests held by S corporations are treated as APIs if the interest otherwise meets the API definition, and further provide 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.

In addition, Section 1061(b) provides Treasury and the IRS with the authority to provide via regulation that income or gain attributable to an asset not held for portfolio investment on behalf of third-party investors will not be recharacterized pursuant to Section 1061. A third-party investor is defined as a person who holds an interest in a partnership which does not constitute property held in connection with an applicable ATB and who does not provide substantial services for such partnership or for any ATB. Commentators had observed that this exception is intended to apply to family offices, and in the Preamble, Treasury agreed with that interpretation. The Preamble posits that this exception may already be effectively implemented in the Proposed Regulations by the exception for Passthrough Interest Direct Investment Allocations; however, the statutory text would seem to contemplate a broader exception. The Proposed Regulations reserve with respect to the application of Section 1061(b), and Treasury has requested comments on the application of this exception.

RECHARACTERIZATION MECHANICS AND COMPUTATIONS

General Rules

The Proposed Regulations specify that Section 1061 applies to recharacterize certain gains and losses of a taxpayer that is subject to tax on net gain with respect to an API or Indirect API during a given taxable year (referred to as an “Owner Taxpayer”), including a non-passthrough owner that indirectly holds an interest in an API through a “Passthrough Taxpayer” (*i.e.*, a Passthrough Entity that is treated as a taxpayer for purposes of determining whether a partnership interest is an API). This approach, which the Preamble describes as a “partial entity approach,” clarifies the use of the term “taxpayer” in Section 1061. Under this approach, the Recharacterization Amount, is determined solely in respect of Owner Taxpayers, but allows for a broader definition of “taxpayer” for purposes of determining whether a partnership interest is an API. Thus, in calculating the Recharacterization Amount, the Proposed Regulations apply Section 1061 at the level of the taxpayer that is the ultimate beneficial owner of one or more APIs with respect to each year in which a taxpayer holds a direct or indirect interest in an API (or Distributed API Property). Accordingly, capital gains and losses derived by such taxpayer held directly or indirectly through different Passthrough Entities are aggregated. It should be noted, however, that despite the fact that Section 1061 applies with respect to gains of an Owner Taxpayer, the holding period of an asset giving rise to a gain is the holding period of the direct owner of the asset in question. For example, a partnership may sell a capital asset that it has owned for five years and allocate the capital gain to a partner who has owned its API for two years, in which case the gain is LTCG and not subject to Section 1061.

The Recharacterization Amount pursuant to Section 1061(a) is equal to excess, if any, of the Owner Taxpayer’s “One Year Gain Amount” over the Owner Taxpayer’s “Three Year Gain Amount.” An Owner Taxpayer’s One Year Gain Amount is defined as the sum of its (i) combined net API One Year Distributive Share Amount from all APIs held during the taxable year and (ii) API One Year Disposition Amount. Correspondingly, an Owner Taxpayer’s Three Year Gain Amount is defined as the sum of its (i) combined net API Three Year Distributive Share Amount from all APIs held during the taxable year and (ii) API Three Year Disposition Amount. While losses are offset against gains for purposes of determining an Owner Taxpayer’s One Year Gain Amount and Three Year Gain Amount, where an Owner Taxpayer’s Three Year Gain Amount represents a net loss, the Three Year Gain Amount is zero and such losses do not offset the amount of one-year gain that is recharacterized as STCG. Where an Owner Taxpayer’s

One Year Gain Amount is equal to zero or represents a net loss, the Recharacterization Amount is zero and Section 1061(a) does not apply to such Owner Taxpayer with respect to such taxable year.

As described in more detail below, the amounts included as One Year Gain Amount and Three Year Gain Amount under the Proposed Regulations are effectively all applicable gains taken into account by an Owner Taxpayer in a given year in respect of its direct or indirect distributive share of gains with respect to an API and applicable gains realized on disposition of an API or Distributed API Property.

An Owner Taxpayer's API One Year Distributive Share Amount, with respect to each partnership in which the Taxpayer owns an API, is equal to (i) its direct or indirect distributive share of net LTCG from the partnership for the taxable year, including capital gain or loss on the disposition of all or a part of an API by a Passthrough Entity through which the Owner Taxpayer holds the underlying API, calculated without the application of Section 1061, less (ii) to the extent included in the amount determined under clause (i), above:

- certain capital gains and losses that are excluded from Section 1061 under the Proposed Regulations, as described below;
- the API Holder's Transition Amount for the taxable year; and
- Capital Interest Gains and Losses, as described above.

An Owner Taxpayer's API Three Year Distributive Share Amount with respect to an API is equal to its API One Year Distributive Share Amount, less certain items included in the definition of API One Year Distributive Share Amount that would not be treated as a LTCG or LTCL (determined by substituting three years for one year in the holding period requirement prescribed by Section 1222 for capital gain to be treated as LTCG), and any adjustments required pursuant to the Lookthrough Rule (described below), if applicable to the direct or indirect disposition of all or a part of an API. Where an Owner Taxpayer is not the API Holder of a particular API (*e.g.*, where the Owner Taxpayer holds through a Passthrough Entity that is itself the API Holder), allocations in respect of an API retain their character under Section 1061 as they tier up to the Owner Taxpayer.

An Owner Taxpayer's API One Year Disposition Amount is the combined net amount of (i) LTCGs and LTCLs recognized during the taxable year by an Owner Taxpayer, including LTCG computed under the installment method that is taken into account for the taxable year (as described below), on the disposition of all or a portion of an API that had been held for more than one year, including a disposition to which the Lookthrough Rule applies, (ii) LTCGs and LTCLs recognized on a distribution with respect to an API during the taxable year that is treated under Sections 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, (iii) LTCGs and LTCLs recognized on the disposition of Distributed API Property during the taxable year that has a holding period of more than one year but not more than three years to the distributee Owner Taxpayer on the date of disposition, and (iv) LTCGs and LTCLs recognized as a result of the application of Section 751(b).

An Owner Taxpayer's API Three Year Disposition Amount is the combined net amount of (i) LTCGs and LTCLs recognized during the taxable year by an Owner Taxpayer, including LTCG computed under the installment method that is taken into account for the taxable year, 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, (ii) LTCGs and LTCLs recognized by an Owner Taxpayer on the disposition during the taxable year of all or a portion of an API that has been held for more than three years, less certain adjustments required under the Lookthrough Rule (described below), (iii) LTCGs and LTCLs recognized on a distribution with respect to an API during the taxable year that is treated under Section 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, and (iv) LTCGs and LTCLs recognized as a result of the application of Section 751(b) that are treated as derived from an asset held for more than three years.

Excluded Gains

Certain items of LTCG and LTCL are excluded from the calculation of both the API One Year Distributive Share Amount and the API Three Year Distributive Share Amount. Specifically, the Proposed Regulations exclude (i) LTCGs and LTCLs determined under Section 1231 (*i.e.*, gains and losses from the disposition of Section 1231 property, which generally includes real property and depreciable personal property used in a trade or business and held for more than one year, as well as certain income relating to natural resources), (ii) LTCGs and LTCLs determined under Section 1256 (*i.e.*, certain gains and losses from regulated futures contracts, foreign currency contracts, nonequity options, dealer equity options and dealer securities future contracts), (iii) qualified dividend income that is taxed as LTCG, and (iv) capital gains and losses that are characterized as long-term or short-term without regard to the holding period rules in Section 1222 (*e.g.*, gains and losses characterized under the mixed straddle rules described in Section 1092(b)).

Installment Sale Gain

LTCG from installment sales is taken into account for purposes of calculating an Owner Taxpayer's One Year Gain Amount and Three Year Gain Amount, based on the holding period of the asset disposed of in the installment sale determined at the time of the installment sale. For example, if a partnership in which an Owner Taxpayer holds an API disposes of an asset which it has held for two years in 2016, and additional LTCG in respect of such installment sale is recognized by the Owner Taxpayer in 2021, the gain in question is treated as arising from an asset that was held for two years and is subject to recharacterization under Section 1061, even though the disposition occurred before the enactment of Section 1061.

QEF Net Capital Gain

An Owner Taxpayer's API One Year Distributive Share Amount and API Three Year Distributive Share Amount include the Owner Taxpayer's share of applicable LTCGs of a PFIC with respect to which a QEF election has been made. The amount of such inclusion may be reduced to reflect amounts that are excluded gains for purposes of Section 1061 (as described above).

RIC and REIT Capital Gain Dividends

Special rules have been proposed with respect to capital gain dividends received from regulated investment companies (RICs) and real estate investment trusts (REITs). If a RIC or a REIT provides a "One Year Amounts Disclosure" (relating to net capital gain, excluding items that are not taken into account for purposes of Section 1061, such as gain and loss determined under Sections 1231 and 1256 and qualified dividend income), and if applicable, a "Three Year Amounts Disclosure" (relating to amounts attributable to the computation of the One Year Amounts Disclosure, but taking into account only LTCGs and LTCLs with respect to assets with a holding period of more than three years), an Owner Taxpayer may include the amounts specified in such disclosures as in its API One Year Distributive Share Amount and/or API Three Year Distributive Share Amount, as applicable. To prevent the avoidance of Section 1061, each of the two additional disclosed amounts provided to each shareholder of a RIC or REIT must be proportionate to the share of capital gain dividends reported or designated to that shareholder for the taxable year. If these reports are not provided, the entirety of a capital gain dividend received by an

Owner Taxpayer with respect to an API generally must be included in its API One Year Distributive Share Amount, and no amount of the capital gain dividend may be included in its API Three Year Distributive Share Amount. In addition, if a RIC or a REIT provides the Three Year Amounts Disclosure, any loss on the sale or exchange of the shares of a 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 Three Year Amounts Disclosure from that RIC or REIT.

Lookthrough Rule for Certain API Dispositions

When an Owner Taxpayer directly or indirectly disposes of an API, the "Lookthrough Rule" may apply to include a portion of any gain realized on the disposition of an API in such Owner Taxpayer's One Year Gain Amount, and not its Three Year Gain Amount. The Lookthrough Rule applies to the disposition of a directly held API if:

- An API Holder disposes of a directly held API in a taxable transaction to which the related party rules of Section 1061(d) (which are discussed in more detail below) do not apply;
- The API Holder's holding period in the API is more than three years; and
- The assets of the partnership in which the API is held meet the Substantially All Test (as discussed below).

In addition, the Lookthrough Rule will also apply to the disposition of a Passthrough Interest held for more than three years in a taxable transaction to which the related party rules of Section 1061(d) do not apply if either (i) the Passthrough Entity through which the API is directly or indirectly held has a holding period in the API of three years or less or (ii) the Passthrough Entity, through which the API is directly or indirectly held, has a holding period in the API of more than three years and the assets of the partnership in which the API is held meet Substantially All Test (as described below).

The Substantially All Test is met if 80% or more of the assets, by FMV, of a partnership in which an API is held are assets that would produce capital gain or loss (other than capital gain or loss that is excluded from the application of Section 1061, as discussed above) and have a holding period to the partnership of three years or less. The Substantially All Test is applied to tiered partnership structures by looking through lower-tier Passthrough Entities that have been held for more than three years.

When the Lookthrough Rule applies, an adjustment must be made to reduce the Owner Taxpayer's Three Year Gain Amount. If the Lookthrough Rule applies to a directly held API, or to an indirectly held API because the Passthrough Entity (through which the API is directly or indirectly held) has a holding period in the API of more than three years and the assets of the partnership in which the API is held meet the Substantially All Test, the adjustment amount is generally equal to (i) the capital gain recognized on the sale of the API, multiplied by (ii) a fraction, the numerator of which is equal to the aggregate FMV of the assets of the partnership in which the API is held that would produce capital gain or loss (other than Excluded Gains and Losses) if disposed of by the partnership as of the date of disposition of the API and that have a holding period of three years or less, and the denominator of which is equal to the aggregate FMV of all of the assets of the partnership in which the API is held as of the date of disposition of the API.

If the Lookthrough Rule applies to an indirectly held API because the Passthrough Entity (through which the API is directly or indirectly held) has a holding period in the API of three years or less, the adjustment amount is equal to the entire gain attributable to such API. Thus if an Owner Taxpayer sells an interest in a Passthrough Entity in which the Owner Taxpayer has a holding period of more than three years at a gain, but such Passthrough Entity owns an API in a lower-tier partnership with a holding period of three year or less, the entire capital gain recognized by the Owner Taxpayer upon the sale of its interest in the Passthrough Entity will constitute a "Recharacterization Amount."

API Holder Transition Amounts

As noted above, Section 1061 does not apply to gains and losses that are API Holder Transition Amounts. API Holder Transition Amounts are allocations to the holder of an API of LTCGs and LTCLs recognized on the disposition of assets held by the partnership for more than three years as of January 1, 2018, if the partnership has elected to treat these amounts as API Holder Transition Amounts. A partnership that was in existence as of January 1, 2018 may irrevocably elect to treat all LTCGs and LTCLs from the disposition of all assets, regardless of whether they would be API gains or losses in prior periods, that were held by the partnership for more than three years as of January 1, 2018, as Partnership Transition Amounts. Upon allocation to the API Holder, a Partnership Transition Amount will constitute API Holder Transition Amounts and will not be taken into account for purposes of determining the Recharacterization Amount. The Preamble indicates that the purpose of this election is to address potential gaps in record-keeping that may result from the fact that taxpayers did not have reason to track what portion of the unrealized appreciation in a partnership's assets was attributable to capital interests as opposed to APIs prior to the enactment of Section 1061.

RELATED PARTY TRANSACTIONS

The Proposed Regulations prescribe recognition and recharacterization rules for transfers of APIs to certain related parties, and these rules, if finalized in their current form, present a significant trap for the unwary. In particular, the Proposed Regulations clarify an ambiguity in the statute: An otherwise nontaxable transfer of an API can become taxable (as STCG) if the Section 1061(d) related party rules apply.

Calculating Related Party STCG

If a taxpayer directly or indirectly transfers an API or any Distributed API Property, or if a Passthrough Entity directly or indirectly transfers an API, to a Related Party (as defined below),[7] then the taxpayer recognizes STCG (Related Party STCG) equal to the excess of (i) the net LTCG from assets held for three years or less that would have been allocated to the taxpayer in respect of the transferred API on a hypothetical liquidation of the partnership at FMV over (ii) any amount otherwise recharacterized as STCG on the transfer of the API under Section 1061(a).

If the transfer is otherwise taxable, and if the Related Party STCG is less than the capital gain that the taxpayer otherwise recognizes on the transfer, then the capital gain is characterized as STCG to the extent of Related Party STCG. However, if Related Party STCG exceeds the capital gain otherwise recognized on the transfer, or if the transfer is otherwise nontaxable, the taxpayer recognizes the excess Related Party STCG. This rule can cause the transferor to recognize gain when he or she otherwise would not (*e.g.*, in a transfer by gift).

The Proposed Regulations raise some questions regarding how to calculate Related Party STCG when Distributed API Property is transferred. The mechanics of the deemed liquidation described do not, by

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[7] This memorandum refers to Section 1061(d) related persons as "Related Parties" in order to avoid confusion with the general definition of "Related Persons" applicable to other aspects of the Proposed Regulations.

their terms, appear to apply to Distributed API Property. In any event, if the transfer is otherwise taxable, Section 1061(a) would appear to already operate to recharacterize the gain as STCG. Furthermore, it is unclear whether a Passthrough Entity's transfer of Distributed API Property (as opposed to a transfer of API) is covered by Section 1061(d), although there does not appear to be a principled reason for treating such a transfer differently.

The Related Party STCG calculation appears to include all types of LTCGs in clause (i) of the calculation, possibly including gains that would generally not be subject to Section 1061 if recognized by the partnership directly.

Scope of "Transfers" Under Section 1061(d); Special Basis Rule for Certain Nontaxable Transfers

For this purpose, a "transfer" is defined broadly to include taxable dispositions (such as sales) and otherwise nontaxable dispositions (such as contributions, distributions and gifts). The Proposed Regulations do not explicitly address whether a "transfer" includes a transfer at death or a forfeiture of an API (*e.g.*, in connection with a typical vesting arrangement). However, a nontaxable contribution to a partnership is not a transfer subject to these rules.

If the transferee would otherwise hold the transferred interest with a carryover basis (*e.g.*, a gift or certain other nontaxable transfers), the basis of the transferred interest is increased, immediately before the transfer, by the amount of additional (but not recharacterized) Related Party STCG recognized by the taxpayer.

Related Party Definition

"Related Party" has a unique definition for purposes of Section 1061(d). It includes only (i) the "family" of the taxpayer (*i.e.*, the spouse, parents, children and grandchildren, but not siblings, of the taxpayer), (ii) the current and former colleagues of the taxpayer (defined as performing a service in the same calendar year or the preceding three calendar years in the Relevant ATB), and (iii) any Passthrough Entity to the extent that an otherwise Related Party owns a direct or indirect interest in such Passthrough Entity.

A Passthrough Entity is treated as an aggregate, not an entity, for purposes of determining Related Party status, which may present a trap for the unwary and increase operational complexity. For example, suppose that a taxpayer sells an API that the taxpayer held for more than three years, the Lookthrough Rule does not apply, but the purchaser of the API is a partnership (*e.g.*, a "stakes" fund). To the extent that a member of the taxpayer's family, or a current or former colleague, is an investor in the purchaser, the taxpayer's gain from the sale may be subject to recharacterization under Section 1061(d). In some cases, it may be difficult to conduct due diligence on these facts.

Gifts of APIs to Related Parties

As noted above, an otherwise nontaxable transfer of an API, such as a gift, can result in gain recognition if made to a Related Party and, in some cases, the amount of such gain may exceed a taxpayer's net built-in-gain with respect to the transferred API. However, even if the underlying partnership has a Section 754 election in effect, the child would not appear to be entitled to a step-up on his or her share of the assets of the partnership, because a gift is generally not a transfer for which a tax basis step-up is permitted. Finally, the interest would appear to continue to be an API in the hands of the child, under the "once an API, always an API" rule discussed above, because a gift is not one of the listed exceptions to this rule, even if Related Party STCG is recognized on the transfer.

Forfeitures of APIs

Forfeitures of APIs, which are common when investment professionals separate from service with an investment manager prior to vesting, present special issues.[8] In the typical case, an unvested carried interest is forfeited to the Passthrough Entity that directly or indirectly holds the API in an underlying fund, and the Passthrough Entity is in turn owned (entirely or in large part) by now former colleagues of the taxpayer. If the forfeiture of the API is treated as a transfer to a Related Party, then the taxpayer may recognize Related Party STCG on the forfeiture in addition to (but perhaps not offsetting) capital loss on the forfeiture, which may produce unintended consequences in many cases.

REPORTING REQUIREMENTS

A partnership that has issued an API must provide the API Holder with additional information needed for the API Holder to comply with Section 1061 and to determine the Recharacterization Amount (including information needed to determine the applicability of the Lookthrough Rule in the event of a disposition of an API). The Proposed Regulations contemplate that this information will generally be provided as an attachment to the Schedule K-1 furnished to the API Holder for the taxable year. This information must also be filed with the IRS.

Additional reporting is required in a tiered structure, and in certain cases an upper-tier entity must request, and a lower-tier entity must provide, additional information. Consequently, a lower-tier partnership with a direct or indirect partner that is an upper-tier partnership that has issued an API may be required to comply with the Section 1061 reporting requirements, even if such lower-tier partnership itself has not issued an API.

If a taxpayer is not furnished the information described above and is not otherwise able to adequately substantiate all or part of these amounts, then items that would otherwise be excluded from the application of Section 1061(a) will not be deducted from such Taxpayer Owner's API One Year Distributive Share Amount; and items that would otherwise be included in such Taxpayer Owner's API Three Year Distributive Share Amount will not be included.

As discussed above, a partnership may elect to treat certain amounts as Partnership Transition Amounts. The election must be signed and dated by the due date of the Form 1065 and filed with the IRS as an attachment to the Form 1065 for the first partnership taxable year in which a partnership treats amounts as Partnership Transition Amounts.

A RIC or a REIT may provide additional information to its shareholders to enable API Holders to determine the amount of capital gain dividends that would be included in their respective API One Year Distributive Share Amount and API Three Year Distributive Share Amount. If a RIC or REIT does not provide such information, an API Holder must generally include all amounts of capital gain dividends from such RIC or REIT in its API One Year Distributive Share Amount and no amounts in its API Three Year Distributive Share Amount.

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[8] Except perhaps in unusual cases in which the partnership that issued the forfeited interest has no liabilities, or the forfeiting partner's share of partnership liabilities is not reduced by the forfeiture, a forfeiture is typically treated as a sale or exchange of the forfeited partnership interest.

A PFIC with respect to which a shareholder has a QEF election in effect may provide additional information to its shareholders to enable API Holders to determine the amount of their QEF inclusion that would be included in the API One Year Distributive Share Amounts and API Three Year Distributive Share Amounts. If the PFIC does not provide such information, an API Holder must include all amounts of net capital gain from the QEF in its API One Year Distributive Share Amount and no amounts in its API Three Year Distributive Share Amount.

EFFECTIVE DATE AND CONSISTENCY

The Proposed Regulations generally will apply to taxpayers only when finalized, and only to taxable years beginning on or after the date on which the final regulations are published in the *Federal Register*. Taxpayers may generally rely on the Proposed Regulations for taxable years beginning before the date final regulations are published, provided they follow the Proposed Regulations in their entirety and in a consistent manner. However, taxpayers may rely on the Proposed Regulations regarding Partnership Transition Amounts and API Holder Transition Amounts for taxable years beginning in 2020, without needing to follow the rest of the Proposed Regulations. Special rules apply to fiscal year partnerships.

However, solely for purposes of the corporate exclusion discussed above, the rule treating an S corporation as not a corporation is applicable for taxable years beginning after December 31, 2017, and the rule treating a PFIC with respect to which the taxpayer has a QEF election in effect as not a corporation is applicable for taxable years beginning after the date of the publication of the Proposed Regulations in the *Federal Register*.

MITIGATION STRATEGIES

Distributions In-Kind

Generally, the tax-deferred distribution of property with respect to an API (referred to as “Distributed API Property”) does not accelerate the recognition of gain under the Proposed Regulations; instead, the Distributed API Property retains its tainted status upon distribution (including through multiple tiers). Accordingly, if Distributed API Property is disposed of by the ultimate distributee when the holding period is three years or less (inclusive of the distributing partnership’s holding period), gain or loss with respect to the disposition is API Gain or Loss. However, once the holding period of the Distributed API Property is more than three years, it loses its character as Distributed API Property and can be sold without recharacterization under Section 1061. By way of example, particularly in the venture capital world, some fund managers have the ability to receive their carried interest as an in-kind distribution of public securities. If the securities have a holding period of three years or less, the carried interest holders may continue to hold the securities directly until the holding period is greater than three years before selling the securities. In certain circumstances, the holding period of the distributed securities may be affected by the straddle rules if the taxpayer (or certain related persons) directly or indirectly holds an offsetting position.

Sales of Assets vs. Interests

Because the holding period (and other applicable tax characterization) of the seller of an asset (or interest) generally controls the operation of Section 1061, it may be possible to structure transactions to mitigate the effect of Section 1061. For example, an investment fund (or a REIT owned by an investment fund) may seek to structure the sale of real estate used in a trade or business held for more than one year but not more than three years as an asset sale to generate Section 1231 gain, which is not subject to Section 1061, as opposed to a sale of an interest in a partnership that holds the real estate, which would generate capital gain that may be subject to Section 1061. In other cases, sales of partnership interests may be more favorable.

Properly Structured Carry Waiver

The Preamble makes clear that the Treasury Department and the IRS are aware that taxpayers may seek to circumvent Section 1061(a) by waiving their rights to gains generated from the disposition of capital assets held for three years or less and later "catching up" on these amounts with respect to gains generated from capital assets held for more than three years, either on an ad hoc or programmatic basis, which are commonly referred to as "carry waivers." The Preamble warns taxpayers that such carry waivers may be challenged under various specified theories. However, this warning seems to contain an implicit assumption that, if properly structured, carry waivers may be respected, which would make them a potentially effective tool in Section 1061 planning. The Preamble is focused on the deferral of carried interest *allocations*. Deferrals of carried interest *distributions*, which are commonly done for non-tax reasons (*e.g.*, to minimize the risk of clawback) generally should not be affected.

OTHER CHANGES AND OBSERVATIONS

Timing of Capital Losses

As discussed above, Section 1061(a) operates by recharacterizing certain LTCG as STCG, but there is no mechanism to separately track component items of this calculation in future years and, accordingly, depending on the timing of a taxpayer's LTCGs and LTCLs, different recharacterizations may result. For example, suppose that a taxpayer, in Year One, recognized a $100 LTCL from the sale of an asset held for three years or less, and in Year Two, recognized a $100 LTCG from the sale of an asset held for three years or less and a $100 LTCG from the sale of an asset held for more than three years. Ignoring the limited ability to offset ordinary income with a capital loss, the LTCL in Year One is carried over to Year Two as a LTCL. However, because the LTCL carryover was not recognized in Year Two, it does not appear to enter into the calculation of the Recharacterization Amount for that year. In Year Two, the $200 of LTCG is recharacterized as $100 of STCG and $100 of LTCG. The $100 LTCL carryover from Year One offsets the $100 LTCG in Year Two, and the taxpayer recognizes $100 of net STCG. If, however, all three items were recognized in the same year, the net LTCG would be $100 and the net LTCG from the sales of assets held for more than three years would also be $100, so no amount of LTCG would be recharacterized as STCG, and the taxpayer would recognize $100 of net LTCG in that year.

Deferral of API Gains via Qualified Opportunity Zone Investments

If a taxpayer defers an item of API Gain by making a qualifying investment in a qualified opportunity fund, then the taxpayer will generally be required to include that item in income on December 31, 2026 (or, if earlier, an inclusion event). Applicable opportunity zone regulations state that, upon the later inclusion, the gain has the same attributes that it would have had if recognition of the gain had not been deferred. Although those regulations do not explicitly cross-reference Section 1061, presumably, the holding period associated with the gain for purposes of Section 1061 (*i.e.*, whether the applicable holding period is greater than three years) is retained.

Divided Holding Period of a Partnership Interest

Under the Proposed Regulations, if a partnership interest is comprised in whole or in part of one or more profits interests, then, under Regulations Section 1.1223-3, the portion of the holding period to which a profits interest relates is determined based on the FMV of the profits interest upon the disposition of all or part of the interest, and not at the time the profits interest is acquired.

Aggregate Tax Allocations in Securities Partnerships

Under existing Regulations Section 1.704-3(e)(3)(i), a securities partnership (such as a typical hedge fund) may aggregate gains and losses from financial assets using any reasonable approach that is consistent with the purpose of Section 704(c). The Proposed Regulations would amend these Regulations to require that in the “partial netting approach” and the “full netting approach,” the partnership must establish separate accounts for taking into account each API Holder’s share of book API Gains and Losses and book Capital Interest Gains and Losses, and for determining each API Holder’s share of tax API Gains and Losses and tax Capital Interest Gains and Losses. The apportionment among such accounts must be reasonable, and the Proposed Regulations provide a safe harbor if apportionment is based on the relative API Gain or Loss Amounts and Capital Interest Gain or Loss Amounts that would be allocated to the API Holder as a result of a deemed liquidation of the partnership.

Partner’s Distributive Share

The Proposed Regulations would amend Regulations Section 1.702-1(a)(2) to provide that, for purposes of calculating a partner’s distributive share, each partner subject to Section 1061 should take into account gains and losses from the sale of capital assets held for more than one year as provided in Section 1061 and the Proposed Regulations.

Risk of Changes in Tax Rates

The effect of Section 1061 is to recharacterize certain LTCG recognized in respect of an API as STCG and thereby subject it to a higher tax rate (currently, 37% instead of 20%). If the preferential LTCG rate disappears as a result of a change in law, the distinction between LTCG and STCG would generally disappear, and Section 1061, although it may still be operative, would generally have little practical effect.

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Primary Authors:

Michelle B. Gold

Colin S. Kelly

Andrew G. Penman

David I. Shapiro

Xenia Garofalo, Jaclyn M. Goldberg, Rodney H. Hill, Sarah M. Madigan, Yaniv Orin and Vivian Y. Ouyang also contributed to this memorandum.

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its contents. If you have any questions about the contents of this memorandum, please call your regular Fried Frank contact or an attorney listed below:

Contacts:

Michael J. Alter	+1.202.639.7094	michael.alter@friedfrank.com
Robert Cassanos	+1.212.859.8278	robert.cassanos@friedfrank.com
Cameron N. Cosby	+1.202.639.7490	cameron.cosby@friedfrank.com
Joseph E. Fox	+1.212.859.8853	joseph.fox@friedfrank.com
Katrin Gänsler*	+49.69.870.030.777	katrin.gaensler@friedfrank.com
Michelle B. Gold	+1.202.639.7243	michelle.gold@friedfrank.com
Alan S. Kaden	+1.202.639.7073	alan.kaden@friedfrank.com
Colin S. Kelly	+1.212.859.8895	colin.kelly@friedfrank.com
Christopher Roman	+1.212.859.8985	christopher.roman@friedfrank.com
Kenneth Rosenfeld	+1.212.859.8034	kenneth.rosenfeld@friedfrank.com
David I. Shapiro	+1.212.859.8039	david.shapiro@friedfrank.com
Nick Thornton	+44.20.7972.9220	nick.thornton@friedfrank.com
Eli Weiss	+1.212.859.8855	eli.weiss@friedfrank.com
Richard A. Wolfe	+1.212.859.8922	richard.wolfe@friedfrank.com
Libin Zhang	+1 212.859.8983	libin.zhang@friedfrank.com

**Ms. Gänsler is not admitted to practice law.*