DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9945]

RIN 1545–BO81

Guidance Under Section 1061

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations that provide guidance under section 1061 of the Internal Revenue Code (Code). Section 1061 recharacterizes certain net long-term capital gains of a partner that holds one or more applicable partnership interests as short-term capital gains. An applicable partnership interest is an interest in a partnership that is transferred to or held by a taxpayer, directly or indirectly, in connection with the performance of substantial services by the taxpayer, or any other related person, in any applicable trade or business. These final regulations also amend existing regulations on holding periods to clarify the holding period of a partner's interest in a partnership that includes in whole or in part an applicable partnership interest and/or a profits interest. These regulations affect taxpayers who directly or indirectly hold applicable partnership interests in partnerships and the passthrough entities through which the applicable partnership interest is held.

DATES:

Effective date: These regulations are effective on January 13, 2021.

Applicability date: For dates of applicability, see §§ 1.702–1(g), 1.704–3(f), 1.1061–1(b), 1.1061–2(c), 1.1061–3(f), 1.1061–4(d), 1.1061–5(g), 1.1061–6(e), and 1.1223–3(g).

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SUPPLEMENTARY INFORMATION:

Background

This document contains final regulations under section 1061 of the Code to amend the Income Tax Regulations (26 CFR part 1). Section 1061 was added to the Code on December 22, 2017, by section 13309 of Public Law 115–97, 131 Stat. 2054 (2017), commonly referred to as the Tax Cuts and Jobs Act (TCJA). Section 1061 applies to taxable years beginning after December 31, 2017. Section 1061 recharacterizes certain net long-term capital gain with respect to applicable partnership interests (*APIs*) as short-term capital gain.

On August 14, 2020, the Department of the Treasury (Treasury Department) and the IRS published a notice of proposed rulemaking (REG–107213–18) in the **Federal Register** (85 FR 49754) containing proposed regulations under sections 702, 704, 1061, and 1223 of the Code (proposed regulations). The Treasury Department and the IRS received written and electronic comments responding to the proposed regulations. No public hearing was requested or held. All comments are available at *www.regulations.gov* or upon request. After full consideration of all comments timely received, this Treasury decision adopts the proposed regulations with modifications in response to the comments as described in the Summary of Comments and Explanation of Revisions section of this preamble.

Summary of Comments and Explanation of Revisions

Most of the comments addressing the proposed regulations are summarized in this Summary of Comments and Explanation of Revisions. However, non-substantive comments or comments merely summarizing or interpreting the proposed regulations, recommending statutory revisions, or addressing provisions outside the scope of these final regulations are not discussed in this preamble.

The final regulations retain the structure of the proposed regulations, with certain revisions. Section 1.1061–1 provides definitions of the terms used in §§ 1.1061–1 through 1.1061–6 of these final regulations (*Section 1061 Regulations* or final regulations). Section 1.1061–2 provides rules and examples regarding APIs and applicable trades or businesses (*ATBs*). Section 1.1061–3 provides guidance on the exceptions to the definition of an API, including the capital interest exception. Section 1.1061–4 provides guidance on the computation of the *Recharacterization Amount* and gives computation examples. Section 1.1061–5 provides guidance regarding the application of section 1061(d) to transfers to certain related parties. Section 1.1061–6 provides reporting rules. Because the application of section 1061 requires a clear determination of the holding period of a partnership interest that is, in whole or in part, an API, the final regulations also provide clarifying amendments to § 1.1223–3. Additional clarifying amendments to §§ 1.702–1(a)(2) and 1.704–3(e) are also provided.

Part I of this Summary of Comments and Explanation of Revisions provides an overview of the statutory provisions and defined terms used in the proposed and final regulations. Part II describes the comments received and revisions made in response to those comments with respect to the following four areas of the proposed regulations: (1) The capital interest exception; (2) the treatment of capital interests acquired with loan proceeds; (3) the *Lookthrough Rule* for certain API dispositions; and (4) transfers of APIs to *Section 1061(d) Related Persons.* Part III discusses additional comments received and revisions made in other areas of the proposed regulations. Part IV summarizes comments received on issues related to section 1061 that are beyond the scope of the regulations and are under study. Part V discusses applicability dates for the final regulations. In addition to the revisions made in response to comments, clarifying changes have been made throughout the final regulations.

I. Overview and Defined Terms

A. Section 1061(a): Recharacterization Amount, Owner Taxpayer, and Related Concepts

1. Recharacterization Amount

Section 1061(a) recharacterizes as short-term capital gain the difference between a taxpayer's net long-term capital gain with respect to one or more APIs and the taxpayer's net long-term capital gain with respect to these APIs if paragraphs (3) and (4) of section 1222, which define the terms long-term capital gain and long-term capital loss, respectively, for purposes of subtitle A of the Code, are applied using a three-year holding period instead of a one-year holding period. The regulations refer to this difference as the Recharacterization Amount. This recharacterization is made regardless of any election in effect under section 83(b).

2. Owner Taxpayers and Passthrough Entities

The regulations provide that the person who is subject to Federal income tax on the Recharacterization Amount is required to calculate such amounts and refer to this person as the *Owner Taxpayer.* Although an API can be held directly by an Owner Taxpayer, it also may be held indirectly through one or more passthrough entities (*Passthrough Entities*). A Passthrough Entity may be a partnership, trust, estate, S corporation, or a passive foreign investment company (PFIC) with respect to which the shareholder has a qualified electing fund (QEF) election in effect. An *API Holder* is any person who holds an API. The regulations provide a framework for determining the Recharacterization Amount when an API is held through one or more tiers of Passthrough Entities (tiered structure).

3. Gains and Losses Subject to Section 1061

Section 1061(a) applies to a taxpayer's net long-term capital gain with respect to one or more APIs held during the taxable year. The regulations provide that the determination of a taxpayer's net long-term capital gain with respect to the taxpayer's APIs held during the taxable year includes the taxpayer's combined net distributive share of long-term capital gain or loss from all APIs held during the taxable year and the Owner Taxpayer's long-term capital gain and loss from the disposition of any APIs during the taxable year. The regulations generally refer to long-term capital gains and losses recognized with respect to an API as *API Gains and Losses.* However, API Gains and Losses do not include long-term capital gain determined under sections 1231 and 1256, qualified dividends described in section 1(h)(11)(B), and any other capital gain that is characterized as long-term or short-term without regard to the holding period rules in section 1222, such as capital gain characterized under the identified mixed straddle rules described in section 1092(b).

Unrealized API Gains and Losses means, with respect to a Passthrough Entity's assets, all unrealized capital gains and losses that would be realized if those assets were disposed of for fair market value in a taxable transaction and allocated to an API Holder with respect to its API, taking into account the principles of section 704(c). In a tiered structure, API Gains and Losses and Unrealized API Gains and Losses retain their character as API Gains and Losses as they are allocated through the tiers.

B. Section 1061(c)(1): Definition of an Applicable Partnership Interest

Section 1061(c)(1) provides that an API is a partnership interest held by, or transferred to, a taxpayer, directly or indirectly, in connection with the performance of substantial services by the taxpayer, or by any other related person, in any ATB. For this purpose, the regulations define a *Related Person* as a person or entity who is treated as related to another person or entity under section 707(b) or 267(b). Both section 1061(c)(1) and the regulations provide that an API does not include certain partnership interests held by employees of entities that are not engaged in an ATB.

The regulations provide that an API means any interest in a partnership which, directly or indirectly, is transferred to (or is held by) an Owner Taxpayer or Passthrough Taxpayer in connection with the performance of substantial services by the Owner Taxpayer or by a Passthrough Taxpayer, or by a Related Person, including services performed as an employee, in any ATB unless an exception applies. There may be one or more Passthrough Entities between the partnership that originally issued the API and the Passthrough Entity in which the Owner Taxpayer holds its indirect interest in the API. Each Passthrough Entity in the tiered structure is treated as holding an API under the regulations, that is, each Passthrough Entity is an API Holder as is the Owner Taxpayer. An API Holder may be an individual, partnership, trust, estate, S corporation (as defined in section 1361(a)(1)), or a PFIC with respect to which the shareholder has a QEF election in effect under section 1295.

Section 1061(c)(1), similar to section 1061(a), uses the term ''taxpayer.'' The proposed regulations provide that an Owner Taxpayer is the taxpayer for purposes of section 1061(a). The regulations further provide that the reference to ''taxpayer'' in section 1061(c)(1) also includes a *Passthrough Taxpayer.* A Passthrough Taxpayer is a Passthrough Entity that is treated as a taxpayer for the purpose of determining the existence of an API, regardless of whether such Passthrough Taxpayer itself is subject to Federal income tax. Generally, if an interest in a partnership is transferred to a Passthrough Taxpayer in connection with the performance of its own services, the services of its owners, or the services of persons related to either such Passthrough Taxpayer or its owners, the interest is an API as to the Passthrough Taxpayer. The Passthrough Taxpayer's ultimate owners will be treated as Owner Taxpayers, unless otherwise excepted.

A partnership interest is an API if it was transferred in connection with the performance of substantial services. The regulations presume that services are substantial with respect to a partnership interest transferred in connection with services. This presumption is based on the assumption, for purposes of section 1061, that the parties have economically equated the services performed or to be performed with the potential value of the partnership interest transferred. The regulations provide that, subject to certain exceptions, once a partnership interest is an API, it remains an API and never loses its API character.

C. Section 1061(c)(2): Definition of an Applicable Trade or Business

Under section 1061, for an interest in a partnership to be an API, the interest must be held or transferred in connection with the performance of substantial services in an ATB. An ATB is defined in section 1061(c)(2) as any activity conducted on a regular, continuous, and substantial basis consisting, in whole or in part, of raising or returning capital, and either (i) investing in (or disposing of) specified assets (or identifying specified assets for such investing or disposition), or (ii) developing specified assets. The regulations refer to these actions, respectively, as *Raising or Returning Capital Actions* and *Investing or Developing Actions* (collectively, *Specified Actions*). The regulations provide that an activity is conducted on a regular, continuous, and substantial basis if it meets the *ATB Activity Test.* The ATB Activity Test is met if the total level of activity (conducted in one or more entities) meets the level of activity required to establish a trade or business for purposes of section 162.

In applying the ATB Activity Test, the regulations provide that it is not necessary for both Raising or Returning Capital Actions and Investing or Developing Actions to occur in a single taxable year. In that regard, the combined Specified Actions are considered together to determine if the ATB Activity Test is met.

Section 1061(c)(3) provides that specified assets (*Specified Assets*) are securities, as defined in section 475(c)(2) (without regard to the last sentence thereof), commodities, as defined in section 475(e)(2), real estate held for rental or 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. The definition of Specified Assets in the regulations generally tracks the statutory language. It also includes an option or derivative contract on a partnership interest to the extent that the partnership interest represents an interest in other Specified Assets.

D. Section 1061(c)(4) and Other Exceptions to API Treatment

Section 1061 includes four exceptions to the treatment of a profits interest as an API and the regulations add an additional exception.

First, the statutory definition of an API in section 1061(c)(1) excludes 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.

Second, section 1061(c)(4)(A) provides that an API does not include any interest in a partnership directly or indirectly held by a corporation. The regulations provide that the term ''corporation'' for purposes of section 1061(c)(4)(A) does not include an S corporation for which an election under section 1362(a) is in effect or a PFIC with respect to which the shareholder has a QEF election under section 1295 in effect.

Third, section 1061(c)(4)(B) provides that an API does not include a capital interest which provides 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 capital interest exception). The regulations provide that long-term capital gains and losses with respect to an API Holder's capital investment in a Passthrough Entity, referred to as *Capital Interest Gains and Losses* (which can include allocations and disposition amounts meeting the requirements), are not subject to recharacterization under section 1061. As explained in more detail in Part II.A. of this Summary of Comments and Explanation of Revisions, to meet this exception to API treatment, the proposed regulations require allocations to API Holders (or Passthrough Entities that hold an API in a lower-tier Passthrough Entity) to be made in the same manner as to certain other partners. The final regulations provide a revised and simplified rule that looks to whether allocations are commensurate with capital contributed.

Fourth, section 1061(b) provides that to the extent provided by the Secretary, section 1061 will not apply to income or gain attributable to any asset not held for portfolio investment on behalf of third party investors.

Finally, the regulations provide that an interest in a partnership that was an API in the hands of the seller will not be treated as an API in the hands of the purchaser if the interest is acquired by a bona fide purchaser who (i) does not provide services in the Relevant ATB to which the acquired interest relates, (ii) is unrelated to any service provider, and (iii) acquired the interest for fair market value.

E. Section 1061(d): Transfer of API to a Section 1061(d) Related Person

Section 1061(d)(1) provides that if a taxpayer transfers an API, directly or indirectly, to a related person described in section 1061(d)(2), the taxpayer must include in gross income (as short term capital gain) the excess of so much of the taxpayer's long term capital gains with respect to such interest for the taxable year attributable to the sale or exchange of any asset held for not more than 3 years as is allocable to such interest over any amount treated as short term capital gain under section 1061(a).

A related person for purposes of section 1061(d)(2) (a *Section 1061(d) Related Person*) is defined more narrowly than a related person for purposes of section 1061(c)(1) and includes only members of the taxpayer's family within the meaning of section 318(a)(1), the taxpayer's colleagues (those who provided services in the ATB during certain time periods) and, under the regulations, a Passthrough Entity to the extent that a member of the taxpayer's family or a colleague is an owner.

F. Section 1061(e): Reporting

Section 1061(e) provides that the Secretary ''shall require such reporting (at the time and in the manner prescribed by the Secretary) as is necessary to carry out the purposes of [section 1061].'' The regulations set forth the reporting requirements and include rules for providing information required to compute the Recharacterization Amount when there is a tiered structure.

G. Regulatory Authority

Section 1061(f) provides that the Secretary ''shall issue such regulations or other guidance as is necessary or appropriate to carry out the purposes of [section 1061].'' The legislative history indicates that such guidance is to address the prevention of abuse of the purposes of the provision. *See* H.R. Conf. Rep. No. 115–466 at 422 (2017) (Conference Report); *see also* Joint Committee on Taxation, General Explanation of Public Law 115–97, JCS–1–18, at 203 (2017) (Blue Book). The Conference Report and the Blue Book also state that the guidance is to address the application of the provision to tiered structures of entities. *See id.*

II. Primary Changes to the Proposed Regulations

The majority of comments received on the proposed regulations relate to four areas: (1) The capital interest exception; (2) the treatment of capital interests acquired with loan proceeds; (3) the Lookthrough Rule for certain API dispositions; and (4) transfers of APIs to Section 1061(d) Related Persons. After considering these comments, the Treasury Department and the IRS have determined that changes in approach are required for each of these sections of the final regulations. The remainder of this section generally describes the comments received in these areas and the changes made in response. While all comments timely received were considered, comments are not described in detail to the extent that the ancillary concerns raised by the commenter were resolved by the changes made to the final regulations.

A. Capital Interest Exception

Section 1061(c)(4)(B) provides that an API does not include certain capital interests. The proposed regulations implement the capital interest exception by excepting from recharacterization long-term capital gains and losses that represent a return on an API Holder's capital invested in a Passthrough Entity. The proposed regulations refer to these amounts as Capital Interest Gains and Losses, and include in that definition *Capital Interest Allocations, Passthrough Interest Capital Allocations,* and *Capital Interest Disposition Amounts* that meet the requirements of proposed § 1.1061–3(c)(3) through (6).

The majority of comments received regarding the capital interest exception suggested that the rules in the proposed regulations are too rigid and do not reflect many common business arrangements, resulting in many capital interest holders being denied eligibility for the exception. Commenters described a variety of concerns, detailed in this Part II.A.

The final regulations provide a revised and simplified rule that looks to whether allocations are commensurate with capital contributed. An allocation will be considered a Capital Interest Allocation if the allocation to the API Holder with respect to its capital interest is determined and calculated in a similar manner to the allocations with respect to capital interests held by similarly situated *Unrelated Non-Service Partners* who have made significant aggregate capital contributions.

1. Capital Interest Allocations, in General

Proposed § 1.1061–3(c)(3) provides that for an allocation to be treated as a Capital Interest Allocation or a Passthrough Interest Capital Allocation, the allocation must be one made in the same manner to all partners. As described further in part II.A.2. of this Summary of Comments and Explanation of Provisions, proposed § 1.1061–3(c)(4) further provides, in part, that Capital Interest Allocations are allocations of long-term capital gain or loss make to an API Holder and to Unrelated Non-Service Partners based on their respective capital account balances where the Unrelated Non-Service Partners have a significant aggregate capital account balance equal to five percent or more of the aggregate capital account balance of the partnership are the time the allocations are made. The proposed regulations also indicate that in general, an allocation will be deemed to satisfy the ''same manner'' requirement if, under the partnership agreement, the allocation is based on the relative capital accounts of the partners (or Passthrough Entity owners) who are receiving the allocation in question and the terms, priority, type and level of risk, rate of return, and rights to cash or property distributions during the partnership's operations and on liquidation are the same. Allocations to an API Holder may be subordinated to allocations to Unrelated Non-Service Partners or reduced by the cost of services provided by such API Holder or a Related Person. Under proposed § 1.1061–3(c)(3)(ii), in the case of a partnership that maintains capital accounts under § 1.704–1(b)(2)(iv), the allocation must be tested based on that partner's capital account. In the case of a Passthrough Entity that is not a partnership (or a partnership that does not maintain capital accounts under § 1.704–1(b)(2)(iv)), if the Passthrough Entity maintains and determines accounts for its owners using principles similar to those provided under § 1.704–1(b)(2)(iv), those accounts will be treated as a capital account for purposes of the proposed regulations.

Several commenters noted that requiring allocations be made in accordance with partners' overall section 704(b) capital accounts in a fund does not comport with the commercial reality of how most venture capital, private equity funds, and hedge funds make their allocations, and would preclude API Holders from ever utilizing the capital interest exception. One commenter noted that many bona fide partnerships use targeted allocations and questioned whether it is fair to exclude partnerships that do not maintain section 704(b) capital or similar accounts from the capital interest exception when those capital accounts lack economic significance in the business arrangement. The commenter asked the same question about partnerships that maintain capital accounts using generally accepted accounting principles (GAAP).

Several commenters objected to the ''same manner'' requirement on the grounds that it did not properly implement section 1061(c)(4)(B), which provides, in part, that an API ''shall not include 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'' by such partner. Commenters explained that while fund managers may earn an economic return on both their capital investment and their APIs, they generally do not have the same economic rights with respect to their capital investment that the limited partners in the fund have with respect to their capital investment. For example, commenters indicated that an API Holder may be entitled to tax distributions, may have different allocations of expenses, may be subject to regulatory allocations (for example, minimum gain chargeback, as described in § 1.704–2), and may have different withdrawal or liquidity rights, which might be more or less favorable than those provided to Unrelated Non-Service Partners. Commenters indicated there could be varying liquidity rights between Unrelated Non-Service Partners and noted that API Holders' capital may be subject to more risk than Unrelated Non-Service Partners' capital in that API Holders may bear the first risk of loss. In the case of hedge funds, commenters noted that limited partners may invest at different times and, as such, earn a return that may not be comparable to other limited partners' returns.

In addition, several commenters explained that economic rights and allocations in private equity and venture capital funds are frequently determined and made on a deal-by-deal basis, including allocations made in a tiered structure by an API Holder that is a Passthrough Entity, and that funds may have multiple classes of interests with different rights and obligations, meaning that economic rights and allocations are rarely, if ever, aligned with respect to all partners based on the partners' section 704(b) capital accounts.

For the aforementioned reasons, several commenters recommended that the ''same manner'' requirement be eliminated and replaced with a rule that permits distributions and allocations to an API Holder, who contributes capital to a fund, to be ''commensurate'' with capital contributed by Unrelated Non-Service partners. Similarly, one commenter suggested that the only requirement be that an allocation to an API Holder be calculated and determined in a similar manner as the allocations to similarly situated Unrelated Non-Service Partners. Several commenters suggested that funds should be able to establish that they satisfied the ''commensurate'' standard using any reasonable method.

Commenters also recommended that the scope of the term ''cost of services'' as used in the proposed regulations be further explained, noting that situations where API Holders' capital investments are not subject to management fees, while other investors' interests are subject to management fees, should not prevent the API Holders' capital interests from qualifying for the capital interest exception. Commenters recommended that the final regulations clarify the meaning of the term ''cost of services'' and specify that an API Holder's capital investment that is not subject to incentive payments or to management fees may still be eligible for the capital interest exception.

Because private equity and hedge funds operate differently, commenters suggested that there should be separate rules, tailored to each structure, with respect to the capital interest exception. The commenters alluded to the notion that, although private equity and hedge funds each operate within a certain blueprint, there are many variations.

The Treasury Department and the IRS generally agree with commenters that under the test in the proposed regulations, it might be difficult for some common business arrangements to meet the capital interest exception and that a partner comparison, based on capital contributed rather than the partners' section 704(b) capital accounts, would be more accurate in determining whether an interest qualifies for the capital interest exception. Accordingly, the final regulations provide that Capital Interest Allocations must be commensurate with capital contributed in order to qualify for the capital interest exception. The final regulations replace the requirement that allocations be made to all partners in the same manner with a requirement that an allocation to an API Holder with respect to its capital interest must be determined and calculated in a similar manner as the allocations with respect to capital interests held by similarly situated Unrelated Non-Service Partners who have made significant aggregate capital contributions. In this regard, the allocations and distribution rights with respect to API Holders' capital interests and the capital interests of Unrelated Non-Service Partners who have made significant aggregate capital contributions must be reasonably consistent. The similar manner test may be applied on an investment-by-investment basis or on the basis of allocations made to a particular class of interests. The final regulations retain the factors used in the proposed regulations to determine whether allocations and distribution rights are made in a similar manner among partners: The amount and timing of capital contributed, the rate of return on capital contributed, the terms, priority, the type and level of risk associated with capital contributed, and the rights to cash or property distributions during the partnership's operations and on liquidation. The final regulations maintain the rule that an allocation to an API Holder will not fail to qualify solely because the allocation is subordinated to allocations made to Unrelated Non-Service Partners or because an allocation to an API Holder is not reduced by the cost of services provided by the API Holder or a Related Person to the partnership. The final regulations also clarify the meaning of cost of services for this purpose. The fact that API Holders are not charged management fees on their capital or that their capital is not subject to allocations of API items will not prevent the API Holder's capital interest from being eligible for the capital interest exception. Similarly, an allocation to an API Holder will not fail if an API Holder has a right to receive tax distributions while Unrelated Non-Service Partners do not have such a right, where such distributions are treated as advances against future distributions.

The final regulations extend these concepts to allocations made through tiered structures. The final regulations remove the terms Passthrough Capital Allocation, Passthrough Interest Capital Allocation, and Passthrough Interest Direct Investment Allocation, and instead provide that an allocation made to a Passthrough Entity that holds an API in a lower-tier Passthrough Entity will be considered a Capital Interest Allocation if made in accordance with the principles applicable in determining Capital Interest Allocations. Under the final regulations, Capital Interest Allocations retain their character when allocated to an upper-tier partnership so long as they are allocated among the partners in the upper-tier partnership with respect to such partners' capital interests in a manner that is respected under section 704(b) (taking the principles of section 704(c) into account).

Because the revised rules provide sufficient flexibility for all structures, the final regulations do not adopt the suggestion to provide a separate set of rules for private equity and hedge funds. The Treasury Department and the IRS continue to study other issues raised by the commenters, including the application of the similar manner requirement to S corporations and the application of the capital interest exception to co-invest vehicles.

The Treasury Department and the IRS request any additional comments on the application of the capital interest exception in the final regulations.

2. Unrelated Non-Service Partner Requirement

As discussed in the prior section, proposed § 1.1061–3(c)(4) provides additional guidance on Capital Interest Allocations. Under the proposed regulations, Capital Interest Allocations are allocations of long-term capital gain or loss made under the partnership agreement to an API Holder and to Unrelated Non-Service Partners based on their respective capital accounts and which meet other requirements. Unrelated Non-Service Partners are defined in proposed § 1.1061–1(a) as partners who have not provided services to the Relevant ATB and who are not, and have never been, related to any API Holder in the partnership or any person who provides, or has provided, services in the Relevant ATB. Proposed § 1.1061–3(c)(4) specifies that Capital Interest Allocations must be made in the same manner to API Holders and to Unrelated Non-Service Partners with a significant aggregate capital account balance (defined as five percent or more of the aggregate capital account balance of the partnership at the time the allocations are made). Proposed § 1.1061–3(c)(4)(iii) provides that the allocations to the API Holder and the Unrelated Non-Service Partners must be 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. The partnership agreement and the partnership books and records must also clearly demonstrate that the requirements for an allocation to be considered a Capital Interest Allocation have been met.

For allocations made on a deal-by-deal or class-by-class basis, commenters noted that it is unclear if the requirement that allocations be made in the same manner to API Holders and Unrelated Non-Service Partners with a significant aggregate capital account balance applies to each deal or class, or if it applies only to a fund generally. One commenter suggested that as an alternative to a strict percentage test, funds should also be able to satisfy the test by establishing that the return on a class of equity was determined at arm's length. Another commenter noted that a specific number or percentage of Unrelated Non-Service Partners must comprise the test group to prevent easy avoidance of the statute but questioned whether the five percent threshold for the test group is the appropriate threshold. The commenter also asked for clarification on the effect of the rule in proposed § 1.1061–3(c)(3)(ii)(C) that a capital account, for these purposes, does not include the contribution of amounts attributable to loans made by other partners or the partnership when comparing the allocations made to API Holders and Unrelated Non-Service Partners.

One commenter stated that many funds would be unable to meet the requirement that allocations to the API Holder and the Unrelated Non-Service Partners be clearly identified in the partnership agreement because their agreements use liquidating distributions to govern an API Holder's rights with respect to its API rather than allocations. The commenter recommended that the requirement be considered satisfied if the distribution provision clearly identified capital interest distributions separate and apart from distributions with respect to APIs. Several other commenters suggested that the rule requiring the allocations to be clearly identified both under the partnership agreement and on the partnership's books and records be disjunctive, that is, that the allocations be clearly demarcated in either the partnership agreement or on the partnership's books and records. Commenters noted that in order to meet the partnership agreement reporting requirement, a fund would have to update its partnership agreements, which could be done only by negotiating with the Unrelated Non-Service Partners. Initiating those negotiations could cause partners to want to negotiate other partnership items, which could take time and alter the agreements. These commenters thus suggested grandfathering existing partnership agreements or providing a transition period for funds to update their agreements to comply with this requirement.

The final regulations retain the requirement that Capital Interest Allocations to an API Holder be compared to Capital Interest Allocations made to Unrelated Non-Service Partners, as well as the requirement that Capital Interest Allocations be made to Unrelated Non-Service Partners with a significant capital account balance, including the five percent threshold. The Treasury Department and the IRS considered a number of alternatives and determined that the five percent threshold adequately insures that there is a significant comparison to meet the statutory exception that an API does not include a capital interest which provides the API Holder with a right to share in partnership capital commensurate with the amount of capital contributed. In accordance with the provision that the similar manner test in the final regulations may be applied on an investment-by-investment or class-by-class basis, the final regulations specify that the Unrelated Non-Service Partner requirement can also be applied on an investment-by-investment basis, or on a class-by-class basis. The final regulations move the definition of Capital Interest Allocations to the definition section of the final regulations but retain the requirement that allocations with respect to, and corresponding to, contributed capital be clearly identified under both the partnership agreement and in the partnership's books and records as separate and apart from allocations made to the API Holder with respect to its API, and specify that the books and records must be contemporaneous. Documenting the allocations in the partnership agreement and in contemporaneous books and records is a necessary corollary to the rule requiring Capital Interest Allocations to be made in a similar manner between API Holders and Unrelated Non-Service Partners with a significant interest, because it shows that the partnership's Unrelated Non-Service Partners considered these allocations a valid return on their contributed capital.

The final regulations do not include a rule that would grandfather existing partnership agreements or provide a transition period for partnerships to update their agreements. Because the final regulations more closely align the capital interest exception to standard industry practice, the number of partnership agreements that will need to be amended is reduced. Allocations made to an API Holder that do not meet the requirements of these final regulations will not be considered Capital Interest Allocations. Finally, due to the revisions made to the capital interest exception in these final regulations, the Treasury and the IRS have determined that it is not necessary to clarify the effect that the rule disregarding contributions made with the proceeds of loans by other partners or by the partnership has on the comparison of the allocation made to API Holders and Unrelated Non-Service Partners.

3. Capital Interest Disposition Amounts

If an owner disposes of an interest in a Passthrough Entity that is composed of a capital interest and an API, proposed § 1.1061–3(c)(6) provides a mechanism for the owner to determine the portion of long-term capital gain or loss recognized on the disposition that is treated as a Capital Interest Disposition Amount and thus, a Capital Interest Gain or Loss.

The final regulations clarify the determination of an API Holder's Capital Interest Disposition Amount when the API Holder transfers a Passthrough Entity interest that is comprised of both an API and a capital interest at a gain and would be allocated only capital loss as a Capital Interest Allocation if all of the assets of the Passthrough Entity had been sold for their fair market value in a fully taxable transaction immediately before the interest transfer. In such an instance, the final regulations provide that all of the long-term capital gain attributable to the interest transfer is API Gain. Conversely, if such API Holder recognizes long-term capital loss on the transfer of a Passthrough Entity interest and would be allocated only capital gain as a Capital Interest Allocation if all of the assets of the Passthrough Entity had been sold for their fair market value in a fully taxable transaction immediately before the interest transfer, the final regulations provide that all of the long-term capital loss attributable to the interest transfer is API Loss. The final regulations provide additional rules where a transferred Passthrough Entity interest results in a gain and the transferor would have been allocated both Capital Interest Gain and API Gain as well as where a transferred Passthrough Entity interest results in a loss and the transferor would have been allocated both Capital Interest Loss and API Loss. In such instances, a fraction is used to determine the portion of the transferred interest gain or loss characterized as a Capital Interest Disposition Amount.

Commenters noted a concern that Example 5 in proposed regulation § 1.1061–3(c)(7)(v), did not adequately address basis proration upon a partial interest sale where a partner holds a partnership interest comprised of both an API and a capital interest. Specifically, one commenter noted that Example 5's reliance on the equitable apportionment approach of § 1.61–6(a) could lead to a situation where the characterization of the gain or loss attributable to the sale of a portion of the partner's partnership interest differs from the characterization of that partner's distributive share of asset gain or loss if all of the assets of the Passthrough Entity were sold for their fair market value in a fully taxable transaction. Another commenter suggested applying the specific identification rules in § 1.1223–3 applicable to publicly traded partnership units to transfers of private interests. These commenters noted that because the issue illustrated in Example 5 has ramifications beyond section 1061, further study should occur before proceeding with the position stated in Example 5.

The Treasury Department and the IRS continue to study the issue noted with respect to Example 5 and have removed the example in the interim as many of the concerns raised on the sale of a partial partnership interest extend beyond section 1061.

4. Unrealized API Gains and Losses

Proposed § 1.1061–1(a) defines Unrealized API Gains and Losses as all unrealized capital gains and losses, including both short-term and long-term, that would be allocated to an API Holder with respect to its API if all relevant assets were disposed of for fair market value in a taxable transaction on the relevant date. Proposed § 1.1061–2(a)(1)(ii) provides rules for the treatment of Unrealized API Gains and Losses, including the requirement to determine Unrealized API Gains and Losses in tiered structures. Proposed § 1.1061–3(c)(3)(iii) provides that Capital Interest Allocations and Passthrough Interest Capital Allocations do not include amounts treated as API Gains and Losses or Unrealized API Gains and Losses.

A commenter stated that the requirement to determine Unrealized API Gains and Losses in tiered structures is not reasonable because an upper-tier Passthrough Entity would not be able to require every uncontrolled lower-tier Passthrough Entity in the chain to revalue its assets under the principles of § 1.704–1(b)(2)(iv)(*f*). The commenter recommended that the mandatory section 1061 revaluation rules be eliminated. The commenter requested instead that the existing rules for revaluations under the section 704(b) and 704(c) regulations govern Unrealized API Gains and Losses. Alternatively, the commenter suggested that anti-abuse regulations be written to address revaluations in chains of controlled tiered partnerships.

The final regulations remove the mandatory revaluation rules and adopt the commenter's suggestion that

Unrealized API Gains and Losses be determined according to the existing rules governing unrealized gains and losses, including section 704(c) principles. Accordingly, the final regulations provide that the term Unrealized API Gains and Losses means, with respect to a Passthrough Entity's assets, all unrealized capital gains and losses that would be (i) realized if those assets were disposed of for fair market value in a taxable transaction on the relevant date, and (ii) allocated to an API Holder with respect to its API, taking into account the principles of section 704(c).

Because the proposed regulations provide that Capital Interest Allocations are made based on partners' relative section 704(b) capital accounts, several commenters questioned whether Unrealized API Gains and Losses that are reflected in an API Holder's capital account could generate Capital Interest Allocations, including book Capital Interest Allocations, before these amounts are recognized. Commenters explained that these issues are particularly relevant for hedge funds and described their operations and incentive structure. When an API Holder in a hedge fund receives incentive allocations with respect to the API, its capital account is increased by the amount of the incentive allocation, and Unrelated Non-Service Partners' capital accounts are decreased. This increase is coupled with allocations of taxable income and gain and also allocations of unrealized gain (reverse section 704(c) allocations). Commenters also requested additional guidance on the treatment of realized and unrealized gains from an API which are contributed to, or reinvested in, a partnership.

The final regulations continue to provide that Unrealized API Gains and Losses are not included in Capital Interest Gains and Losses. In response to comments, the final regulations clarify that if an API Holder is allocated API Gain by a Passthrough Entity, to the extent that an amount equal to the API Gain is reinvested in Passthrough Entity by the API Holder (either as the result of an actual distribution and recontribution of the API Gain amount or the retention of the API Gain amount by the Passthrough Entity), the amount will be treated as a contribution to the Passthrough Entity for a capital interest that may produce Capital Interest Allocations for the API Holder, provided such allocations otherwise meet the requirements to be a Capital Interest Allocation.

B. Capital Contributions Made With the Proceeds of Partnership or Partner Loans

Proposed § 1.1061–3(c)(3)(ii)(C) provides that for purposes of proposed §§ 1.1061–1 through 1.1061–6, 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, the partnership, or a Related Person with respect to any other partner or the partnership. Repayments on the loan are included in capital accounts as those amounts are paid by the partner, provided that the loan is not repaid with the proceeds of another similarly sourced loan. *Id.*

Several commenters criticized this treatment, suggesting that the exclusion of these amounts from the partner's capital account inhibits common and reasonable business practices, and creates barriers to entry for service partners, particularly those who are less represented based on age, gender, or race or do not have ready access to capital. One commenter noted that it is typical for fund managers to either extend loans to their employees, or to guarantee loans issued to such employees by third parties, so that employees may invest in the manager's own investment funds. Similarly, another commenter stated that the proposed regulations would introduce a substantial impediment to raising capital for commercial real estate investment by creating a disincentive for general partners to finance or support the financing of the participation of its employees in its commercial real estate investments. The commenter claimed that contributions made in this manner are a significant source of capital available for real estate investment and also an important factor in attracting third party capital because they create an alignment of interest between the limited partners and the general partner and its employees.

Commenters noted that neither the statute nor the legislative history indicates that the use of loan proceeds to make a capital contribution precludes the interest from being included in a partner's capital account and contended that adding such a rule is not justified by the commensurate with capital statutory language of the capital interest exception. To the contrary, commenters argued that the authors of the TCJA were familiar with prior proposals regarding profits interests that contained exceptions for loaned capital and their decision not to include such an exception in section 1061 is an indication that the choice was intentional. Instead, one commenter maintained that Congress addressed any concerns through the rule that a service provider's rights with respect to its contributed capital must match the rights of other non-service partners with respect to their shares of contributed capital.

Some commenters recognized that the exclusion from capital accounts of contributions attributable to partner or partnership loans is an attempt to control the perceived abuse of limited partners loaning the general partner of the partnership an amount of capital that entitles the general partner to a portion of the partnership's profits in order to avoid the application of section 1061 and fit within the capital interest exception. Commenters noted that section 1061(f) provides the Secretary with authority to issue guidance as is necessary or appropriate to carry out the purposes of section 1061 and that the legislative history indicates that such guidance is to address the prevention of abuse of the purposes of the provision.

Other commenters, suggesting that the policy behind the capital interest exception is to ensure a partner has capital at risk to qualify for the exception, acknowledged that there are fact patterns in which a partner might be considered less at risk. One commenter pointed to the at-risk limitation on losses under section 465, noting that a service provider would not be considered at-risk with respect to contributed capital that is financed through a loan from another partner, even if the loan were fully recourse to the service provider. By contrast, a partner is considered at-risk when an investment is funded by a third-party loan for which the partner has personal liability. Another commenter noted that the proposed regulations' treatment of a capital interest funded through a loan from the issuing partnership is consistent with the treatment of partnership loans under other areas of Subchapter K. The commenter pointed out that the contribution of a partner's own promissory note generally does not increase the partner's basis in its partnership interest under section 722. Similarly, pursuant to § 1.704–1(b)(2)(iv)(*d*)(*2*), the partner's capital account will be increased with respect to the promissory note only when there is a taxable disposition of the note by the partnership or when the partner makes principal payments on such note, provided that the note is not readily tradable on an established securities market.

Despite recognizing these concerns regarding abuse, commenters maintained that the loan proceeds exclusion should be eliminated because general income tax principles, such as those in sections 83 and 7872, are sufficient to determine whether a loan-financed arrangement should not qualify for the capital interest exception. Other commenters suggested that if limitations must be imposed, the rule should be narrowly tailored, recommending that only loans that are nonrecourse or lack substantial security be excluded from the capital interest exception. Commenters also suggested that guarantees should not be treated in the same manner as a loan, particularly in the context of a recourse loan or a loan from a third-party bank. Another commenter suggested that if the loan or guarantee operates under normal arms-length standards, it should be eligible to support a capital contribution. Another commenter noted that the proposed regulations are silent on loans that are fully secured with partnership assets.

The Treasury Department and the IRS remain concerned that capital contributions made with the proceeds of loans made or guaranteed by another partner, the partnership, or a Related Person with respect to such partner or partnership could lead to abuse of the capital interest exception. Therefore, the final regulations do not adopt the suggestions to remove the rule. However, the Treasury Department and the IRS agree with commenters that the potential for abuse is reduced when a loan or advance is made by another partner (or Related Person with respect to such other partner, other than the partnership) to an individual service provider if the individual service provider is personally liable for the repayment of such loan or advance. Accordingly, the final regulations provide that an allocation will be treated as a Capital Interest Allocation if the allocation is attributable to a contribution made by an individual service provider that, directly or indirectly, results from, or is attributable to, a loan or advance from another partner in the partnership (or any Related Person with respect to such lending or advancing partner, other than the partnership) to such individual service provider if the individual service provider is personally liable for the repayment of such loan or advance as described in the final regulations. The final regulations apply a similar approach with respect to loans or advances made by a partner in the partnership (or a Related Person to such partner, other than the partnership) to a wholly owned entity that is disregarded as separate from an individual service provider where the individual service provider that owns such disregarded entity is personally liable for the repayment of any borrowed amounts that are not repaid by the disregarded entity. The final regulations provide that an individual service provider is personally liable for the repayment of a loan or advance made by a partner (or any Related Person, other than the partnership) if (i) the loan or advance is fully recourse to the individual service provider; (ii) the individual service provider has no right to reimbursement from any other person; and (iii) the loan or advance is not guaranteed by any other person. The Treasury Department and the IRS continue to study the treatment of guarantees generally in light of questions about who the borrower is for Federal tax purposes.

A commenter noted that the proposed regulations' treatment of loans, together with the section 704(b) capital account approach being taken with respect to the capital interest exception, could mean that a partner who borrows from a related person to make even a small portion of his or her capital contribution might be denied the capital interest exception with respect to his or her entire capital interest. A few commenters recommended that if the treatment of related party loans is retained in the final regulations, adjustments should be made to ensure that partners are able to receive appropriate credit for capital contributions they make that are not attributable to loans. Another commenter stated that the proposed regulations did not provide a tracing regime to connect loan proceeds with capital contributions. One commenter suggested that final regulations clarify how to treat a partner that fully funded a capital contribution with loan proceeds but repaid such amounts before there was a capital interest allocation, including whether a revaluation would change the answer. The commenter recommended that it would be appropriate to treat the partner's capital account as funded at the time of actual contribution. Finally, the commenter recommended that final regulations include a transition rule related to related party loans made, advanced, guaranteed, or repaid before final regulations are issued. The Treasury Department and the IRS considered these comments and believe that the concerns raised in them are resolved by the commensurate with capital approach to the capital interest exception taken in the final regulations because this approach does not rely on a comparison of allocations based on the partners' overall section 704(b) capital accounts.

C. Lookthrough Rule for Certain API Dispositions

Proposed § 1.1061–4(b)(9) provides a limited Lookthrough Rule that may apply to the sale of an API where capital gain is recognized and the holding period of the API is more than three years. In the case of a disposition of a directly held API with a holding period of more than three years, the proposed Lookthrough Rule applies if the assets of the partnership in which the API is held meet the Substantially All Test. The Substantially All Test is met if 80 percent or more of the assets of the partnership in which the API is held, based on fair market value, are assets that would produce capital gain or loss that is not described in proposed § 1.1061–4(b)(6) if disposed of by the partnership, and that have a holding period of three years or less. In the case of a tiered structure in which an API Holder holds its API through one or more Passthrough Entities, the Lookthrough Rule applies if the API Holder disposes of a Passthrough Interest held for more than three years and recognizes capital gain, and either: (i) The Passthrough Entity through which the API is directly or indirectly held has a holding period in the API that is three years or less, or (ii) the Passthrough Entity through which the API is 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 Treasury Department and the IRS received several comments stating that, although the application of the Lookthrough Rule for directly-held APIs is reasonable, the application of the Lookthrough Rule for indirectly-held APIs is punitive and imposes an unreasonable and significant administrative burden. The commenters recommended that the scope of the Lookthrough Rule for indirectly-held APIs be limited, particularly in the case of indirectly-held APIs where the relevant taxpayer does not control a partnership that issued the API. Another commenter questioned the authority for the Lookthrough Rule but noted that it is consistent with partnership tax principles and that the proposed regulation would be easily manipulated without the rule.

Commenters suggested that the proposed regulations be amended in one or more of the following ways: (i) Limit the Lookthrough Rule to situations in which a Passthrough Entity controls all of the relevant lower-tier Passthrough

Entities (or only applying it to lower-tier Passthrough Entities that it controls); (ii) limit the Lookthrough Rule for indirectly held APIs to situations in which the API is held by a lower-tier Passthrough Entity for three years or less; (iii) limit the application of the Lookthrough Rule to situations in which assets that produce capital gain or loss of a type taken into account under section 1061 are a material amount (greater than 50 percent) of the value of the underlying assets of the partnership; (iv) eliminate the Substantially All Test in the context of tiered structures (that is, determine the applicability of the Substantially All Test with respect to the assets held by the partnership whose interest was sold); (v) amend the Substantially All Test so that a transferring taxpayer who has held its interest for more than three years will be required to look through to the underlying assets' character only if 80 percent or more of the assets held directly or indirectly by the Passthrough Entity have a holding period of three years or less; (vi) make information reporting related to the Lookthrough Rule mandatory for partnerships and S corporations and for required PFIC annual information statements regardless of whether a Passthrough Entity has issued or holds an API; (vii) provide a de minimis rule by which an upper-tier partnership holding a five percent or less interest in the lower-tier partnership would be allowed to use its holding period in the lower-tier partnership; and (viii) as a part of the de minimis rule, not require revaluations of lower-tier partnerships when an Owner Taxpayer disposes of an upper-tier interest that holds five percent or less of a lower-tier partnership. A commenter recommended that the Lookthrough Rule approach calculations in tiered structures from the lower-tier entities up, aligning with the approach to tiered structures elsewhere in the proposed regulations, and allowing the rule to appropriately accommodate lower-tier gains from assets whose sale proceeds are treated as capital gains without regard to section 1222(3) and (4).

After considering the comments, the Treasury Department and the IRS agree that the Lookthrough Rule as proposed could be difficult for Owner Taxpayers and Passthrough Entities to apply, particularly in the context of tiered structures. However, the Treasury Department and the IRS remain concerned that taxpayers could avoid section 1061 by transferring assets to, and issuing APIs from, existing partnerships. Accordingly, the final regulations retain the Lookthrough Rule, but instead of applying the Lookthrough Rule to the disposition of an API held for more than three years and where the Substantially All Test is met, the final regulations limit the application of the Lookthrough Rule to situations where, at the time of disposition of an API held for more than three years, (1) the API would have a holding period of three years or less if the holding period of such API were determined by not including any period prior to the date that an Unrelated Non-Service Partner is legally obligated to contribute substantial money or property directly or indirectly to the Passthrough Entity to which the API relates (this rule does not apply to the disposition of an API to the extent that the gain recognized upon the disposition of the API is attributable to any asset not held for portfolio investment on behalf of third party investors); or (2) a transaction or series of transactions has taken place with a principal purpose of avoiding potential gain recharacterization under section 1061(a). The Lookthrough Rule similarly applies with respect to a Passthrough Interest issued by an S corporation or a PFIC to the extent the Passthrough Interest is treated as an API. The final regulations also simplify the method for applying the Lookthrough Rule.

Commenters also stated that the Lookthrough Rule raises a concern that going concern value in a lower-tier entity might be subject to ordinary income rates if an upper-tier partnership interest is sold, the Lookthrough Rule applies, and the upper-tier partnership owns a lower-tier partnership interest. These commenters recommended that gain associated with goodwill or enterprise value retain the holding period of the partnership interest itself, as opposed to the underlying assets, and that the Lookthrough Rule apply only to the gain associated with the hypothetical liquidation of the underlying assets. The Treasury Department and the IRS continue to study this issue and may address it in future guidance.

One commenter requested clarification that the phrase ''total net capital gain'' in proposed § 1.1061–4(b)(9)(ii)(C)(*1*) refers to ''net long-term capital gain'' and that short- and long-term capital gains and losses cannot be netted against each other. The final regulations do not include this language. The Treasury Department and the IRS believe that the concerns raised by the commenter are alleviated by the simplified Lookthrough Rule adjustment in the final regulations.

D. Section 1.1061–5: Transfers to Related Parties

Proposed § 1.1061–5(a) provides that if an Owner Taxpayer transfers any API, or any Distributed API Property, directly or indirectly, to a Section 1061(d) Related Person, or if a Passthrough Entity in which an Owner Taxpayer holds an interest, directly or indirectly, transfers an API to a Section 1061(d) Related Person, regardless of whether gain is otherwise recognized on the transfer under the Code, the Owner Taxpayer must include in gross income as short-term capital gain, the excess of: (1) The Owner Taxpayer's net long-term capital gain with respect to such interest for such taxable year determined as provided in proposed § 1.1061–5(c), over (2) any amount treated as short-term capital gain under proposed § 1.1061–4 with respect to the transfer of such interest (that is, any amount included in the Owner Taxpayer's API One Year Disposition Gain Amount and not in the Owner Taxpayer's Three Year Disposition Gain Amount with respect to the transferred interest). Proposed § 1.1061–5(b) provides that for purposes of section 1061(d), the term transfer includes contributions, distributions, sales and exchanges, and gifts.

Several commenters addressed whether section 1061(d) should be interpreted as an acceleration provision or merely a recharacterization provision. With certain exceptions, the proposed regulations require that gain be accelerated on the transfer of an API to a Section 1061(d) Related Person, regardless of whether the transfer is otherwise a taxable transaction for Federal income taxes or whether gain is otherwise realized or recognized under the Code on the transfer. One commenter supported this treatment, noting that section 1061(d)(1) is literally worded as an income acceleration provision while acknowledging that others have viewed the language as a recharacterization provision, such as section 751(a). Another commenter noted that neither the text nor the legislative history shed any light on its purpose and stated that the provision's language is susceptible to numerous different readings. The commenter noted that section 1061(d) could be read as a narrow recharacterization lookthrough provision similar to section 751, a recharacterization and assignment of income provision that provides for nonrecognition transfers and requires the transferor rather than the transferee to include API Gain when ultimately realized, a recharacterization and acceleration provision, or a proration provision. The commenter did not provide a recommendation, but noted that the proposed regulations create many traps for the unwary. The commenter stated that the broad definition of transfer in the proposed regulations combined with the overriding of nonrecognition treatment could lead to significant, adverse tax impacts on transferors as well as otherwise uninvolved, passive interest holders in a variety of transactions. The commenter suggested that the Treasury Department and the IRS carefully consider whether the effect of the proposed regulations is appropriate and aligns with section 1061(d)'s language, function, and origins.

Other commenters argued that applying section 1061(d) to transactions where gain is not otherwise recognized is inconsistent with the statutory language. One commenter stated that section 1061(d) itself does not refer to any nonrecognition provisions, nor does it contain any express statement of intent to override nonrecognition treatment. This commenter and others noted that section 1061(d) operates by reference to the taxpayer's long-term capital gains, which as defined in section 1223(3) include only gains that are recognized for U.S. Federal income tax purposes. Consequently, these commenters argued that the statute by its terms does not apply to situations in which the taxpayer has no actual long-term capital gain with respect to such interest. Commenters also noted that the legislative history does not provide support for treating section 1061(d) as an acceleration provision. Previous carried interest provisions included language that explicitly overrode non-recognition; section 1061 as enacted contains no such language.

One commenter stated that it is not necessary to accelerate gain on the transfer of an API to a Section 1061(d) Related Person, noting that the API in the hands of the transferee is still subject to section 1061(a) because an API includes interests held by or transferred to the taxpayer in connection with the performance of a substantial service by the taxpayer or a related person.

Commenters also raised a variety of concerns about the proposed regulation's definition of transfer. Commenters recommended that the term transfer be further defined to address potential cases involving indirect transfers of an API, such as the admission of new partners into the partnership, the withdrawal of old partners from the partnership, the transfer of an employee between teams, or an award to a high performer. One commenter explained that, in these circumstances, because there is no change in the relative economic position between fund managers and third-party investors, there should be no requirement for the fund manager or employees of the fund manager to recognize unrealized built-in gain. Commenters also recommended that the final regulations consider whether a forfeiture of an API is a transfer for purposes of section 1061(d) but stated that such an interpretation would be overbroad. One commenter noted that forfeiture and reallocations involve circumstances in which the partners' legal and economic interests in the partnership's Unrealized API Gains are contingent rather than fixed. Where a partner's interest in Unrealized API Gains is contingent, the commenter argued that it is not appropriate to tax a partner on a reduction in that interest under section 1061(d).

Another commenter asked for clarification that the distribution of an API by a direct API Holder to an Owner Taxpayer (indirect API Holder) would be exempt from the application of section 1061(d). The commenter noted that section 1061(a) would continue to apply to the distributed API and that this treatment would be consistent with the rules related to Distributed API Property in § 1.1061–4. Under those rules, a distribution of property by a Passthrough Entity to an API Holder is not subject to recharacterization under section 1061 but the Distributed API Property continues to be subject to section 1061. The commenter argued that this rule would also treat similarly situated taxpayers the same, rather than treating distributees of Distributed API Property differently from Owner Taxpayers who receive a distribution of an API from a partnership.

Another commenter asked for clarification that the definition of gift refers to transfers which are gifts for income tax purposes (rather than for gift tax purposes). The commenter noted that many common estate planning techniques involve transfers of assets to grantor trusts with the transferor as the grantor and the grantor's family members as beneficiaries of the trust, and that these types of transfers often result in a completed gift for gift tax purposes but do not constitute a transfer of ownership for income tax purposes.

Commenters also recommended that the final regulations exclude specific nonrecognition transactions, including (i) transfers resulting from the death of an Owner Taxpayer; (ii) gifts to a non-grantor trust by an Owner Taxpayer; and (iii) transfers resulting from a change in tax status of a grantor trust. One commenter noted that, in light of section 1061(d)'s specific reference to section 318(a)(1), and not to section 318(a)(2), a gift to a non-grantor trust for the benefit of a taxpayer's spouse, children, grandchildren or parents should not be considered an "indirect transfer" that would trigger the application of section 1061(d). The commenter noted that Congress's use of the phrase "directly or indirectly" does not warrant disturbing the conclusion that a transfer to a non-grantor trust does not constitute an acceleration event for purposes of section 1061(d). This commenter suggested in the alternative that if a transfer to a non-grantor trust is an acceleration event for purposes of section 1061(d), only upon a subsequent distribution of the API out of the non-grantor trust should the acceleration event occur.

After considering the comments, the Treasury Department and the IRS have determined that while section 1061(d) can reasonably be interpreted as an acceleration provision, in the absence of clear language to the contrary, it is more appropriate to apply section 1061(d) only to transfers in which long-term capital gain is recognized under chapter 1 of the Code. Interpreting section 1061(d) as only a recharacterization provision is consistent with the statutory language that looks to so much of the taxpayer's long-term capital gain with respect to such interest for such taxable year as is attributable to the sale or exchange of any asset held. This treatment also prevents the acceleration of gain in the many non-abusive nonrecognition transactions described by commenters. Furthermore, it is not necessary to accelerate gain on the transfers of an API to a Section 1061(d) Related Person in a non-taxable transaction because the API will remain an API in the hands of the transferee under § 1.1061–2(a). Accordingly, the final regulations provide that the Section 1061(d) Recharacterization Amount includes only long-term capital gain that the Owner Taxpayer recognizes under chapter 1 of the Code upon a transfer through a sale or exchange of an API to a Section 1061(d) Related Person.

Proposed § 1.1061–5(c) provides a formula for calculating the Owner Taxpayer's short-term capital gain upon a transfer of an API to a Section 1061(d) Related Person based upon a hypothetical sale of all of the partnership's property in a fully taxable transaction. A commenter noted that because the calculation is not based on the Recharacterization Amount under a hypothetical liquidation, it includes amounts excluded from the Recharacterization Amount, such as capital interest gains and losses. The commenter recommended that the formula be amended so that it is based upon the Recharacterization Amount in a hypothetical partnership liquidation, and that the final regulations contain an exception from taxation for transactions in which the Owner Taxpayer's deemed distributions with respect to the Owner Taxpayer's API on a hypothetical liquidation basis are the same immediately before and after the transaction (not including any deemed distributions due to changes in debt allocations). Another commenter suggested that, in order to avoid double-counting in a tiered structure, there should be a cap on the amount that would be taxed equal to the gain that would be realized if the directly transferred API were sold for its fair market value by the Owner Taxpayer.

Another commenter noted that the proposed regulations provide that section 1061(d) applies to transfers of APIs by Passthrough Entities and to transfers of Distributed API Property by Owner Taxpayers, but that the rules do not provide guidance on how to calculate the amount to be included. The commenter suggested that, in the case of a transfer of an API by a Passthrough Entity, the inclusion amount should be the amount that would be allocated to each of the Passthrough Entity's direct or indirect Owner Taxpayers in a deemed taxable sale of assets by the lower-tier entity in which the Passthrough Entity holds its API, and that the amounts that such Passthrough Entity includes in the API One Year Distributive Share Amount, but not in the API Three Year Distributive Share Amount, for each Owner Taxpayer should be subtracted from the aforementioned amounts to calculate an Owner Taxpayer's recharacterization amount under section 1061(d). In the case of a transfer of Distributed API Property by an Owner Taxpayer, the commenter suggested that the inclusion amount should be the amount of long-term capital gain that the Owner Taxpayer would have recognized on a taxable sale for cash at the Distributed API Property's fair market value.

The Treasury Department and the IRS appreciate these thoughtful suggestions. The final regulations have revised and simplified the computation of the inclusion amount in § 1.1061–5(c) and have added the term Section 1061(d) Recharacterization Amount. The final regulations provide that, if section 1061(d) applies, an Owner Taxpayer's Section 1061(d) Recharacterization Amount is the Owner Taxpayer's share of the amount of net long-term capital gain from assets held for three years or less that would have been allocated to the Owner Taxpayer with respect to the transferred API if the partnership had sold all of its property in a fully taxable transaction for cash in an amount equal to the fair market value of such property immediately prior to the Owner Taxpayer's transfer of the API (or a portion of such gain if only a portion of the API is transferred).

A commenter requested clarification as to whether ''capital gain recognized'' on an otherwise taxable transfer in proposed § 1.1061–5(c)(2) means that the amount recharacterized under section 1061(d) includes only gain that would otherwise be treated as long-term gain or whether it sets the total amount of short-term gain on the transfer. The final regulations provide that the long-term gain that is recharacterized to short-term under section 1061(d) is the lesser of (i) the amount of net long-term capital gain recognized by the Owner Taxpayer upon the transfer of such interest, or (ii) the Section 1061(d) Recharacterization Amount as computed under § 1.1061–5(c). Thus, only gain that would otherwise be treated as long-term gain is recharacterized under section 1061(d).

Proposed § 1.1061–5(d) provides that the basis of a transferred API or transferred Passthrough Interest (in the case of a transferred Indirect API) is increased by the additional gain recognized. A commenter requested that the rule be revised to explicitly coordinate with section 743 so that the basis adjustments will be allocated to the assets that result in the gain recognition. The concerns raised in this comment are resolved because the final regulations limit the application of section 1061(d) to transactions in which gain is recognized.

Another commenter recommended that the final regulations explicitly exclude amounts that would be subject to the Capital Interest Exception. The final regulations do not adopt this comment because the Capital Interest Exception is an exception to the definition of an API. Therefore, such a rule is not needed. Commenters also recommended that the final regulations explicitly exclude amounts specified in proposed § 1.1061–4(b)(6) (designated as § 1.1061–4(b)(7) in the final regulations) from the calculation of the Section 1061(d) Recharacterization Amount. One commenter noted that the scope of section 1061(d)(1) is broader than the tax result that would occur if the partnership had actually sold all its property, noting that neither the statute nor the proposed regulations exclude section 1231 gains (and other excluded gains such as those under section 1256) from the Section 1061(d) Recharacterization Amount. Another commenter argued that section 1061(d) should not recharacterize section 1231 gain, stating that while the statutory language in section 1061(d) provides arguable authority for including section 1231 gains in the computation of the Section 1061(d) Recharacterization Amount, the approach is hard to justify from a policy perspective. The commenter argued that because section 1061(d) is aimed at preventing an API Holder from circumventing section 1061(a), the regulations should not impose on taxpayers a result under section 1061(d) that is worse than if section 1061(a) had applied to assets sold by the partnership. The commenter recommended that ''long-term capital gains'' should be interpreted consistently for purposes of section 1061(a) and section 1061(d), and that long-term capital gain recognized with respect to section 1231 assets should not be recharacterized under either paragraph.

The final regulations adopt these comments and provide that the Section 1061(d) Recharacterization Amount does not include amounts not taken into account for purposes of section 1061 under § 1.1061–4(b)(7).

Proposed § 1.1061–5(c)(1) provides that if an Owner Taxpayer transfers an Indirect API and is subject to section 1061(d), the computation of the Section 1061(d) Recharacterization Amount must be applied at the level of any lower-tier Passthrough Entities. One commenter recommended that this rule be aligned with the rules for tiered partnerships elsewhere in the proposed regulations, such as the Lookthrough Rule, which explicitly states that it applies only to the ''assets of the partnership in which the API is held.'' A commenter recommended that the final regulations clarify whether the transfer of a distributed asset held, or deemed to be held, by the partnership for three years or less is subject to section 1061(d). Another commenter noted that there is no principled reason for not applying section 1061(d) in tiered partnerships to transfers of Distributed API Property by Passthrough Entities to Section 1061(d) Related Persons of the ultimate Owner Taxpayer.

Under the final regulations, the Section 1061(d) Recharacterization Amount is computed by the Owner Taxpayer. The transfer of a distributed asset held, or deemed to be held, by a Passthrough Entity for three years or less is subject to section 1061(d). The final regulations clarify that for purposes of section 1061(d), an Owner Taxpayer will be treated as transferring the Owner Taxpayer's share of any Indirect API or Distributed API Property if the Indirect API or Distributed API Property is transferred by the API Holder to a person that is a Section 1061(d) Related Person with respect to the Owner Taxpayer. The final regulations also provide that the rules for determining the Section 1061(d) Recharacterization Amount also apply to the transfer of a Passthrough Interest issued by an S corporation or PFIC to the extent the Passthrough Interest is treated as an API.

Proposed § 1.1061–5(e) defines a Section 1061(d) Related Person as: (i) A person that is a member of the taxpayer's family within the meaning of section 318(a)(1); (ii) a person that performed a service within the current calendar year or the preceding three calendar years in a Relevant ATB to the API transferred by taxpayer; or (iii) a Passthrough Entity to the extent that a person described in paragraph (e)(1)(i) or (ii) owns an interest, directly or indirectly. One commenter recommended that the definition of Section 1061(d) Related Person be amended to exclude a Passthrough Entity to the extent that a member of the taxpayer's family or colleague is an owner, noting that language is not in the statute and is not discussed in the legislative history. The final regulations do not adopt this comment. Section 1061(d)(1) provides that the inclusion required by section 1061(d) applies if a taxpayer transfers any API, directly or indirectly, to a person related to the taxpayer.

III. Additional Comments Received and Revisions Made

A. Sections 1.1061–1 and 1.1061–2: Definitions, Operational Rules, and Examples

1. Definitions, In General

A commenter expressed the view that the interrelated new terms and definitions make the proposed regulations difficult to read and comprehend in some places. The final regulations largely retain the terms and definitions provided in § 1.1061–1(a) but simplify many of the computational rules and concepts used to determine the Recharacterization Amount and the Section 1061(d) Recharacterization Amount. The terms and definitions provide a helpful roadmap to the regulations and are also needed to provide Owner Taxpayers, Passthrough Entities, and the IRS with a common vocabulary that can be used to describe the necessary computations and reporting requirements. The final regulations make clarifying changes throughout the definitions, including providing that a Passthrough Entity can also be a trust or estate. Terms have also been added and removed in accordance with the revisions discussed elsewhere in this Summary of Comments and Explanation of Revisions.

A commenter noted that the preamble to the proposed regulations provides that ''taxpayer'' means Owner Taxpayer in sections 1061(a) and (d), and both Owner Taxpayer and Passthrough Taxpayer in section 1061(c)(1). The commenter further noted that the proposed regulations use the definition of ''person'' as that term is generally used under section 7701(a)(1). The commenter requested that the final regulations provide explicit definitions of ''taxpayer'' and ''person'' in each relevant part because the terms have different meanings in different contexts.

The final regulations do not adopt this comment because defining taxpayer and person in different ways in each relevant section would introduce unnecessary complexity. However, the use of these terms has been modified in certain places in the final regulations to alleviate confusion.

2. Operational Rules

a. Definition of API; An API Remains an API

Proposed § 1.1061–1(a) provides that API means any interest in a partnership which, directly or indirectly, is transferred to (or is held by) an Owner Taxpayer or Passthrough Taxpayer in connection with the performance of substantial services by the Owner Taxpayer or by a Passthrough Taxpayer, or by any Related Person, including services performed as an employee, in any ATB unless an exception applies, and that for purposes of this definition, an interest in a partnership also includes any financial instrument or contract, the value of which is determined in whole or in part by reference to the partnership (including the amount of partnership distributions, the value of partnership assets, or the results of partnership operations.)

A commenter expressed concern that defining an interest in a partnership to include a financial instrument or contract, the value of which is determined in whole or in part by reference to the partnership, could include investment management contracts that provide for a fee based on the assets of a fund partnership and not a carried interest or other performance allocation, creating a risk that the sale of a management company or indirect sale of a management contract could be subject to section 1061. This in turn could cause the enterprise value of the management company to be taxed at ordinary income rates. The commenter recommended that the definition of API be modified to exclude financial instruments or contracts that merely reference the value of partnership assets or that provide for fee income that is subject to ordinary income tax treatment.

Because financial instruments can replicate the performance of a partnership interest, the inclusion of such items in the definition of an API is necessary for purposes of implementing section 1061. Accordingly, the final regulations do not adopt this comment. As stated in Part IV of this Summary of Comments and Explanation of Revisions, the Treasury Department and the IRS continue to study the impact of section 1061 on the taxation of enterprise value related to the transfer or exchange of partnership interests and management contracts.

Proposed § 1.1061–2(a)(1)(i) provides that once a partnership interest qualifies an API, the partnership interest remains an API unless and until the requirements of one of the exceptions to qualification of a partnership interest as an API are satisfied. A commenter questioned whether this provision is valid given that it is not explicit in the statute, but reasoned that the rule is implicit in the statutory scheme and is necessary to prevent avoidance of the statute.

The Treasury Department and the IRS agree with the commenter that this rule is implicit in the statutory scheme. Neither the statute nor the legislative history provide a time limit or other means of ending API treatment beyond the exceptions to qualification as an API. Consequently, no modifications have been made to § 1.1061–2(a)(1)(i).

b. Presumption That Services are Substantial

Proposed § 1.1061–2(a)(1)(iv) provides that if a partnership interest is transferred to or held by an Owner Taxpayer, Passthrough Taxpayer, or any Related Person in connection with the performance of services, the Owner Taxpayer, the Passthrough Taxpayer, or the Related Person is presumed to have provided substantial services for purposes of section 1061. Commenters suggested that presuming all services to be substantial is overbroad and recommended that the presumption be removed. In addition, one commenter recommended the inclusion of non-exclusive safe harbors that service partners could rely on to determine that partnership interests they hold or that have been transferred to them are not in connection with the performance of substantial services. Another commenter recommended adding a means to rebut the presumption that the services are substantial.

The final regulations retain the proposed rule's presumption that all services provided for a partnership interest are substantial services for purposes of section 1061. However, the Treasury Department and the IRS will continue to study and consider possible circumstances under which the presumption might be rebutted as well as the possibility of providing safe harbors for circumstances under which the presumption will not apply. These considerations may be addressed in future guidance.

c. Application of the ATB Activity Test

i. In General, ATB

Proposed § 1.1061–1(a) provides that applicable trade or business (ATB) means any activity for which the ATB Activity Test with respect to Specified Actions is met, and includes all Specified Actions taken by Related Persons, including combining activities occurring in separate partnership tiers or entities as one ATB. Proposed § 1.1061–1(a) defines an Owner Taxpayer as the person subject to Federal income tax on net gain with respect to an API or an Indirect API during the taxable year, including an owner of a Passthrough Taxpayer unless the owner of the Passthrough Taxpayer is a Passthrough Entity itself or is excepted under proposed § 1.1061–3(a), (b), or (d).

ii. ATB Activity Test

Proposed § 1.1061–2(b)(1) provides that the ATB Activity Test is satisfied if Specified Actions are conducted by one or more Related Persons and the total level of activity, including the combined activities of all Related Persons, satisfies the level of activity that would be required to establish a trade or business under section 162. Proposed § 1.1061–1(a) provides that Specified Actions means Raising or Returning Capital Actions and Investing or Developing Actions. Raising or Returning Capital Actions means actions involving raising or returning capital but does not include Investing or Developing Actions. Investing or Developing Actions means actions involving either (i) investing in (or disposing of) Specified Assets (or identifying Specified Assets for such investing or disposition), or (ii) developing Specified Assets.

Commenters requested clarification that joint ventures of a real estate developer involving a single stand-alone project at a single location will not satisfy the ATB Activity Test. One of these commenters recommended that the definition of Raising or Returning Capital should be refined so that it includes only raising or returning capital activities in which the business earns compensation based on either capital committed, capital contributed, or capital invested. Another commenter noted that additional guidance may be needed to make the statute more administrable because real estate held for rental or investment is a Specified Asset but holding the property may not constitute a trade or business under section 162.

The final regulations do not adopt these comments. Whether a single project or raising of capital involves the level of activity needed to constitute a trade or business under section 162 is dependent on the facts and circumstances unique to the project or raising of capital. Furthermore, guidance under section 162 is beyond the scope of these regulations.

Example 6 of proposed § 1.1061–2(b)(2)(vi) describes a situation in which A manages a hardware store that Partnership owns. A is issued a profits interest in Partnership in connection with A's services. Partnership owns the building in which the hardware store operates. The example notes that the building is held by Partnership not for rental or investment, but to conduct Partnership's hardware business and, thus, the building is not a Specified Asset. The example provides that the partnership maintains and manages a certain amount of working capital for its business, but notes that working capital is not taken into account for the purpose of determining whether the ATB Activity Test is met. A commenter suggested that another example should be added to analyze how to apply the ATB Activity Test where the facts are changed so that the business is held in a C corporation, the partnership only holds the C corporation stock, and the holding partnership is held by an investment partnership. The commenter stated that the ATB Activity Test should not be met by the holding partnership and the manager should not be an API Holder.

The final regulations do not adopt this comment. Depending on the specific facts and circumstances of the situation, the Treasury and the IRS believe that the ATB Activity Test could be met by such a holding partnership and the manager might be an API Holder.

A commenter requested clarification regarding what activities occurring in separate partnership tiers or entities will be considered combined and treated as one ATB, and recommended that the regulations be amended to include an example illustrating how the ATB and API rules work in this situation. The commenter recommended that the application of section 1061 be limited to an Owner Taxpayer solely with respect to partnership interests that serve as compensation for services relating to Specified Assets. Another commenter requested simplifying safe harbors for activities conducted in multiple entities either in the same chain or in a brother-sister chain.

The Treasury Department and the IRS continue to study these issues and may consider providing future guidance on these matters. However, the Treasury Department and the IRS note the definition of ATB includes any and all activities, no matter how minimal, conducted by entities that are Related Persons to each other, for purposes of determining whether the ATB Activity Test is met, and if that test is met, then each such participating entity is considered to be engaged in an ATB.

Another commenter requested clarification that businesses that do not both raise or return capital and engage in either investment or development activities do not satisfy the ATB Activity Test, and that the regular, continuous, and substantial standard applies independently to each prong of the ATB Activity Test. The commenter suggested that because the proposed regulations aggregate activities of one or more entities and related parties, the final regulations should not include the statement that the fact that either Raising or Returning Capital Actions or Investing or Developing Actions are only infrequently taken does not preclude the test from being satisfied if the combined Specified Actions meet the test. The commenter expressed concern that this language combined with the rule that Raising or Returning Capital Actions and Investing or Developing Actions are not required to be taken in each taxable year could cause the activities of a fund sponsor's affiliates to satisfy the raising or returning capital prong with respect to any of the sponsored funds.

The final regulations do not adopt this comment. It is necessary for both the Raising or Returning Capital Actions and Investing or Developing Actions to be present for the ATB Activity Test to be satisfied. The aggregation rule and the language regarding infrequent actions are necessary to prevent abuse of section 1061. Without these rules, activities could be spread among multiple related entities with the intent of not satisfying the ATB Activity Test.

iii. Definition of Specified Assets

Proposed § 1.1061–1(a) defines Specified Assets as: (i) Securities, including interests in partnerships qualifying as securities (as defined in section 475(c)(2) without regard to the last sentence thereof); (ii) commodities (as defined in section 475(e)(2)); (iii) real estate held for rental or investment; (iv) cash or cash equivalents; (v) an interest in a partnership to the extent that the partnership holds Specified Assets; and, (vi) options or derivative contracts with respect to any of the foregoing.

Commenters requested additional guidance on the treatment of partnerships that engage in the production, storage, transportation, processing, or marketing of physical commodities in the ordinary course of business (including hedges with respect to the commodities). The commenters requested that such partnerships not be treated as engaged in Investing and Developing Actions as a result of such activities, and that Specified Assets only include commodities that are themselves actually actively traded on an established financial market, not merely commodities of the same type as commodities that are or can be actively traded on an established financial market.

The final regulations do not adopt this comment; however, the Treasury Department and the IRS continue to study this issue and may address it in future guidance.

Another commenter noted that it is unclear whether the rule treating a derivative contract with respect to a partnership interest as a partnership interest for purposes of applying section 1061 is needed to appropriately administer section 1061. The commenter noted that the proposed regulation's position regarding such a derivative injects unnecessary complexity into the tax system, and stated that because payments made before termination of a swap are almost always ordinary income, it may not make economic or tax sense to use such a financial instrument in lieu of a partnership interest in an attempt to avoid section 1061.

The final regulations do not adopt this comment. While the use of a derivative contract in this circumstance may be rare, the Treasury and the IRS are concerned that the potential for abuse exists. Consequently, the treatment of a derivative contract as a partnership interest for purposes of applying section 1061 is necessary to prevent the circumvention of, and compliance with, section 1061.

B. Section 1.1061–3: Exceptions to the Definition of API

1. Corporate Exception

Section 1061(c)(4)(A) provides that an API ''shall not include any interest in a partnership directly or indirectly held by a corporation.'' In implementing this exception, proposed § 1.1061–3(b)(2) provides that a corporation does not include an entity for which an election was made to treat the entity as a Passthrough Entity, and that therefore, an S corporation for which an election under 1362(a) is in effect and a PFIC with respect to which the shareholder has a QEF election under section 1295 in effect (such entity is a QEF with respect to the shareholder), are not treated as corporations for purposes of section 1061. One commenter approved of this decision, noting that section 1061(f) provides ample authority for excluding S corporations and PFICs from the term corporation. The commenter noted that allowing such structures to benefit from the corporate exception would allow section 1061 to be entirely circumvented. Another commenter, discussing PFICs subject to QEF elections, noted that the exclusion of QEFs from the definition of corporation for purposes of section 1061 is consistent with section 1(h)(9) and (h)(10).

One commenter disagreed regarding authority, noting that the ability to treat QEFs and S corporations as subject to section 1061 is subject to substantial doubt and contrary to the plain text of the statute. The commenter also noted that Notice 2018–18, 2018–2 I.R.B. 443, and the provision's legislative history offer no reason why S corporations should, or should not, qualify for the exception. Another commenter said that a legislative clarification should be sought prior to including a rule in the final regulations providing that S corporations are subject to section 1061.

The Treasury Department and the IRS agree with commenters that the exclusion of S corporations and QEFs from the corporate exception is necessary to avoid circumvention of section 1061. Accordingly, no change has been made to this section of the final regulations. As explained in the preamble to the proposed regulations, section 1061(f) provides that the Secretary has authority to issue regulations or other guidance as is necessary or appropriate to carry out the purposes of section 1061. Both the Conference Report and the Blue Book further direct the Treasury Department and the IRS to issue regulations to address the prevention of abuse of the purposes of the provision. The grant of authority in section 1061(f) is sufficient to issue regulations providing that the exception in section 1061(c)(4)(A) does not include S corporations and PFICs with respect to which shareholders have QEF elections in effect. See also section 1(h)(9) and (10).

2. Unrelated Purchaser Exception

Proposed § 1.1061–3(d) provides that if a taxpayer acquires an interest in a partnership (target partnership) by taxable purchase for fair market value that, but for the exception in § 1.1061–3(d), would be an API, the taxpayer will not be treated as acquiring an API if, immediately before the purchase (1) the taxpayer is not related within the meaning of section 267(b) or 707(b) to any person who provides services in the Relevant ATB, or any service providers who provide services to or for the benefit of the target partnership or a lower-tier partnership in which the target partnership holds a direct or indirect interest; (2) section 1061(d) does not apply to the transaction (as provided in § 1.1061–5); and (3) the taxpayer has not provided in the past, does not then provide, and does not anticipate providing services in the future to, or for the benefit of, the target partnership, directly or indirectly, or any lower-tier partnership in which the target partnership holds a direct or indirect interest.

A few commenters stated that the proposed regulations are unclear as to whether the exception applies only to an API that is directly acquired or whether it also applies to an API in which the buyer acquired an indirect interest through an upper-tier partnership. One commenter recommended that final regulations provide that the exception applies to both APIs purchased directly as well as an APIs purchased indirectly, noting that the unrelated purchaser might not be able to rely on Rev. Rul. 87–115, 1987–2 C.B. 163, to adjust the basis of the underlying fund assets to prevent the recognition of built-in gain, as fund sponsors generally do not make section 754 elections at the fund level. Further, the commenter suggested that the final regulations provide that the exception applies regardless of whether the lower-tier partnership interest is acquired after the third-party purchases the interest in the upper-tier partnership or acquires the upper-tier partnership interest by contribution. Another commenter suggested that the exception be extended to interests in other Passthrough Entities.

The final regulations do not adopt these comments because of the complexity of administering the unrelated purchaser exception through tiers of Passthrough Entities. The final regulations make non-substantive clarifying changes to the rule.

The preamble to the proposed regulations provides that the exception does not apply to an Unrelated Non-Service Partner who becomes a partner by making a contribution to a Passthrough Entity that holds an API and in exchange receives an interest in the Passthrough Entity's API, stating that, in this case, allocations to the Unrelated Non-Service Partner with respect to the API are API Gains and Losses and retain their character as API Gains and Losses. One commenter noted that this exception to the unrelated purchaser exception is not explained in the proposed regulations' preamble and suggested that the exception to the exception is most likely intended to refer to a situation in which an investor makes a contribution in form to an upper-tier partnership, which then distributes an API with respect to a lower-tier partnership to the contributing upper-tier partner. The commenter notes that these transfers might be a purchase of the API by the investor from the upper-tier partnership. The Treasury Department and the IRS intend that the third-party purchaser exception be limited to API purchases and not apply when a third party contributes cash or property to a Passthrough Entity holding an API in a transaction qualifying for nonrecognition under section 721(a), or any similar provision, resulting in the contributor receiving allocations attributable to the transferee Passthrough Entity's API.

C. Section 1.1061–4: Computing the Recharacterization Amount

1. Computation of the Recharacterization Amount

Proposed § 1.1061–4(a)(1) provides that the Recharacterization Amount equals the Owner Taxpayer's One Year Gain Amount less the Owner Taxpayer's Three Year Gain Amount. The Owner Taxpayer's One Year Gain Amount is the sum of the Owner Taxpayer's combined net API One Year Distributive Share Amount from all APIs held during the taxable year and the Owner Taxpayer's API One Year Disposition Amount. An Owner's Taxpayer's Three Year Gain Amount is equal to the Owner Taxpayer's combined net API Three Year Distributive Share Amount from all APIs held during the taxable year and the Owner Taxpayer's API Three Year Disposition Amount. The API One Year and Three Year Distributive Share Amounts exclude Capital Interest Gains and Losses. Capital Interest Disposition Amounts are not included in the computation of the API One Year and Three Year Disposition Amounts because they relate to the disposition of a Capital Interest rather than an API.

Proposed § 1.1061–4(a)(3)(i) provides that the API One Year Distributive Share Amount equals the API Holder's distributive share of net long-term capital gain from the partnership for the taxable year, including capital gain or loss on the disposition of all or a part of an API, with respect to the partnership interest held by the API Holder calculated without the application of section 1061 less, to the extent included in the amount determined under proposed § 1.1061–4(a)(3)(i)(A), the aggregate of amounts that are excluded from section 1061 under proposed § 1.1061–4(b)(6), the *API Holder's Transition Amount* for the taxable year; and Capital Interest Gains and Losses as determined under proposed § 1.1061–3(c)(2).

One commenter stated that the definition of API One Year Distributive Share Amount does not allow for this amount to be a loss. For example, if an Owner Taxpayer holds two APIs and one partnership allocates the taxpayer a loss and the other a gain, the loss does not offset the gain because the API One Year Distributive Share Amount for the partnership that allocated the taxpayer a loss will be zero. The commenter recommended allowing the API One Year Distributive Share Amount to be less than zero. The final regulations adopt this suggestion by revising the computation for the API One Year Distributive Share Amount to include both capital gain and loss. In addition, the commenter suggested that the final regulations provide that if each of the API One Year Distributive Share Amount and the API Three Year Distributive Share Amount is greater than zero but the API One Year Distributive Share Amount is less than the API Three Year Distributive Share Amount, no portion of the API One Year Distributive Share Amount is recharacterized as short-term capital gain. The final regulations adopt this suggestion by providing that if the One Year Gain Amount and the Three Year Gain Amount are both greater than zero but the One Year Gain Amount is less than the Three Year Gain Amount, none of the One Year Gain Amount is included in the Recharacterization Amount for the taxable year. In addition to adopting this comment, the final regulations make minor clarifying changes to the computation rules.

Commenters raised several additional concerns related to the computation rules. One commenter recommended that regulations provide guidance on how losses limited by section 1211 affect the Recharacterization Amount. Another commenter noted that the proposed regulations do not address how net capital gain is computed or the order of steps in doing so under section 1(h)(1). The commenter stated that because section 1061(a) recharacterizes what would have been long-term capital gain as short-term capital gain, it is apparent that section 1061(a) must be applied somewhere in the process before the application of section 1(h). Further, the proposed regulations do not address § 1.1(h)–1, which provides a look-through rule when a partnership interest is sold, to determine what portion of the gain on sale will be treated as collectibles gain or section 1250 capital gain. The commenter also noted that, although section 1231 and section 1256 gains are excluded from section 1061 by the proposed regulations, a sale of a partnership interest holding such assets is not excluded, and all the gain is subject to section 1061(a) unless section 751(a) applies. Finally, the commenter stated that there is no provision in the proposed regulations addressing suspension of the holding period of an API when an API owner seeks to obtain a more-than-three-year holding period without undertaking additional risk—that is, the hedging of the API. The commenter recommended that an express rule be provided, such as the rule provided in § 1.1400Z2(a)–1(b) for interests in partnerships self-certified as qualified opportunity funds.

The Treasury Department and the IRS continue to study the issues raised by these comments in regard to the computation rules and may address them in future guidance.

2. Distributed API Property

Proposed § 1.1061–1(a) provides that Distributed API Property means property distributed by a Passthrough Entity to an API Holder with respect to the API if the holding period, as determined under sections 735 and 1223, in the API Holder's hands is three years or less at the time of disposition of the property by the API Holder.

A commenter questioned whether the Treasury Department and the IRS have the authority to treat Distributed API Property as subject to section 1061(a). The commenter further stated that in order for the rule to be a valid exercise of regulatory authority, distributed property for this purpose should exclude property that, if sold by the partnership, would be excluded from section 1061, such as property that would generate 1231 and 1256 gains.

The final regulations continue to treat Distributed API Property as subject to section 1061(a) under the authority of section 1061(f). However, the Treasury Department and the IRS agree with the commenter that long-term capital gain from the disposition of Distributed API Property that, if sold by the partnership, would be excluded from section 1061, such as 1231 and 1256 gain, qualified dividends described in section 1(h)(11)(B), and any other capital gain that is characterized as long-term or short-term without regard to the holding period rules in section 1222, should not be recharacterized under section 1061(a). The final regulations clarify this point by excluding these items from the calculation of the API One Year Disposition Amount. Additionally, because a Passthrough Entity does not calculate an API One Year Disposition Amount, the final regulations clarify that for purposes of calculating the API One Year Distributive Share Amount, an API Holder's distributive share of net long-term capital gain from the partnership includes capital gain or loss on the disposition of Distributed API Property or all or part of an API by an API Holder that is a Passthrough Entity.

Another commenter suggested that the final regulations explicitly provide rules for the treatment of Distributed API Property when the Distributed API Property is distributed from one Passthrough Entity to another and the upper-tier entity disposes of the Distributed API Property. The commenter also requested confirmation in the final regulations that partnerships should subtract capital gain or loss from property that had been Distributed API Property but no longer is at the time of disposition when calculating the API One Year Distributive Share Amount because such gain is excluded from the calculation of the Recharacterization Amount.

The final regulations partially adopt this comment by revising the computation of the One Year Distributive Share Amount to explicitly include dispositions of API Distributed Property by a partnership or other Passthrough Entity. The final regulations do not adopt the suggestion to explicitly provide that partnerships should subtract capital gain or loss from property that had been Distributed API Property but no longer is at the time of disposition when calculating the API One Year Distributive Share Amount. The definition of Distributed API Property provides that it only applies to property with a holding period of three years or less on the date of disposition by an API Holder. Any property with a greater than three-year holding period is therefore not Distributed API Property. A special rule for Distributed API Property distributed to an upper-tier entity by a lower-tier entity is unnecessary because the definition of API Holder includes a Passthrough Entity.

Commenters noted that the proposed regulations are unclear as to how the Distributed API Property rules apply where an API Holder owns both a profits interest and a capital interest in a partnership, and recommended that the final regulations clarify that a distribution to a partner is not Distributed API Property to the extent that it is distributed with respect to the portion of the partner's interest qualifying for the Capital Interest Exception. One commenter suggested that such guidance should also address how to apply the recommended rule in the context of tiered structures.

The Treasury Department and the IRS continue to study this issue and may address it in future guidance.

3. Special Rules for Capital Gain Dividends From Regulated Investment Companies (RICs) and Real Estate Investment Trusts (REITs)

The preamble to the proposed regulations recognizes that long-term capital gain treatment should be available for a capital gain dividend paid by a RIC or REIT to the extent that the capital gain dividend is attributable to assets held for more than three years or is attributable to assets that are not subject to section 1061. Proposed § 1.1061–4(b)(4) facilitates this treatment by allowing a RIC or REIT to disclose two additional amounts based on modified computations of the RIC's or REIT's net capital gain. First, the RIC or REIT may disclose the amount of the capital gain dividend that is attributable to the RIC's or REIT's net capital gain excluding any amounts not taken into account for purposes of section 1061 under proposed § 1.1061–4(b)(6) from the computation. Second, the RIC or REIT may disclose the amount of the capital gain dividend that is attributable to the RIC's or REIT's net capital gain both (1) excluding any amounts not taken into account for purposes of section 1061 under proposed § 1.1061–4(b)(6) from the computation, and (2) substituting three years for one year in applying section 1222. The proposed regulations allow a RIC or REIT to disclose these two additional amounts in writing to its shareholders with its section 852(b)(3)(C)(i) capital gain dividend statement or section 857(b)(3)(B) capital gain dividend notice.

One commenter suggested that it would be extremely rare for a RIC to have shareholders for whom this provision is relevant and stated that requiring this additional reporting would be unnecessarily burdensome as it creates a third type of capital gain that RICs would need to track and report. Consequently, the commenter requested that final regulations continue to permit, but not require, RICs to report this information if they have a shareholder for whom such amounts are relevant. In addition, the commenter noted that most funds will not calculate this information at the time capital gain dividends are reported on Forms 1099–DIV. The commenter requested that final regulations allow reporting on a written statement furnished to the applicable shareholder on request, without tying the reporting of such amounts to the reporting of capital gain dividends.

Another commenter suggested that RICs and REITs should be permitted to disclose these additional amounts, upon request by a shareholder, and report the One Year Amounts Disclosure and Three Year Amounts Disclosure (as those terms are defined in proposed § 1.1061–6(c)) until the extended due date of their returns.

The final regulations retain the rules as proposed but designate them as § 1.1061–4(b)(5). As suggested by these commenters, the final regulations retain the option to disclose to shareholders the two additional amounts (that is the final regulations do not make disclosure mandatory). The final regulations do not adopt the suggestion to allow RICs and REITs to disclose these additional amounts only upon the request of a shareholder because such treatment may allow a RIC or REIT to choose to provide information only to certain shareholders but not to other shareholders. The Treasury Department and the IRS continue to study comments suggesting that the disclosure of this information be separated from the reporting of capital gain dividends and may issue guidance in the future. In the interim, the final regulations retain the rule that the disclosures are to be provided with the section 852(b)(3)(C)(i) capital gain dividend statement or section 857(b)(3)(B) capital gain dividend notice.

4. Computation of the Recharacterization Amount for Owner Taxpayers With Interests in QEFs

The proposed regulations provide special rules for Owner Taxpayers that hold their APIs indirectly through PFICs for which they have made a QEF election. Specifically, under proposed § 1.1061–4(b)(5), the API One and Three Year Distributive Share Amounts include an Owner Taxpayer's section 1293(a)(1) inclusions from QEFs, reduced by amounts that are excluded from section 1061(a) if the QEF complies with the reporting rules under § 1.1061–6(d). These reporting rules provide that QEFs may provide information to allow Owner Taxpayers to compute their Recharacterization Amount. If a QEF fails to provide such information, an Owner Taxpayer includes its entire pro rata share of the QEF's net capital gain in its API One Year Distributive Share Amount and no portion of its pro rata share of the QEF's net capital gain is ultimately included in its API Three Year Distributive Share Amount. One commenter made several suggestions regarding the computation of an Owner Taxpayer's API One Year Distributive Share Amount and API Three Year Distributive Share Amount with respect to a QEF's net capital gain. Broadly, the commenter expressed a concern that the corporate-level capital gain netting rules applicable to QEFs are not consonant with the requirement that the Recharacterization Amount be computed at the Owner Taxpayer level. A QEF determines its net capital gain at the corporate level, and may do so in one of three ways: First, the QEF may calculate and report the amount of each category of long-term capital gain described in section 1(h) of the Code; second, the QEF may report its net capital gain for the year and state that it is subject it to the highest capital gain rate of tax applicable to the shareholder; or third, the QEF may determine its current earnings and profits (E&P) and report the entire amount as ordinary earnings. Section 1.1293–1(a)(2). A QEF's net capital gain is limited to its current E&P, regardless of how it computes such amount under § 1.1293–1(a)(2) (QEF E&P limitation). Section 1293(e)(2). The commenter had several suggestions on how to clarify or improve the rules under section 1061 applicable to QEFs.

First, the commenter suggested that the three year QEF net capital gain provision was not entirely clear, particularly in regard to the API Three Year Distributive Share Amount. The commenter recommended that the final regulations clarify that an Owner Taxpayer includes in its API Three Year Distributive Share Amount the same base amount as determined for the API One Year Distributive Share Amount (as adjusted to reflect only net long-term capital gains and losses calculated by substituting a greater-than-three-year holding period for a greater-than-one-year holding period).

The Treasury Department and the IRS confirm that an Owner Taxpayer's API Three Year Distributive Share Amount is based on the amount computed for its API One Year Distributive Share Amount and adjusted to include only items that would be treated as a long-term gain or loss if three years were substituted for one year in paragraphs (3) and (4) of section 1222 if the QEF satisfies certain reporting obligations. *See* § 1.1061–6(d). However, the final regulations revise proposed § 1.1061–4(b)(5) (designated as § 1.1061–4(b)(6) in the final regulations) to more precisely identify the inputs for computing an Owner Taxpayer's API One and Three Year Distributive Share Amounts and illustrate an Owner Taxpayer's API Three Year Distributive Share Amount computation with respect to a QEF. Specifically, § 1.1061–4(b)(6)(i) provides that an Owner Taxpayer's inclusion under section 1293(a)(1)(B) that is taken into account in determining the API One Year Distributive Share Amount with respect to a QEF is limited to the QEF's E&P by section 1293(e)(2) and that the section 1293(a)(1)(B) inclusion may be reduced by the Owner Taxpayer's share of the excess (if any) of the Capital Interest Gain over Capital Interest Loss with respect to the QEF as well as amounts not taken into account for purposes of section 1061 pursuant to § 1.1061–4(b)(7). In either case, however, § 1.1061–4(b)(6)(i) permits such reductions only if a QEF has provided an Owner Taxpayer with the relevant information necessary for the Owner Taxpayer to determine those amounts.

Additionally, § 1.1061–4(b)(6)(ii) of the final regulations provides that the minuend of an Owner Taxpayer's API Three Year Distributive Share Amount computation (under § 1.1061–4(a)(3)(ii)) includes its entire amount determined under § 1.1061–4(b)(6)(i) (one year QEF net capital gain). The final regulations further provide that if the QEF does not provide the Owner Taxpayer with information necessary under § 1.1061–6(d) to determine the amount of its section 1293(a)(1)(B) inclusion (less any allowed reductions) with respect to the QEF that would be included in its API One and Three Year Distributive Share Amounts, then the entire amount of the Owner Taxpayer's one year QEF net capital gain (less any allowed reductions) is also included in the subtrahend of its API Three Year Distributive Share Amount formula (under § 1.1061–4(a)(3)(ii)(A)). This results in an Owner Taxpayer's entire section 1293(a)(1)(B) inclusion (less any allowed reductions) being treated as short-term capital gain. However, if the QEF provides the Owner Taxpayer with the additional necessary information, then the Owner Taxpayer includes only the amount of its one year QEF net capital gain amount that would not be treated as long-term capital gain substituting a greater-than-three-year holding period in applying paragraphs (3) and (4) of section 1222 in the subtrahend of this formula (under § 1.1061–4(a)(3)(ii)(A)). This can result in a portion of an Owner Taxpayer's section 1293(a)(1)(B) inclusion being characterized as long-term capital gain with the balance being treated as short-term capital gain.

To illustrate, assume an Owner Taxpayer owns an interest in a QEF that holds an API; the Owner Taxpayer owns no other API directly or indirectly. The QEF generates both long- and short-term capital gain in its taxable year, none of which are amounts described in § 1.1061–4(b)(7) or Capital Interest Gains; the Owner Taxpayer's pro rata share of the QEF's long-term capital gain is $100, $70 of which would not be long-term capital gain if a greater-than-three-year holding period were used in applying paragraphs (3) and (4) of section 1222, and its share of the QEF's short-term capital gain (determined without regard to section 1061) is $15. Before applying section 1061, under § 1.1293–1(a)(2), the Owner Taxpayer's pro rata share of the QEF's net capital gain is $100. Under § 1.1061–4(b)(6)(i), with respect to the QEF, the Owner Taxpayer's one year QEF net capital gain amount, and thus its API One Year Distributive Share Amount, is $100. In its API Three Year Distributive Share Amount computation with respect to the QEF, this $100 is the minuend (under § 1.1061–4(a)(3)(ii)). If the QEF does not provide the Owner Taxpayer with information to determine how much of its pro rata share of the QEF's net capital gain would constitute long-term capital gain if a greater-than-three-year holding period were used in applying paragraphs (3) and (4) of section 1222, the Owner Taxpayer would include all $100 under § 1.1061–4(a)(3)(ii)(A) in the subtrahend of its computation. This results in an API Three Year Distributive Share Amount of $0 with respect to the QEF (that is: $100 under § 1.1061–4(a)(3)(ii) introductory text, minus $100 under § 1.1061–4(a)(3)(ii)(A)) and a Recharacterization Amount of $100 (that is, $100 API One Year Distributive Share Amount minus $0 API Three Year Distributive Share Amount). However, if the QEF does provide the Owner Taxpayer with this information, the Owner Taxpayer includes $70 in the subtrahend of its API Three Year Distributive Share Amount computation with respect to the QEF under § 1.1061–4(a)(3)(ii)(A). This results in an API Three Year Distributive Share Amount of $30 (that is: $100 under § 1.1061–4(a)(3)(ii) introductory text, minus $70 under § 1.1061–4(a)(3)(ii)(A)) and a $70 Recharacterization Amount (that is: $100 API One Year Distributive Share Amount minus $30 API Three Year Distributive Share Amount).

Additionally, the commenter asked that the final regulations harmonize the QEF reporting rules with the reporting rules applicable to other Passthrough Entities. Specifically, the commenter requested that if a QEF does not report relevant information, then QEF shareholders that are Owner Taxpayers should be able to substantiate amounts included in the API One Year Distributive Share Amount and Three Year Distributive Share Amount, as well as items excluded from section 1061(a), through alternative means.

The Treasury Department and the IRS have concluded that, when coupled with § 1.1061–6(d), the QEF reporting rules in § 1.1295–1(g) provide a sufficiently comprehensive framework for information reporting and no additional rule for section 1061 is necessary. Under § 1.1295–1(g)(1), for a PFIC to be treated as a QEF by its shareholders it must provide either an annual statement including the shareholder's pro rata share of the QEF's net capital gain for the year or a statement that it has granted its shareholders access to its books and records (or other documents) for the purpose of determining those amounts; under § 1.1295–1(g)(3), the same information must be reported to indirect PFIC shareholders on an intermediary statement. Under § 1.1295–1(g)(2), in ''rare and unusual circumstances,'' a PFIC can provide alternative documentation if it obtains a private letter ruling from, and enters into a closing agreement with, the IRS. In addition to these reporting requirements, § 1.1061–6(d) permits (but does not require) a QEF to provide its shareholders that are Owner Taxpayers with additional information for the purpose of determining the Owner Taxpayer's API One Year Distributive Share Amount and Three Year Distributive Share Amount.

The Treasury Department and the IRS have determined that the reporting mechanisms under §§ 1.1295–1(g) and 1.1061–6(d) provide sufficient avenues for an Owner Taxpayer to obtain information from a QEF to determine its API One Year Distributive Share Amount and Three Year Distributive Share Amount. A special rule allowing Owner Taxpayers to substantiate QEF information through alternative means for purposes of section 1061 would also run counter to § 1.1295–1(g), which generally requires a QEF, and not its shareholders, to report information for purposes of section 1293. As a result, to reconcile the optional nature of QEF reporting as compared with reporting requirements of other Passthrough Entities, the final regulations revise § 1.1061–6(b)(2)(ii) to provide that a Passthrough Entity from which information is requested must provide such information, but only to the extent the information is necessary for the requesting Passthrough Entity to meet its reporting and filing requirements under § 1.1061–6. The final regulations also revise § 1.1061–6(d) to provide that Owner Taxpayers are not permitted to separately substantiate amounts with respect to a QEF under § 1.1061–6(a)(2). Accordingly, the comments suggesting changes to the QEF reporting rules under section 1061 are not adopted.

The commenter also suggested that the final regulations should provide guidance on how to apportion the QEF E&P limitation for purposes of section 1061. Specifically, the commenter suggested that the QEF E&P limitation should be apportioned according to the shareholder's relative share of the API One Year Distributive Share Amount and the API Three Year Distributive Share Amount with respect to the QEF. The commenter also suggested that consideration be given to bypassing netting at the PFIC level, with guidance to be provided on how to allocate the QEF E&P limitation at the Owner Taxpayer level.

The QEF E&P limitation is imposed by section 1293(e)(2) and is taken into account in determining a shareholder's pro rata share of the net capital gains of a QEF that is required to be included in a shareholder's income pursuant to section 1293(a)(1). Netting of losses must therefore be carried out before determining the net capital gain of a QEF that is required to be included by a shareholder. The Treasury Department and the IRS recognize the complexity regarding apportioning the QEF E&P limitation for purposes of section 1061. This issue is particularly acute in light of the different types of capital gain and loss relevant for purposes of section 1061 that may be included in a QEF's net capital gain, including one- and three-year capital gains and losses, and amounts excluded from section 1061 under § 1.1061–4(b)(7) or under the capital interest exception. Further complication arises from the fact that a loss may arise either from a QEF's ordinary business operations, or from one or more of the four categories listed in the prior sentence.

In this regard, the Treasury Department and the IRS considered several possible ways of apportioning the QEF E&P limitation. One possibility would be to adopt an approach that apportions the QEF E&P limitation between the relevant types of capital gains for purposes of section 1061 on a pro rata basis, which the Treasury Department and the IRS determined would be appropriate in many circumstances, though not all. For example, if a loss arises from a QEF's ordinary business operations while its capital gain income is derived from an API, there may be no direct link between the ordinary loss and the API-derived capital gain. In such a case a pro rata approach may be appropriate. Alternatively, for other circumstances, the Treasury Department and the IRS considered apportioning a QEF's E&P limitation based on more specific ordering rules. For example, if a loss were related to one or more categories of capital gain, allocation first to those categories might be appropriate. Another possible approach would be to allocate the loss giving rise to the E&P limitation in the manner that most closely approximates how an Owner Taxpayer would be permitted to allocate the loss if the QEF's gains and losses were derived directly by the Owner Taxpayer and the Owner Taxpayer's income was limited to otherwise-long-term capital gain income. In light of the complexity regarding the different scenarios under which a pro rata approach or an alternative approach would be more appropriate, the Treasury Department and the IRS have determined that this issue warrants further study and welcome comments in this regard. Until the Treasury Department and the IRS issue further guidance on this issue, taxpayers may adopt any reasonable method for apportioning the QEF E&P limitation for purposes of section 1061 taking into account these considerations.

Finally, the commenter requested that the Treasury Department and the IRS provide a rule that would identify an Owner Taxpayer's distributive share of a QEF's net capital gain from a

Passthrough Entity attributable to the Owner Taxpayer's qualifying capital interest and API. The Treasury Department and the IRS continue to study this issue and may address it in future guidance.

5. Items Not Taken Into Account for Purposes of Section 1061

Proposed § 1.1061–4(b)(6) provides that certain items of long-term capital gain and loss are excluded from the calculation of the API One Year Distributive Share Amount and the API Three Year Distributive Share Amount. Specifically, long-term capital gain and long-term capital loss determined under section 1231 or 1256, qualified dividends included in net capital gain for purposes of section 1(h)(11)(B), and capital gains or losses that are characterized as long-term or short-term without regard to the holding period rules in section 1222 are excluded from these calculations.

Two commenters questioned the exclusion of long-term capital gain determined under section 1231 from recharacterization under section 1061. Those commenters discussed the discrepancies in language between section 1061(a)(1) and 1061(a)(2), noting that only section 1061(a)(2) refers to section 1222. Both commenters suggested that the treatment of section 1231 gains in the proposed regulations is contrary to the statutory text of section 1061. The first commenter stated that section 1061(a)(1) applies to net long-term capital gain and noted that other portions of section 1061 indicate that it is supposed to apply to gains that are taxed at favorable rates for disposition of investment assets. This commenter argued that the reference to section 1222 in section 1061(a)(2) can be read as excluding certain section 1222 gains from the reach of section 1061(a), rather than limiting section 1061(a) to such gains by implication. The commenter noted that if a determination is made that section 1061(a) does apply to section 1231, then regulations need to address the holding periods of section 1231 and how the netting rules of section 1231 interact with section 1061.

The second commenter suggested that, under the proposed regulations, the portion of any net section 1231 gains attributable to APIs could arguably be included in the amount described in section 1061(a)(1). The commenter stated that this would lead to nonsensical results if net section 1231 gains are included in the amount described in section 1061(a)(1) but excluded from the amount described in section 1061(a)(2). Because of the conflicting statutory language in sections 1061(a)(1) and 1061(a)(2), the commenter recommended that the treatment of section 1231 gains be reconsidered, suggesting that one approach would be to include the net 1231 gain attributable to APIs in the section 1061(a) computation after recomputing this amount by substituting 3 years for 1 year.

In contrast, several commenters supported the proposed regulation's treatment of qualified dividends and long-term capital gains determined under section 1231 and 1256 as not subject to recharacterization under section 1061 and recommended these provisions be finalized as proposed. Commenters noted that this treatment aligns with the clear language of the statute and is consistent with Congressional intent. One commenter stated that section 1256 amounts should not be subject to section 1061(a) because they are not gains that are taxed at favorable rates that arise from the disposition of assets. Another commenter noted that the statutory references to section 1223(3) and (4) raise the question of section 1061's potential effect on other Code provisions without regard to section 1222. The commenter indicated that some provisions have their own holding period, such as section 1231, while others, such as section 1256, just mandate tax treatment. The commenter stated that this results in a haphazard inclusion or exclusion of items from section 1061 and noted that because the section 1061 legislative history is devoid of guidance on this issue, the approach taken in the proposed regulations is reasonable but a technical correction from Congress would be welcome.

The final regulations do not adopt suggestions that section 1231 gain should be subject to recharacterization under section 1061(a) and maintain the rules in proposed § 1.1061–4(b)(6), which is designated as 1.1061–4(b)(7) in the final regulations. As stated in the preamble to the proposed regulations, section 1231 gains and losses are treated as long-term based on the operation of section 1231, and not by reference to paragraphs (3) and (4) of section 1222. Similarly, section 1256 provides for specific character treatment and does not calculate gain by reference to section 1222. Accordingly, the Treasury Department and the IRS have determined that it is appropriate to exclude these amounts from both the One Year and Three Year Gain Amounts. In contrast, because section 1061(d)(1) looks to the excess of long-term capital gains with respect to the transferred interest to the sale or exchange of any asset held for not more than three years as is allocable to such interest over what is otherwise short-term capital gain under section 1061(a), and does not reference section 1222, these amounts are captured in transactions to which section 1061(d) applies. The final regulations do not adopt the suggestion to provide guidance on section 1231 holding periods or netting rules because such guidance would be beyond the scope of these final regulations.

One commenter suggested that proposed § 1.1061–4(b), which excludes certain items from the calculation of the API One Year and Three Year Distributive Share Amounts, should be modified to explicitly reference both One Year Disposition Gains and One Year Distributive Share Amounts in providing for an exclusion of section 1231 property from the scope of section 1061. The commenter suggested that the Treasury Department and the IRS should also determine whether a similar modification is appropriate for the exclusion for section 1256 property.

The final regulations do not adopt this comment. The API One Year Disposition Amount includes long-term capital gains and losses recognized by an Owner Taxpayer on the disposition of all or a portion of an API. Pursuant to section 741, the sale or exchange of a partnership interest, including an API, is the sale or exchange of a capital asset. Accordingly, the character of the gain is determined with reference to section 1222. The items listed in § 1.1061–4(b)(7), including section 1231 gain, are excluded from the calculation of the API One Year and Three Year Distributive Share Amounts because they are not determined without regard to section 1222. Furthermore, asymmetrical tax treatment occasionally is a result of the difference between the sale of a partnership interest and the sale of assets by a partnership.

One commenter noted that under section 197(f), acquired goodwill is treated as depreciable property, thereby causing gain recognized on the sale of acquired goodwill to be treated as section 1231 gain. By contrast, self-created goodwill does not qualify as an amortizable intangible under section 197; therefore, any gain recognized on the sale of the self-created goodwill is not section 1231 gain. Instead, it is treated as a capital asset giving rise to capital gain upon a sale or exchange. Consequently, under the proposed regulations, gain on the sale of acquired goodwill is excluded from the Recharacterization Amount while gain on the sale of self-created goodwill is not excluded. The commenter recommended that in addition to the exclusion for section 1231 gain, the regulations should provide that any gain recognized on the sale of goodwill held in connection with the conduct of a trade or business (whether or not determined under section 1231) is also excluded from the Recharacterization Amount because there is no evidence Congress intended to subject self-created goodwill held in connection with a trade or business to section 1061.

The final regulations do not adopt this comment. The disparate treatment of purchased and self-created goodwill is prescribed by section 197 and nothing in section 1061 changes this treatment.

6. Holding Periods

Proposed § 1.1061–4(b)(8) clarifies that the relevant holding period of either an asset or an API is determined under all provisions of the Code or regulations that are relevant to determining whether the asset or the API has been held for the long-term capital gain holding period by applying those provisions as if the holding period were three years instead of one year. For this purpose, the relevant holding period is the direct owner's holding period in the asset sold.

The final regulations maintain this rule as proposed. One commenter requested clarification that the modification of a partnership agreement does not itself create a new holding period for the API. The final regulations do not adopt this comment as section 1061 does not generally change the holding period of an asset.

7. API Holder Transition Amounts and Partnership Transition Amounts

The proposed regulations provide that a partnership that was in existence as of January 1, 2018, could irrevocably elect to treat all long-term capital gains and losses recognized from the disposition of all assets held by the partnership for more than three years as of January 1, 2018, as Partnership Transition Amounts. An amount of long-term gain or loss treated as a Partnership Transition Amount and included in the allocation of long-term capital gains and losses under sections 702 and 704 to an API Holder with respect to its interest in a Passthrough Entity was treated as an API Holder Transition Amount. API Holder Transition Amounts were not taken into account for purposes of determining the Recharacterization Amount. The preamble to the proposed regulations also requests comments on whether a transition rule is needed and whether the Partnership Transition Amount rules are useful or whether another approach would be more helpful in easing transition difficulties.

Several commenters questioned the need for an elective transition rule. One commenter noted that while they appreciated the Treasury Department and the IRS seeking to minimize the burdens associated with the change in law, they did not believe the transition rules would measurably lessen the recordkeeping burden on funds. The commenter also noted that whether and for whom the transition rules would be beneficial is unpredictable. Another commenter recommended that final regulations include an example illustrating, or otherwise better explaining, the importance of the API Holder Transition Amount rules, that is, what benefits the API Holder Transition Amount rules are intended to confer on taxpayers. No commenter provided an example of the potential applicability of the API Holder Transition Amount rules. After considering the comments, the Treasury Department and the IRS have determined that the Partnership Transition Amount rules are unnecessary. Accordingly, the final regulations do not include these rules.

D. Section 1.1061–6: Reporting Requirements

Proposed § 1.1061–6(a) provides filing and reporting requirements for Owner Taxpayers and Passthrough Entities. Proposed § 1.1061–6(a)(1) provides that an Owner Taxpayer must file such information with the IRS as the Commissioner may require in forms, instructions, or other guidance as is necessary for the Commissioner to determine that the Owner Taxpayer is in compliance with section 1061 and the regulations. Proposed § 1.1061–6(b)(1) provides that a Passthrough Entity must file such information with the IRS as the Commissioner may require in forms, instructions, or other guidance as is necessary for the Commissioner to determine that the Passthrough Entity and its partners have complied with section 1061 and the regulations and that a Passthrough Entity that has issued an API must furnish to the API Holder, including an Owner Taxpayer, such information at such time and in such manner as is necessary to determine the One Year Gain Amount and the Three Year Gain Amount with respect to the Owner Taxpayer that directly or indirectly holds the API.

Proposed § 1.1061–6(a)(2) provides that if a Passthrough Entity does not furnish the information that an Owner Taxpayer needs to determine its Recharacterization Amount and meet its reporting requirements, and the Owner Taxpayer is not able to otherwise substantiate all or a part of those amounts to the satisfaction of the Secretary, then (i) the negative adjustments under proposed § 1.1061–4(a)(3)(i)(B) necessary to calculate the API One Year Distributive Share Amount will be deemed to equal zero, and (ii) the negative adjustment to the API One Year Distributive Share Amount for purposes of determining the API Three Year Distribution Amount under proposed § 1.1061–4(a)(3)(ii)(B) will be deemed to equal zero.

Proposed § 1.1061–6(b)(2) provides that a Passthrough Entity that holds an interest in a lower-tier entity and needs information from the lower-tier entity to meet its reporting obligations under the proposed regulations must request such information from that entity by the later of the 30th day after the close of the taxable year to which the information request relates or within 14 days after the date of a request for information from an upper-tier Passthrough Entity and the lower-tier entity must respond by the due date (including extensions) of the Schedule K–1 for the taxable year. Proposed § 1.1061–6(b)(2)(vii) provides that a Passthrough Entity that fails to comply with the reporting rules in the proposed regulations or as further required in forms, instructions, or other guidance will be subject to penalties.

One commenter stated that the reporting rules are based on the assumption that there will be a limited number of individuals who are in control and who have access to all relevant factual information. Consequently, the rules are extensive and smaller partnerships and non-controlled partnerships may have difficulty complying without significant cost and expense. The commenter suggested this argued in favor of exempting small partnerships from these rules.

A few commenters stated that lower-tier passthrough entities are not required to furnish information until the due date of their returns and that this deadline does not permit upper-tier entities sufficient time to incorporate lower-tier passthrough entity information into their reporting. Further, the commenter noted that the regulations appear to prevent Owner Taxpayers from excluding anything from the API One Year Distributive Share Amount even if only part of the information cannot be substantiated. The commenter recommended that for groups of non-controlled entities, the requestor should be allowed any reasonable approach to substantiate the information and suggested that issues from non-compliant tiers should be resolved by having the IRS impose failure to furnish penalties on those tiers. Finally, the commenter recommended guidance on how to substantiate unreported amounts.

Several commenters suggested that the information reporting requirements are onerous and that denying exclusions from recharacterization for non-compliance is too harsh a penalty for Owner Taxpayers and upper-tier partnerships who are unable to secure the necessary information from lower-tier partnerships, particularly where an Owner Taxpayer or upper-tier partnership has no control over whether the reporting requirements are met by the lower-tier partnership. One commenter argued that there is no indication in the statute or legislative history that this is what Congress intended. The commenter noted that the TCJA conference report indicates that Congress intended section 6031(b) penalties to apply to a failure to report to partners and those penalties are sufficient to deter non-compliance while not acting to change the character of distributive share items.

A few commenters noted that the reporting requirements will require significant amendments to partnership agreements and reporting systems. These commenters requested that the effective date for the reporting requirements and associated penalties be delayed until at least 12 months after the year end in which the regulations are finalized to give funds and API Holders time to amend their operations and establish proper information reporting systems, particularly in light of the increased reporting requirements resulting from partner tax capital account reporting, Forms K–2 and K–3, the section 163(j) limitation, and other recent guidance.

One commenter suggested that the regulations should provide a de minimis exception to the reporting requirements, especially in tiered partnership arrangements. The commenter suggested that if a limited partner owns less than five percent of a fund, there should be limitations on reporting requirements to those partners, arguing that information reporting is costly in a tiered fund context and the lower-tiered funds may not want to dedicate the resources to provide the proper reporting for such small fund interests.

The final regulations do not adopt these comments. The reporting rules, including the zero presumptions, are necessary to effectively administer section 1061 and the regulations. The Treasury Department and the IRS note that the amounts required to be reported under the reporting rules may be substantiated by any reasonable means if a Passthrough Entity fails to report the necessary information to the Owner Taxpayer. Similarly, a de minimis rule or an exception for small partnerships would frustrate Owner Taxpayers' ability to correctly determine the Recharacterization Amount and the IRS's ability to administer the statute. For these reasons, the Treasury Department and the IRS also decline to provide a delay in the applicability date for the reporting rules.

The final regulations retain the reporting rules as proposed with minor clarifying changes, including the changes discussed in paragraph III.C.4 of this preamble with respect to QEF reporting. In addition, the final regulations provide that if an Owner Taxpayer requires information from a Passthrough Entity to determine the Section 1061(d) Recharacterization Amount, the Owner Taxpayer should request such information from that entity. The Passthrough Entity is required to provide the information to the extent requested by an API Holder and necessary to determine the Owner Taxpayer's Section 1061(d) Recharacterization Amount. Finally, the final regulations substitute ''Commissioner'' for ''Secretary of the Treasury'' in § 1.1061–6(a)(2) to avoid any misperception that any office or bureau within the Treasury Department other than the IRS is responsible for examining taxpayers' returns.

E. Securities Partnerships

The proposed regulations include an amendment to § 1.704–3(e), which provides that a method for aggregating gains and losses by a securities partnership will not be considered reasonable unless it takes into account the application of section 1061. Specifically, the proposed regulations require partnerships that use the partial or full netting approaches described in § 1.704–3(e) to establish accounts to track API Holders' Capital Interest Gains and Losses, Unrealized API Gains and Losses, and API Gains and Losses. A commenter questioned whether these rules were necessary, given the likelihood of hedge fund managers to leave a fund before the three-year holding period expires. Another commenter noted that funds would need to implement sophisticated tracking mechanisms to distinguish between Capital Interest Gains and Losses and API Gains and Losses. The commenter thought that such tracing conflicted with the principles of aggregation provided by § 1.704–3(e).

Another commenter recommended that the final regulations confirm that partnerships can change their section 704(c) aggregation method in order to address section 1061 in a manner consistent with the regulations and that any such change would not violate the requirement to use the same aggregation approach once an approach is adopted. The commenter requested that the final regulations provide examples illustrating the intended application of the creation of separate accounts for APIs and capital interests.

The final regulations provide a simplified rule in § 1.704–3(e) that states that section 1061 must be taken into account in applying the aggregation rule for securities partnerships, but does not provide a specific method for doing so. The Treasury Department and the IRS continue to study the comments received on this issue and may provide additional guidance in the future.

IV. Additional Areas Under Study

A. Section 1061(b) Exception

Section 1061(b) provides that ''[t]o the extent provided by the Secretary, [section 1061(a)] shall not apply to income or gain attributable to any asset not held for portfolio investment on behalf of third party investors.'' The proposed regulations reserve with respect to the application of section 1061(b). The preamble to the proposed regulations states that the Treasury Department and the IRS generally believe that the section 1061(b) exception is effectively implemented in the proposed regulations with the exception to section 1061 for Passthrough Interest Direct Investment Allocations. The preamble further requested comments on the application of section 1061(b) and whether the proposed regulations' exclusion for Passthrough Interest Direct Investment Allocations properly implements the exception.

One commenter suggested that the Passthrough Interest Direct Investment Allocations would exempt certain family offices from section 1061(a) but stated that the exception is too narrow to account for all types of family offices. The commenter noted that section 1061(b) is not intended to cover family offices managed by a professional investment manager who is not a family member and who receives an API because the family members are third-party investors with respect to the professional investment manager. Several commenters suggested that additional guidance under section 1061(b) is needed for family offices, management companies, and other partnerships that do not hold assets for portfolio investment on behalf of third-party investors. One commenter argued that the Treasury Department and the IRS should not reserve on section 1061(b) because carried interests as used in asset management businesses were the particular focus of Congress as it contemplated carried interest proposals.

One commenter noted that it had recommended prior to the issuance of the proposed regulations that the authority under section 1061(b) should be exercised to confirm that section 1061(a) does not apply to recharacterize income or gain attributable to the value of intangibles, including goodwill, created or used in an ATB. The commenter recognized that the Passthrough Interest Direct Investment Allocation rules in the proposed regulations operate in part to implement an exception for enterprise value, but recommended that final regulations should provide specifically that section 1061(a) does not apply to recharacterize income or gain attributable to enterprise value. Furthermore, the commenter argued that the enterprise value exception should apply to allocations through tiers and should not require allocations in accordance with partner capital accounts if the intangible asset it not held for portfolio investment on behalf of third-party investors.

As discussed in Part II.A. of this Summary of Comments and Explanation of Revisions, the final regulations modify the rules related to the capital interest exception, including removing the Passthrough Interest Direct Investment Allocation rules. As discussed in Part II.C. of this Summary of Comments and Explanation of Revisions, the final regulations provide that the delayed holding period prong of the Lookthrough Rule does not apply to the disposition of an API to the extent that the gain recognized upon the disposition is attributable to any asset not held for portfolio investment on behalf of third party investors. The Treasury Department and the IRS continue to study the comments regarding section 1061(b) and may address the application of the provision in future guidance, including whether section 1061(a) applies to recharacterize income or gain attributable to enterprise value. The Treasury Department and the IRS request additional comments related to section 1061(b).

B. Small Partnerships

In the preamble to the proposed regulations, the Treasury Department and the IRS requested comments and suggestions on whether a simplified method for determining and calculating the API Gain or Loss should be provided for small partnerships and if so, the criteria that should be used to determine which partnerships should be eligible to use the simplified method. One commenter stated that a small partnership exception is critically important to the integrity of the entire section 1061 regulatory regime. The commenter also noted that given the burdensome nature of the reporting requirements that could apply to small business taxpayers, a modification of these requirements for either ''small partnerships'' or ''small partners'' would appear to be justified. As discussed in the section on reporting requirements, a commenter also recommended a *de minimis* exception to the reporting requirements for passthrough entities in which a limited partner owns five percent, or less, of a fund. The Treasury Department and the IRS continue to study this issue and may address this in future guidance. The Treasury Department and the IRS request additional comments and suggestions on whether a simplified method for determining and calculating the API Gain or Loss should be provided for small partnerships and if so, the criteria that should be used to determine which partnerships should be eligible to use the simplified method.

V. Applicability Dates

The final regulations retain the applicability dates as proposed. Accordingly, the final regulations generally apply to taxable years of Owner Taxpayers and Passthrough Entities beginning on or after January 19, 2021. Section 1.1061–3(b)(2)(i) applies to taxable years beginning after December 31, 2017. Section 1.1061–3(b)(2)(ii) applies to taxable years beginning after August 14, 2020. An Owner Taxpayer or Passthrough Entity may choose to apply the final regulations in their entirety to a taxable year beginning after December 31, 2017, provided that they consistently apply the final regulations in their entirety to that year and all subsequent years.

With respect to an API in a partnership with a fiscal year ending after December 31, 2017, section 706 determines the capital gains and losses the Owner Taxpayer includes in income with respect to an API after December 31, 2017. Section 706 provides that the taxable income of a partner for a taxable year includes amounts required by sections 702 and 707(c) with respect to a partnership based on the income, gain, loss, deduction, or credit of a partnership for any taxable year ending within or with the taxable year of the partner. Accordingly, if a calendar year Owner Taxpayer has an API in a fiscal year partnership whose taxable year ends after December 31, 2017, section 1061 applies to the Owner Taxpayer's distributive share of long-term capital gain or loss with respect to the API in calendar year 2018 regardless of whether the partnership disposed of the property giving rise to the gains and losses in the period prior to January 1, 2018. *See* § 1.706–1(a).

Special Analyses

I. Regulatory Planning and Review—Economic Analysis

Executive Orders 12866, 13563, and 13771 direct agencies to assess costs and benefits of available regulatory alternatives and, if regulation is necessary, to select regulatory approaches that maximize net benefits (including potential economic, environmental, public health and safety effects, distributive impacts, and equity). Executive Order 13563 emphasizes the importance of quantifying both costs and benefits, of reducing costs, of harmonizing rules, and of promoting flexibility.

These regulations have been designated as economically significant under Executive Order 12866 pursuant to the Memorandum of Agreement (April 11, 2018) between the Treasury Department and the Office of Management and Budget (OMB) regarding review of tax regulations.

A. Need for Final Regulations

These final regulations provide certainty and clarity to taxpayers affected by statutory changes introduced in section 1061 by TCJA. The Treasury Department and the IRS have received questions and comments regarding the meaning of various provisions in section 1061 and issues not explicitly addressed in the statute. The Treasury Department and the IRS have determined that such comments warrant the issuance of further guidance.

B. Background

Section 1061 of the Internal Revenue Code (Code), enacted by TCJA, characterizes certain long-term capital gains recognized with respect to an API as short-term capital gains. Short-term capital gains are generally taxed at a higher rate than long-term capital gains.

Section 1061 defines an API as an interest in a partnership transferred to or held by the taxpayer in connection with the performance of substantial services by the taxpayer, or any other related person, in any ''applicable trade or business'' (ATB). Under section 1061 the term ATB encompasses a range of financial service activities. Specifically, an ATB is any activity conducted on a regular, continuous, and substantial basis which consists, in whole or in part, of raising or returning capital, and either (i) investing in (or disposing of) ''specified assets'' (or identifying specified assets for such investing or disposition), or (ii) developing specified assets. ''Specified assets'' are certain securities, certain commodities, 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.

Prior to the TCJA, the Internal Revenue Code made no distinction between capital gains allocated to APIs versus other partnership interests and partnership assets. Generally, the required holding period to obtain the lower long-term capital gains tax rate was one year for all partnership interests and partnership capital assets. Under the new provision, the required holding period for an API must be greater than three years to obtain long-term capital gains treatment.

The Treasury Department and the IRS previously published proposed regulations under section 1061 (''proposed regulations'').

C. Overview of the Final Regulations

The final regulations provide taxpayers with definitional and computational guidance regarding the application of section 1061. In particular, the final regulations provide a number of definitions, including the term 'taxpayer' for the purpose of determining the existence of an API. Additionally, the regulations clarify the rules for certain exceptions to section 1061, including the exception for capital interests, and provide for an additional exception for bona fide purchases of APIs by an unrelated party who is not a service provider. The final regulations also provide rules for calculating the recharacterized gain amount.

D. Economic Analysis

1. Baseline

In this analysis, the Treasury Department and the IRS assess the benefits and costs of the final regulations relative to a no-action baseline reflecting anticipated Federal income tax-related behavior in the absence of these final regulations.

2. Summary of Economic Effects

The final regulations provide certainty and consistency in the application of section 1061 by providing definitions and clarifications regarding the statute's terms and rules. An economically efficient tax system generally aims to treat income and expense derived from similar economic decisions consistently across taxpayers and activities in order to reduce incentives for individuals and businesses to make choices based on tax rather than market incentives. In the absence of the guidance provided in these final regulations, taxpayers would bear the burden of interpreting the statute and the chances that different taxpayers might interpret the statute differently would be exacerbated. For example, two similarly situated taxpayers might interpret the statutory provisions pertaining to the definition of taxpayer or the capital interest exception differently, causing one to enter into a partnership that another comparable taxpayer might decline because of a different interpretation of how the income will be treated under section 1061. If this opportunity did not go to the more productive taxpayer, this lack of clarity results in an economically inefficient pattern of activity. An economic loss may also arise if all taxpayers have identical interpretations of the tax treatment of particular income streams under the statute but which differ slightly from the interpretation that Congress intended for these income streams. In this case, guidance provides value by bringing economic decisions closer in line with the intent and purpose of the statute.

The final regulations include multiple substantive changes compared to the proposed regulations. The Treasury Department and the IRS view these changes as favorable to taxpayers, providing more flexibility and reducing burden and complexity. In particular, the final rules governing the capital interest exception are more flexible to better accommodate common business practices, which vary considerably across industries. Compared to the proposed regulations, the final regulations considerably narrow the range of related party transactions triggering 1061 recharacterization, and the associated compliance burden. Finally, compared to the proposed regulations, the Lookthrough Rule on the sale of APIs included in the final regulations is a more narrowly targeted anti-abuse rule, only imposing a compliance burden on taxpayers that appear to have engaged in abusive practices with the primary aim of avoiding section 1061(a) recharacterization.

The proposed regulations solicited comments on the economic analysis of the proposed regulations. No such comments were received.

3. Economic Analysis of Specific Provisions

a. Provisions Not Substantially Revised From the Proposed Regulations

i. Definition of Taxpayer

The statute requires taxpayers to make a number of determinations, including the determination of the existence of an API, and the calculation of the section 1061 amount, or amount of long-term gain recharacterized under section 1061. However, the term ''taxpayer'' is not defined in either section 1061 or in the Conference Report. Comments received by the Treasury Department and IRS highlight the importance of the definition of the term taxpayer for purposes of section 1061. Without guidance, taxpayers could use different approaches to define ''taxpayer,'' leading otherwise similar taxpayers to experience different degrees of complexity, and to report different recharacterized amounts.

The final regulations include two definitions of taxpayer to address the level at which the determination of the existence of an API is made and the level at which the calculation of the section 1061 amount is made. The final regulations define the Owner Taxpayer as the person generally required to pay tax on the gain or loss with respect to the API. Under the final regulations, the section 1061 calculation is only performed by the person (the Owner Taxpayer) who must pay tax on the gains and losses recognized with respect to the API. The final regulations also introduce the term Passthrough Taxpayer. A Passthrough Taxpayer is an entity that does not itself generally pay tax on capital gains but must determine when an API exists and allocate income, gain, deduction and loss to its owners. Both the Owner Taxpayer and the Passthrough Taxpayer are treated as taxpayers for the purpose of determining whether an API exists.

The Treasury Department and the IRS considered and rejected two alternative approaches to the definition of taxpayer outlined in received comments, the ''aggregate approach'' and the ''full entity approach''. Under the aggregate approach, a partnership is not treated as a taxpayer for purposes of section 1061. Instead, section 1061 is applied solely to the partners that are ultimately subject to tax on the partnership's items of capital gain and loss. A concern with using this approach for the purpose of determining whether an API exists is that it could incentivize partners to use tiered ownership structures to avoid section 1061 recharacterization. For example, an upper tier partnership may receive an interest in a lower-tier fund in connection with the upper-tier partnership's performance of services in an ATB. Partners of the upper-tier partnership may contend that they did not receive their interest in the upper-tier partnership in connection with the services performed by the upper-tier partnership. Stopping such avoidance strategies would require complex rules and potentially burdensome reporting requirements when tiered ownership structures are involved.

Under the ''full entity approach'', the partnership is treated as a taxpayer for purposes of both determining the existence of an API and calculating the section 1061 recharacterization amount. Treating the partnership as a taxpayer for purposes of calculating the section 1061 recharacterization amount was found to be more burdensome than the approach taken in the final regulations for three reasons. First, using the full entity approach for determining the section 1061 recharacterization amount may lead to increased recharacterization of gains under section 1061 because individuals would not be able to net gains and losses across multiple APIs. Second, the administrative burden on both the taxpayer and the IRS would be increased in cases of tiered ownership. Under the full entity approach, a separate section 1061 calculation would be required at each level at which an API is held in a tiered partnership structure. Finally, the full entity approach may add complexity and burden in cases in which an exception to section 1061 applies, such as if a corporation is a direct or indirect partner. Because corporations are excluded from section 1061, any amount recharacterized at the partnership level would need to be tracked as it is allocated to partners to ensure that corporate or other excepted partners are not subject to the three-year holding period under section 1061.

The Treasury and the IRS have concluded that the chosen alternative, incorporating the concepts of Owner Taxpayer and Passthrough Taxpayer, is less burdensome than other alternatives and provides helpful certainty to taxpayers.

ii. Clarification of the Treatment of an API Purchased by an Unrelated Party

The statute states that capital gain or loss recognized by a taxpayer on the sale of an API held for more than one year is subject to section 1061. The statute also provides guidance for ongoing treatment under section 1061 when the API is purchased by, or transferred to, a related party or another service provider. However, the statute does not provide guidance for the taxpayer who purchases an API and is neither a service provider to the relevant ATB, nor related to the seller of the API. The final regulations add an exception to section 1061 and provide that the term API does not include an interest in a partnership that would be treated as an API but is held by a bona fide purchaser of the interest who does not currently and has never provided services in the relevant ATB and who is not related to a person who provides services currently or has provided services in the past. By clarifying the treatment of an API that is sold at arm's length, the final regulations reduce uncertainty and compliance burdens for taxpayers entering into these transactions. The Treasury Department and the IRS have determined that this exception is consistent with the purpose of section 1061, which applies to service providers and persons related to service providers and which is not meant to apply to bona fide purchasers of a partnership interest who do not provide services.

The Treasury Department and the IRS considered not providing this exception. However, it was determined that failure to provide this exception would treat unrelated purchasers of an API in an inequitable fashion, and that continued treatment of the partnership interest as an API would be inconsistent with the purpose of section 1061 because unrelated purchasers did not receive their interest in connection with the performance of substantial services.

b. Provisions Substantially Revised From the Proposed Regulations

i. Capital Interest Exception

Section 1061(c)(4)(B) provides that the definition of 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 the interest included in income under section 83 upon the receipt or vesting of such interest.'' However, the statute does not provide guidance on what it means for a right to share in partnership capital to be ''commensurate'' with the amount of capital contributed.

The final regulations clarify that allocations are deemed commensurate with capital contributed if, under the partnership agreement, the allocation to an API Holder is calculated in a similar manner as the allocations to similarly situated Unrelated Non-Service Partners. This may be determined on an investment-by-investment or class-by-class basis. To qualify as a benchmark for comparison, the Unrelated Non-Service Partners must hold a significant investment, defined as at least five percent of the partnership. In the absence of these regulations, taxpayers might face confusion, along with substantial compliance cost, in calculating their qualifying capital interest. Further, partners with realized gains would be incentivized to engage in a series of inefficient transactions in order to minimize tax.

The Treasury Department and the IRS considered alternative interpretations of ''commensurate with capital contributed.'' In particular, the proposed regulations provide that an allocation is ''commensurate with capital'' if the allocation is based on the relative section 704(b) capital accounts of the partners under the partnership agreement. The proposed regulations then provide multiple rules for calculating an API holder's capital account, including a rule disallowing unrealized API capital gains in calculating the API holder's capital account, and a rule for determining the capital account when an API is held through another partnership. In light of numerous comments, the Treasury Department and the IRS have determined that the proposed regulations were too rigid and were not well suited to the wide variety of common business practices regarding ownership structure, accounting conventions, and compensation arrangements. Specifically, many partnerships subject to section 1061 do not maintain section 704(b) capital accounts. For many other partnerships, the capital account of one partner may relate to economic rights associated with multiple separate investments held by a partnership, while the capital account of another partner may relate to economic rights associated with a separate set of investments held by a partnership. For these reasons, the Treasury Department and the IRS have determined that the section 704(b) capital accounts of partners provide a poor means of measuring commensurate economic capital interest rights.

The proposed regulations also prohibited use of the capital interest exception if a capital contribution was funded with related party loan proceeds. Commenters noted that it is a common business practice in industries subject to Section 1061 for employees to require new partners to make substantial capital contributions, which are often acquired through a loan. This arrangement, designed not to avoid tax but to align the incentives of general partners and limited partners, would be unduly penalized under the proposed regulations, incentivizing firms to choose a less efficient ownership and governance structure. The final regulations amend the rule to allow an individual service provider's capital contributions to be funded with loan proceeds from partners and persons related to partners if the individual service provider is personally liable for the loan, meaning the loan is fully recourse to the individual service provider, the individual service provider has no right to be reimbursed by any person, and no person has guaranteed the individual service's provider's loan. The Treasury Department and the IRS believe the final rules address abusive avoidance strategies, while imposing less burden on taxpayers engaged in standard business practices relative to not allowing any contributions from proceeds from related part loans to be eligible for the capital interest exception.

ii. Lookthrough Rule on Sale of APIs

Section 1061(a) provides that if one or more APIs are held by a taxpayer at any time during the taxable year, the excess (if any) of (1) the taxpayer's net long-term capital gain with respect to such interests for such taxable year, over (2) the taxpayer's net long-term capital gain with respect to such interests for that taxable year computed by applying paragraphs (3) and (4) of sections 1222 by substituting ''3 years'' for ''1 year,'' must be treated as short-term capital gain, notwithstanding section 83 or any election in effect under section 83(b). The House Report explains that section 1061 ''imposes a three-year holding period (not the generally applicable one-year holding period) in the case of long-term capital gain from applicable partnership interests.'' Neither section 1061 nor the Reports, however, explicitly provides what the relevant holding period is for purposes of section 1061(a) for the sale of an API with assets of different holding periods.

The final regulations include a Lookthrough Rule that is triggered if a transaction or series of transactions has taken place with a principal purpose of avoiding potential gain recharacterization under section 1061(a). Under this Lookthrough Rule, all gain not attributable to assets held for more than three years is subject to recharacterization under section 1061(a). Additionally, the Lookthrough Rule applies if the API disposition would be subject to Section 1061(a) recharacterization using a holding period not beginning until the date that Unrelated Non-Service Partners legally commit to contribute substantial capital to the applicable partnership. Without this rule, fund managers might attempt to avoid the recharacterization of gains by establishing partnerships and leaving them inactive for three years before attracting investment from limited partners, thereby circumventing Section 1061.

The Treasury Department and the IRS considered and rejected alternative approaches, including applying a simple interest approach, an alternative lookthrough rule (as provided in the proposed regulations), and an underlying assets approach. The simple interest approach looks solely to the holding period in the API, regardless of the length of time the partnership has engaged in substantive investment. This approach might allow taxpayers to avoid section 1061 characterization for long-term capital gains on assets that are not held for the more than three years by the partnership. This result would encourage distortive behavior in investment funds, which might look to create partnerships for different investors solely for tax purposes, relative to the approach adopted in the final regulations. That is, the partners of that investment partnership would not be subject to section 1061 if they had owned their APIs for more than three years, irrespective of how long the investment partnership had been active and attracting capital from outside investors.

Alternatively, the underlying asset, or full lookthrough, approach looks solely to the holding period in the underlying asset (or assets) of the partnership, regardless of whether the underlying asset is sold by the partnership or the API is sold by its owner. The underlying asset approach would be more difficult (and burdensome) for taxpayers to apply (relative to the provision provided in the final regulations) as it would require a determination of the unrealized gain for each asset held by the partnership, even in cases in which a relatively small share of assets by value have a holding period of three years or less.

The proposed regulations included an alternative lookthrough rule applied to the sale of an API if 80% or more of the value of the assets held by the partnership at the time of the API disposition were assets held for three years or less that would produce capital gain or loss subject to section 1061 if disposed of by the partnership. If the lookthrough rule in the proposed regulations applied, a portion of the capital gain on the disposition of the API attributable partnership assets held for three or fewer years would be recharacterized as short-term capital gain. This alternative was rejected in the final regulations because the calculations required by the proposed lookthrough rule would impose unnecessary compliance burden on individual taxpayers selling an API without any accompanying general economic benefit. The rules requiring partnerships to furnish taxpayers with the relevant information to perform the calculations would also impose undue additional burden on the relevant partnerships. The lookthrough rule provided in the final regulations applies in more limited circumstances, narrowly targeting taxpayers that appear to be engaged in abusive practices to avoid section 1061(a) recharacterization. Therefore, the final regulations provide helpful guidance and certainty for taxpayers, while imposing minimal compliance burden relative to the no-action baseline or alternative regulatory approaches.

iii. Treatment of API Transfers to Related Parties

Section 1061(d) recharacterizes certain long-term capital gain as short-term capital gain when a taxpayer transfers an API to a related person. While the statute provides a definition of a related person and a general description of the recharacterization amount, numerous commenters expressed uncertainty regarding the scope of transfers subject to section 1061(d), pointing out that although the statutory language of section 1061(d) refers to the transfer of an API, it refers to income inclusion associated with an API transfer that is related to the sale or exchange of partnership assets held for three years of less. Based on the statutory language, commenters expressed the view that section 1061(d) transfers should be limited to taxable transfers.

Although one read of the text of section 1061(d) suggests that the provision can be broadly applied to capture all API transfers, including gifts and other nonrecognition transfer, the Treasury Department and the IRS considered and rejected applying section 1061(d) to nontaxable transfers. Applying section 1061(d) to nontaxable transfers would impose income recognition on gifts including an API, where no income recognition is imposed on otherwise similar gifts, creating a tax disadvantage for gifts including an API. Instead, the Treasury and the IRS have determined that the section 1061(d) statute is better read as a recharacterization provision that looks to how much of the taxpayer's long-term capital gain upon the sale of an API is attributable to the sale or exchange of any asset held for three years or less and that the provision's use of the word ''transfer'' does not supersede application of the sale or exchange requirement in the statute.

II. Paperwork Reduction Act

A. Collection of Information in § 1.1061–6(a) on the Owner Taxpayer is on Existing Forms

The collection of information in § 1.1061–6(a) requires an Owner Taxpayer to file such information with the IRS as the Commissioner may require in forms, instructions and other published guidance as is necessary for the IRS to determine that the taxpayer has properly complied with section 1061 and the Section 1061 Regulations. This information is necessary for the IRS to determine that the Owner Taxpayer has properly complied with section 1061. In general, the Owner Taxpayer is an individual and the Owner Taxpayer's Recharacterization Amount and Section 1061(d) Recharacterization Amount will be required to be reported to the IRS as short-term capital gain on Schedule D, ''Capital Gains and Losses,'' of the Form 1040, ''U.S. Individual Income Tax Return.'' Less frequently, the Owner Taxpayer is a trust and the Owner Taxpayer's Recharacterization Amount and Section 1061(d) Recharacterization Amount will be required to be reported to the IRS as short-term capital gain on Schedule D, ''Capital Gains and Losses,'' of the Form 1041, ''U.S. Income Tax Return for Estates and Trusts.''

The current status of the Paperwork Reduction Action submission related to § 1.1061–6(a) is provided in the following table. The burdens associated with the collection of information from the Owner Taxpayer to comply with section 1061 are included in the aggregate burden estimates for Form 1040 under OMB control number 1545–0074 and Form 1041 under OMB control number 1545–0092. The overall burden estimates provided in OMB Control Number 1545–0074 represents a total estimated burden time, including all other related forms and schedules for individuals, of 1.784 billion hours and total estimated monetized costs of $31.74 billion (in 2017 dollars). The overall burden estimates provided in OMB Control Number 1545–0092 represents a total estimated burden time, including all other forms and schedules for trusts and estates of 307.8 million hours and total estimated monetized costs of $9.95 billion (in 2016 dollars). These amounts are aggregate amounts that relate to all information collections associated with the applicable OMB control numbers, and will in the future include, but not isolate, the estimated burden of Owner Taxpayers as a result of the information collections in the regulations. No burden estimates specific to the final regulations are currently available. The Treasury Department and IRS have not estimated the burden, including that of any new information collections, related to the requirements under the final regulations. Those estimates would capture both changes made by the TCJA and those that arise out of discretionary authority exercised in the regulations. The Treasury Department and the IRS request comments on all aspects of information collection burdens related to the collection of information applicable to the Owner Taxpayer in these regulations. In addition, when available, drafts of IRS forms are posted for comment at *www.irs.gov/draftforms.*

Form	Type of filer	OMB No.(s)	Status
Form 1040 (Including Schedule D).	Individual (NEW Model)	1545–0074	Published in the **Federal Register** on 9/30/19. Comment period closed on 11/29/19. 84 FR 51712. Thirty-day notice published on 12/18/19. 84 FR 69458. Approved by the Office of Information and Regulatory Affairs (OIRA) on 1/30/20.
Form 1041 (Including Schedule D).	Trusts and Estates (Legacy Model).	1545–0092	Published in the **Federal Register** on 4/4/2018. 83 FR 14552. Public comment period closed 6/4/2018. Thirty-day notice published on 9/27/18. 83 FR 48894. Approved by OIRA on 5/8/19.

B. Collection of Information on Passthrough Entities in § 1.1061–6(b) and (c) on Existing Forms

1. Passthrough Entities

The collection of information in § 1.1061–6(b) requires a Passthrough Entity that has issued an API to furnish to the API Holder, including the Owner Taxpayer, such information at such time and in such manner as the Commissioner may require in forms, instructions, and other published guidance as is necessary to determine the One Year Gain amount and the Three Year Gain Amount with respect to an Owner Taxpayer. This includes: (i) The API One Year Distributive Share Amount and the API Three Year Distributive Share Amount (as determined under § 1.1061–4); (ii) Capital gains and losses allocated to the API Holder that are excluded from section 1061 under § 1.1061–4(b)(7); (iii) Capital Interest Gains and Losses allocated to the API Holder (as determined under § 1.1061–3(c)); (iv) In the case of a disposition by the API Holder of an interest in the Passthrough Entity during the taxable year, any information required by the API Holder to properly take the disposition into account under section 1061, including information necessary to apply the Lookthrough Rule and to determine its Capital Interest Disposition Amount and any information necessary to determine an Owner Taxpayer's Section 1061(d) Recharacterization Amount. The regulations seek to minimize the information that a Passthrough Entity is required to automatically furnish annually. In some cases, an upper-tier Passthrough Entity may be an API Holder in a lower-tier Passthrough Entity, and the information furnished by the lower-tier Passthrough Entity to the upper-tier Passthrough Entity may not be sufficient for the upper-tier Passthrough Entity to meet its reporting obligations under the regulations. In this case, the regulations require the lower-tier Passthrough Entity to furnish information to the upper-tier Passthrough Entity if requested. Thus, if an upper-tier Passthrough Entity in a tiered entity structure holds an interest in a lower-tier Passthrough Entity and it needs information from the lower-tier Passthrough Entity to comply with its obligation to furnish information under the regulations, it must request information from the lower-tier entity and the lower-tier entity must furnish the requested information. This passing of information upon request between the tiers of entities is necessary to minimize the quantity of information required to be annually furnished by a Passthrough Entity and because each Passthrough Entity in a tiered entity arrangement is the only entity that has access to the information that is required to be furnished. The collection of information in the regulations is necessary to ensure that the Owner Taxpayer receives information sufficient to correctly calculate its Recharacterization Amount under section 1061.

2. RICs and REITs

Section 1.1061–6(c) permits a RIC or a REIT that reports or designates all or a part of a dividend as a capital gain dividend, to disclose additional information to their shareholders for purposes of section 1061. The furnishing of this information may allow a Passthrough Entity to include a portion of the capital gain dividend in the API Three Year Distributive Share amount furnished to API Holders and may ultimately enable an Owner Taxpayer to reduce its Recharacterization Amount under the regulations.

3. Table for Collections of Information in § 1.1061–6(b) and (c)

The collection of information with respect to § 1.1061–6(b) and (c) is provided in the following table. In the case of a Passthrough Entity that is a partnership, the information will be required to be furnished as an attachment to the Schedule K–1, ''Partner's Share of Income, Deduction, Credit, Etc.'' of Form 1065, ''U.S. Return of Partnership Income.'' In the case of a Passthrough Entity that is an S corporation, the information will be required to be furnished as an attachment to the Schedule K–1, ''Shareholder's Share of Income, Deductions, Credit, Etc.,'' of Form 1120–S, ''U.S. Income Tax Return for an S Corporation.'' The burdens associated with the collection of information from the Passthrough Entities will be included in the aggregate burden estimates for the Form 1065 and the Form 1120S under OMB control number 1545–0123. The overall burden estimates provided in OMB Control Number 1545–0123 represents a total estimated burden time, including all others related forms and schedules, of 3.344 billion hours and total estimated monetized costs of $61.558 billion (in 2019 dollars). The burden estimates provided in OMB Control Number 1545–0123 are aggregate amounts that relate to all information collections associated with the applicable OMB control number, and will in the future include, but not isolate, the Passthrough Entities' estimated burden as a result of the information collections in the proposed regulations.

In the case of a Passthrough Entity that is a trust or estate, the information will be required to be furnished as an attachment to the Schedule K–1, ''Beneficiary's Share of Income, Deductions, Credit, Etc.,'' of Form 1041, ''U.S. Income Tax Return for Estates and Trusts.'' The burdens associated with the collection of information from a Passthrough Entity that is a trust or estate will be included in the aggregate burden estimates for the Form 1041 OMB control number 1545–0092. The overall burden estimates provided in OMB Control Number 1545–0092 represents a total estimated burden time, including all other forms and schedules for trusts and estates of 307.8 million hours and total estimated monetized costs of $9.95 billion (in 2016 dollars). The burden estimates provided in OMB Control Number 1545–0092 are aggregate amounts that relate to all information collections associated with the applicable OMB control number, and will in the future include, but not isolate, the Passthrough Entities' estimated burden as a result of the information collections in the regulations.

In the case of RICs and REITs the information will be furnished in connection with the Form 1099–DIV, ''Dividends and Distributions.'' The burden estimates associated with the collection of information from RICs and REITs will be included in the aggregate burden estimated for the Form 1099–DIV under OMB Control Number 1545–0110. The overall burden estimates provided in OMB Control Number 1545–0110 represents a total estimated burden time of 32,119,195 hours and total estimated monetized costs of $ 1.64 billion (in 2016 dollars). The burden estimates provided in OMB Control Number 1545–0110 relate to all information collections associated with the applicable OMB Control Number, and will in the future include, but not isolate, the RIC and REIT estimated burden as a result of the information collections in the regulations.

The Treasury Department and IRS have not estimated the burden, including that of any new information collections, related to the requirements under the regulations. Those estimates would capture both changes made by the TCJA and those that arise out of the discretionary authority exercised in the regulations. The Treasury Department and the IRS request comments on all aspects of information collection burdens related to the collection of information applicable to the Passthrough Entities in the regulations. In addition, when available, drafts of IRS Forms and the applicable instructions are posted for comment at *https://www.irs.gov/pub/irs-dft/.*

Form	Type of filer	OMB No.(s)	Status
Form 1041 (including Schedule K–1).	Trusts and Estates (Legacy Model).	1545–0092	Published in the **Federal Register** on 4/4/2018. 83 FR 14552. Public comment period closed 6/4/2018. Thirty-day notice published on 9/27/18. 83 FR 48894. Approved by OIRA on 5/8/19.
Form 1065 (including Schedule K–1).	Business (NEW Model)	1545–0123	Sixty-day notice published in the **Federal Register** on 9/30/19. Public Comment period closed on 11/29/19. 84 FR 51718. Thirty-day notice published in the **Federal Register** on 12/19/19. Public Comment period closed on 1/21/20. 84 FR 69825. Approved by OIRA on 1/30/20.
Form 1120S (Including Schedule K–1).	Business (New Model)	1545–0123	Sixty-day notice published in the **Federal Register** on 9/30/19. Public Comment period closed on 11/29/19. 84 FR 51718. Thirty-day notice published in the **Federal Register** on 12/19/19. Public Comment period closed on 1/21/20. 84 FR 69825. Approved by OIRA on 1/30/20.
Form 1099–DIV	(Legacy Model)	1545–0110	Sixty-day notice published in the **Federal Register** on 9/19/19. Public comment period closed 11/18/19. 84 FR 49379. Thirty-day notice published in the **Federal Register** on 12/20/19. 84 FR 70269.

Form	Type of filer	OMB No.(s)	Status
	Link: *https://www.federal register.gov/documents/2018/05/23/2018-10981/proposed-collection-comment-request-for-form-1099-div.*		

C. Chart Showing Number of Respondents Regarding Existing Forms

The following chart shows the estimated number of returns that are expected to have attachments providing additional information with respect to section 1061. As noted previously, Owner Taxpayers will be required to provide section 1061 information on an attachment to Schedules D for Forms 1040 and 1041. Passthrough Taxpayers will be required to report section 1061 on Forms 1041, 1065, and 1120S to the IRS and to furnish information to their API Holders on attachments to the respective K–1s. RICs and REITs may voluntarily report additional information at an attachment to Form 1099–DIV.

Schedule D Form 1040	20,475
Schedule D Form 1041	2,275
Schedule K Form 1065	28,500
Schedule K–1s Form 1065	57,000
Schedule K Form 1120S	1,500
Schedule K–1s Form 1120	1,000
Form 1099–DIV filed by REITs	836
Form 1099–DIV filed by RICs	3,880

D. Voluntary Collection of Information in § 1.1061–6(d) on PFIC Shareholder Will Be Added to Existing OMB Control Number for PFIC Information Retention

Section 1.1061–6(d) permits a PFIC with respect to which the shareholder is an API Holder who has a QEF election is in effect for the taxable year to provide additional information to the shareholder to determine the amount of the shareholder's inclusion that would be included in the API One Year Distributive Share Amount and the API Three Year Distributive Share Amount. If the PFIC furnishes this information to the shareholder, the shareholder must retain a copy of this information along with the other information required to be retained under § 1.1295–1(f)(2)(ii). The burden associated with retaining this additional information will be included in the aggregate burden estimates for § 1.1295–1(f) under OMB Control Number 1545–1555. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books and records related to the collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

III. Regulatory Flexibility Act

Pursuant to the Regulatory Flexibility Act (5 U.S.C. chapter 6), it is hereby certified that these final regulations will not have a significant economic impact on a substantial number of small entities within the meaning of section 601(6) of the Regulatory Flexibility Act. These regulations generally only impact investment funds that have capital gains and losses that derive from the disposition of assets that have a holding period of more than one year but not more than three years. Investment funds are considered small business if they have annual average receipts of $41.5 million or less (13 CFR part 121). The rule may affect a substantial number of small entities, but data are not readily available to assess how many entities will be affected.

The Treasury Department and the IRS received no actionable comments on the impact that the proposed regulations would have on small entities. Although certain commenters requested that partnerships with an unspecified amount of limited assets be excepted from the application of the statutory rules of section 1061, these commenters did not provide any data to demonstrate that any burden would be significant. Similarly, a commenter requested an exception to the reporting requirements for passthrough entities in which a limited partner owns 5 percent or less of a fund but did not quantify the burden. In addition, the final regulations adopt other comments that limit the general burden of the regulations to all entities, including small entities.

Even if a substantial number of small entities are affected, the economic impact of these regulations on small entities is not significant. The regulations provide taxpayers with definitional and computational guidance regarding the application of section 1061. The impact of the regulations is to impose an additional reporting obligation that applies only with respect to the sale of assets held for more than one year but not more than three years. The Treasury Department and the IRS recognize that this reporting obligation may increase, at least to some extent, the tax preparation burden for affected taxpayers beyond that imposed by the statute. This reporting obligation generally will only apply to a minority of the asset dispositions by an entity. The entity will also have a reporting obligation in certain circumstances regarding the disposition of an API, but the extent of the reporting obligation depends on the number of assets disposed by the entity and their holding periods. The information reported is readily available to taxpayers and reported on forms already in use beginning with the 2019 taxable year such as Schedule D to IRS Form 1065. Finally, some taxpayers may find they need an initial investment of time to read and understand these regulations at an approximate cost of $95/hour and an estimated time of ten hours. Accordingly, the Secretary certifies that these regulations will not have a significant economic impact on a substantial number of small entities.

Pursuant to section 7805(f), the notice of proposed rulemaking preceding this regulation was submitted to the Chief Counsel for the Office of Advocacy of the Small Business Administration for comment on its impact on small businesses. No comments were received from the Chief Counsel for the Office of Advocacy of the Small Business Administration.

IV. Unfunded Mandates Reform Act

Section 202 of the Unfunded Mandates Reform Act of 1995 requires that agencies assess anticipated costs and benefits and take certain other actions before issuing a final rule that includes any Federal mandate that may result in expenditures in any one year by a state, local, or tribal government, in the aggregate, or by the private sector, of $100 million in 1995 dollars, updated annually for inflation. This rule does not include any Federal mandate that may result in expenditures by state, local, or tribal governments, or by the private sector in excess of that threshold.

V. Executive Order 13132: Federalism

Executive Order 13132 (entitled ''Federalism'') prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial, direct compliance costs on state and local governments, and is not required by statute, or preempts state law, unless the agency meets the consultation and funding requirements of section 6 of the Executive order. This rule does not have federalism implications and does not impose substantial direct compliance costs on state and local governments or preempt state law within the meaning of the Executive order.

VI. Congressional Review Act

The Administrator of the Office of Information and Regulatory Affairs of the Office of Management and Budget has determined that this Treasury decision is a major rule for purposes of the Congressional Review Act (5 U.S.C. 801 *et seq.*). Under 5 U.S.C. 801(a)(3), a major rule takes effect 60 days after the rule is published in the **Federal Register**.

Notwithstanding this requirement, 5 U.S.C. 808(2) allows agencies to dispense with the requirements of 5 U.S.C. 801 when the agency for good cause finds that such procedure would be impracticable, unnecessary, or contrary to the public interest and the rule shall take effect at such time as the agency promulgating the rule determines. Pursuant to 5 U.S.C. 808(2), the Treasury Department and the IRS find, for good cause, that a 60-day delay in the effective date is contrary to the public interest.

Following the enactment of section 1061 by the TCJA, the Treasury Department and the IRS published the proposed regulations to provide certainty to taxpayers. In particular, as demonstrated by the wide variety of public comments in response to the proposed regulations received, taxpayers continue to express uncertainty regarding the proper application of the statutory rules under section 1061. This is especially the case for taxpayers in the trade or business of operating investment funds, which may be unwilling to engage in certain commercial transactions without the additional clarity provided by these final regulations. Additionally, various rules contained within these regulations attempt to curb certain abusive transactions designed to avoid the application of section 1061 and an earlier effective date is necessary to address these abusive transactions. Accordingly, the Treasury Department and the IRS have determined that the rules in this Treasury decision will take effect on the date of filing for public inspection in the **Federal Register**.

Statement of Availability of IRS Documents

Notice 2018–18, 2018–2 I.R.B. 443 (in addition to any other revenue procedures or revenue rulings, etc. cited in this preamble) is published in the Internal Revenue Bulletin (or Cumulative Bulletin) and is available from the Superintendent of Documents, U.S. Government Publishing Office, Washington, DC 20402, or by visiting the IRS website at *http://www.irs.gov.*

Drafting Information

The principal authors of these regulations are Kara K. Altman, Sonia K. Kothari, and Wendy L. Kribell of the Office of Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the Treasury Department and the IRS participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Amendment to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

■ **Paragraph 1.** The authority citation for part 1 is amended by adding entries for §§ 1.1061–0, 1.1061–1, 1.1061–2, 1.1061–3, 1.1061–4, 1.1061–5, and 1.1061–6 in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.1061–0 added under 26 U.S.C. 1061(f).

Section 1.1061–1 added under 26 U.S.C. 1061(f).

Section 1.1061–2 added under 26 U.S.C. 1061(f).

Section 1.1061–3 added under 26 U.S.C. 1(h)(9) and 1061(f).

Section 1.1061–4 added under 26 U.S.C. 1061(f).

Section 1.1061–5 added under 26 U.S.C. 1061(f).

Section 1.1061–6 added under 26 U.S.C. 1061(f).

* * * * *

■ **Par. 2.** Section 1.702–1 is amended by adding a sentence at the end of paragraph (a)(2) and adding paragraph (g) to read as follows:

§ 1.702–1 Income and credits of partner.

(a) * * *

(2) * * * Each partner subject to section 1061 must take into account gains and losses from sales of capital assets held for more than one year as provided in section 1061 and §§ 1.1061–1 through 1.1061–6.

* * * * *

(g) *Applicability date.* The last sentence of paragraph (a)(2) of this section applies for the taxable years beginning on or after January 19, 2021.

■ **Par. 3.** Section 1.704–3 is amended by:

■ 1. In paragraph (e)(3)(vi)(B), remove the word ''and'' at the end of the paragraph;

■ 2. Redesignating paragraph (e)(3)(vi)(C) as paragraph (e)(3)(vi)(D);

■ 3. Adding new paragraph (e)(3)(vi)(C); and

■ 4. Revising the heading and first sentence of paragraph (f) and adding a sentence to the end of paragraph (f).

The additions and revisions read as follows:

§ 1.704–3 Contributed property.

* * * * *

(e) * * *

(3) * * *

(vi) * * *

(C) With respect to any person who directly or indirectly holds an Applicable Partnership Interest, as defined in § 1.1061–1(a)(1), take into account the application of section 1061 with respect to such interest in an appropriate manner; and

* * * * *

(f) *Applicability dates.* With the exception of paragraphs (a)(1), (a)(8)(ii) and (iii), (a)(10) and (11), and (e)(3)(vi)(C) of this section, and of the last sentence of paragraph (d)(2) of this section, this section applies to properties contributed to a partnership and to revaluations pursuant to § 1.704–1(b)(2)(iv)(*f*) or (*s*) on or after December 21, 1993. * * * Paragraph (e)(3)(vi)(C) of this section applies to taxable years beginning on or after January 19, 2021.

* * * * *

■ **Par. 4.** Sections 1.1061–0 through 1.1061–6 are added before the undesignated center heading ''Changes to Effectuate F.C.C. Policy'' to read as follows:

Sec.

* * * * *

* * * * *

§ 1.1061–0 Table of contents.

This section lists the captions that appear in §§ 1.1061–1 through 1.1061–6.

§ 1.1061–1 Section 1061 definitions.

(a) Definitions.
(b) Applicability date.

§ 1.1061–2 Applicable partnership interests and applicable trades or businesses.

(a) API rules and examples.
(1) Rules.
(i) An API remains an API.
(ii) Application of section 1061 to Unrealized API Gains and Losses.
(iii) API Gains and Losses retain their character.
(iv) Substantial services by the Owner Taxpayer, Passthrough Taxpayer or any Related Person.
(v) Grantor trusts and entities disregarded as separate from their owners.
(2) Examples.
(b) Application of the ATB Activity Test.
(1) In general.
(i) Rules for applying the ATB Activity Test.
(A) Aggregate Specified Actions taken into account.
(B) Raising or Returning Capital Actions and Investing or Developing Actions are not both required to be taken in each taxable year.
(C) Combined conduct by multiple related entities taken into account.
(ii) Developing Specified Assets.
(iii) Partnerships.
(2) Examples.
(c) Applicability date.

§ 1.1061–3 Exceptions to the definition of an API.

(a) A partnership interest held by an employee of another entity not conducting an ATB.
(b) Partnership interest held by a corporation.
(1) In general.
(2) Treatment of interests held by an S corporation or a qualified electing fund.
(c) Capital Interest Gains and Losses.
(1) In general.
(2) Capital Interest Gains and Losses defined.
(3) General rules for determining Capital Interest Allocations.
(i) Commensurate with capital contributed.
(ii) In a similar manner.
(A) Relevant factors.
(B) Clear identification requirement.
(iii) Reinvestment of API Gain.
(iv) Unrelated Non-Service Partner requirement.
(v) Proceeds of certain loans not taken into account for Capital Interest Allocation purposes.
(A) General rule.
(B) Recourse liability.
(vi) Items that are not included in Capital Interest Allocations.
(4) Capital Interest Disposition Amounts.
(i) In general.
(ii) Determination of the Capital Interest Disposition Amount.
(5) Capital Interest Allocations made by a Passthrough Entity that is an API Holder.
(6) Examples.
(d) Partnership interest acquired by purchase by an unrelated person.
(1) Acquirer not a Related Person.
(2) Section 1061(d) not applicable.
(3) Acquirer not a service provider.
(e) [Reserved]
(f) Applicability date.
(1) General rule.
(2) Partnership interest held by an S corporation.
(3) Partnership interest held by a PFIC with respect to which the shareholder has a QEF election in effect.

§ 1.1061–4 Section 1061 computations.

(a) Computations.
(1) Recharacterization Amount.
(2) One Year Gain Amount and Three Year Gain Amount.
(i) One Year Gain Amount.
(ii) Three Year Gain Amount.
(3) API One Year Distributive Share Amount and API Three Year Distributive Share Amount.
(i) API One Year Distributive Share Amount.
(ii) API Three Year Distributive Share Amount.
(4) API One Year Disposition Amount and API Three Year Disposition Amount.
(i) API One Year Disposition Amount.
(ii) API Three Year Disposition Amount.
(b) Special rules for calculating the One Year Gain Amount and the Three Year Gain Amount.
(1) One Year Gain Amount equals zero or less.
(2) Three Year Gain Amount equals zero or less.
(3) One Year Gain Amount less than Three Year Gain Amount.
(4) Installment sale gain.
(5) Special rules for capital gain dividends from regulated investment companies (RICs) and real estate investment trusts (REITs).
(i) API One Year Distributive Share Amount.
(ii) API Three Year Distributive Share Amount.
(iii) Loss on sale or exchange of stock.
(6) Pro rata share of qualified electing fund (QEF) net capital gain.
(i) One year QEF net capital gain.
(ii) Three year QEF net capital gain adjustment.
(7) Items not taken into account for purposes of section 1061.
(8) Holding period determination.
(i) Determination of holding period for purposes of the Three Year Gain Amount.
(ii) Relevant holding period.
(9) Lookthrough Rule for certain API dispositions.
(i) Determination that the Lookthrough Rule applies.
(A) In general.
(B) Determination that the Lookthrough Rule applies to the disposition of a Passthrough Interest.
(ii) Application of the Lookthrough Rule.
(10) Section 83.
(c) Examples.
(1) Recharacterization rules.
(2) Special rules examples.
(d) Applicability date.

§ 1.1061–5 Section 1061(d) transfers to related persons.

(a) In general.
(b) Transfer.
(c) Section 1061(d) Recharacterization Amount.
(d) Special rules.
(e) Section 1061(d) Related Person.
(f) Examples.
(g) Applicability date.

§ 1.1061–6 Reporting rules.

(a) Owner Taxpayer filing requirements.
(1) In general.
(2) Failure to obtain information.
(b) Passthrough Entity filing requirements and reporting.
(1) Requirement to file information with the IRS and to furnish information to API Holder.
(2) Requirement to request, furnish, and file information in tiered structures.
(i) Requirement to request information.
(ii) Requirement to furnish and file information.
(iii) Timing of requesting and furnishing information.
(A) Requesting information.
(B) Furnishing information.
(iv) Manner of requesting information.
(v) Recordkeeping requirement.
(vi) Passthrough Entity is not furnished information to meet its reporting obligations under paragraph (b)(1) of this section.
(vii) Filing requirements.
(viii) Penalties.
(c) Regulated investment company (RIC) and real estate investment trust (REIT) reporting.
(1) Section 1061 disclosures.
(i) One Year Amounts Disclosure.
(ii) Three Year Amounts Disclosure.
(2) Pro rata disclosures.
(3) Report to shareholders.
(d) Qualified electing fund (QEF) reporting.
(e) Applicability date.

§ 1.1061–1 Section 1061 definitions.

(a) *Definitions.* The following definitions apply solely for purposes of this section and §§ 1.1061–2 through 1.1061–6.

API Gains and Losses are any long-term capital gains and capital losses with respect to an API and include:

(i) The *API One Year Distributive Share Amount* as defined in § 1.1061–4(a)(3)(i);

(ii) The *API Three Year Distributive Share Amount* as defined in § 1.1061–4(a)(3)(ii);

(iii) The *API One Year Disposition Amount* as defined in § 1.1061–4(a)(4)(i);

(iv) The *API Three Year Disposition Amount* as defined in § 1.1061–4(a)(4)(ii); and

(v) Capital gains or losses from the disposition of Distributed API Property.

API Holder is a person who holds an API.

Applicable Partnership Interest (API) means any interest in a partnership which, directly or indirectly, is transferred to (or is held by) an Owner Taxpayer or Passthrough Taxpayer in connection with the performance of substantial services by the Owner Taxpayer or by a Passthrough Taxpayer, or by any Related Person, including services performed as an employee, in any ATB unless an exception in § 1.1061–3 applies. For purposes of defining an API under this section and section 1061 of the Internal Revenue Code (Code), an interest in a partnership also includes any financial instrument or contract, the value of which is determined in whole or in part by reference to the partnership (including the amount of partnership distributions, the value of partnership assets, or the results of partnership operations). An Owner Taxpayer and a Passthrough Taxpayer can hold an API directly or indirectly through one or more Passthrough Entities.

Applicable Trade or Business (ATB) means any activity for which the ATB Activity Test with respect to Specified Actions is met, and includes all Specified Actions taken by Related Persons, including combining activities occurring in separate partnership tiers or entities as one ATB.

ATB Activity Test has the meaning provided in § 1.1061–2(b)(1).

Capital account means a capital account maintained under § 1.704–1(b)(2)(iv) or similar principles.

Capital Interest Allocations means, with respect to a partnership, allocations of long-term capital gain or loss made under the partnership agreement to an API Holder and to Unrelated Non-Service Partners based on such partners' capital contributed with respect to the partnership to the extent such allocations otherwise meet the requirements of § 1.1061–3(c). With respect to other Passthrough Entities, the principles of this definition apply.

Capital Interest Disposition Amount has the meaning provided in § 1.1061–3(c)(4).

Capital Interest Gains and Losses has the meaning provided in § 1.1061–3(c)(2).

Distributed API Property means property distributed by a Passthrough Entity to an API Holder with respect to an API if the holding period, as determined under sections 735 and 1223, in the API Holder's hands is three years or less at the time of disposition of the property by the API Holder.

Indirect API means an API that is held through one or more Passthrough Entities.

Investing or Developing Actions means actions involving either—

(i) Investing in (or disposing of) Specified Assets (or identifying Specified Assets for such investing or disposition); or

(ii) Developing Specified Assets (see § 1.1061–2(b)(1)(ii)).

Lookthrough Rule means the recharacterization rule described in § 1.1061–4(b)(9).

One Year Gain Amount has the meaning provided in § 1.1061–4(a)(2)(i).

Owner Taxpayer means the person subject to Federal income tax on net gain with respect to an API or an Indirect API during the taxable year, including an owner of a Passthrough Taxpayer unless the owner of the Passthrough Taxpayer is a Passthrough Entity itself or is excepted under § 1.1061–3(a), (b), or (d).

Passthrough Entity means a partnership, trust, estate, S corporation described in § 1.1061–3(b)(2)(i), or passive foreign investment company described in § 1.1061–3(b)(2)(ii).

Passthrough Interest means an interest in a Passthrough Entity that represents in whole or in part an API.

Passthrough Taxpayer means a Passthrough Entity that is treated as a taxpayer for the purpose of determining the existence of an API.

Raising or Returning Capital Actions means actions involving raising or returning capital but does not include Investing or Developing Actions.

Recharacterization Amount has the meaning provided in § 1.1061–4(a)(1).

Related Person means a person or entity who is treated as related to another person or entity under sections 707(b) or 267(b).

Relevant ATB means the ATB in which services were provided and in connection with which an API is held or was transferred.

Section 1061(d) Recharacterization Amount has the meaning provided in § 1.1061–5(c).

Section 1061(d) Related Person has the meaning provided in § 1.1061–5(e).

Section 1061 Regulations means the provisions of this section and §§ 1.1061–2 through 1.1061–6.

Specified Actions means the combination of Raising or Returning Capital Actions and Investing or Developing Actions.

Specified Assets means—

(i) Securities, including interests in partnerships qualifying as securities (as defined in section 475(c)(2) without regard to the last sentence thereof);

(ii) Commodities (as defined in section 475(e)(2));

(iii) Real estate held for rental or investment;

(iv) Cash or cash equivalents; and

(v) An interest in a partnership to the extent that the partnership holds Specified Assets. See § 1.1061–2(b)(1)(iii).

(vi) Specified Assets include options or derivative contracts with respect to any of the items provided in paragraphs (i) through (v) of this definition.

Three Year Gain Amount has the meaning provided in § 1.1061–4(a)(2)(ii).

Unrealized API Gains and Losses means, with respect to a Passthrough Entity's assets, all unrealized capital gains and losses that would be:

(i) Realized if those assets were disposed of for fair market value in a taxable transaction on the relevant date; and

(ii) Allocated to an API Holder with respect to its API, taking into account the principles of section 704(c).

Unrelated Non-Service Partners means partners who do not (and did not) provide services in the Relevant ATB and who are not (and were not) Related Persons with respect to any API Holder in the partnership or any person who provides or has provided services in the Relevant ATB.

(b) *Applicability date.* The provisions of this section apply to taxable years of Owner Taxpayers and Passthrough Entities beginning on or after January 19, 2021. An Owner Taxpayer or Passthrough Entity may choose to apply this section to a taxable year beginning after December 31, 2017, provided that they consistently apply the Section 1061 Regulations in their entirety to that year and all subsequent years.

§ 1.1061–2 Applicable partnership interests and applicable trades or businesses.

(a) *API rules and examples*—(1) *Rules*—(i) *An API remains an API.* Once a partnership interest qualifies as an API, the partnership interest remains an API unless and until the requirements of one of the exceptions to qualification of a partnership interest as an API, set forth in § 1.1061–3, are satisfied.

(ii) *Application of section 1061 to Unrealized API Gains and Losses.* Unrealized API Gains and Losses are API Gains and Losses subject to section 1061 when the gains and losses are realized and recognized. Unrealized API Gains and Losses do not lose their character as such until they are recognized.

(iii) *API Gains and Losses retain their character.* API Gains and Losses retain their character as API Gains and Losses as they are allocated from one Passthrough Entity to another Passthrough Entity and then to the Owner Taxpayer.

(iv) *Substantial services by an Owner Taxpayer, Passthrough Taxpayer, or any Related Person.* If an interest in a partnership is transferred to or held by an Owner Taxpayer, Passthrough Taxpayer, or any Related Person in connection with the performance of services, the Owner Taxpayer, the

Passthrough Taxpayer, or the Related Person is presumed to have provided substantial services for purposes of section 1061.

(v) *Grantor trusts and entities disregarded as separate from their owners.* A trust wholly described in subpart E, part I, subchapter J, chapter 1 of the Internal Revenue Code (that is, a grantor trust), a qualified subchapter S subsidiary described in section 1361(b)(3), and an entity with a single owner that is treated as disregarded as an entity separate from its owner under any provision of the Internal Revenue Code or any part of 26 CFR (including § 301.7701–3 of this chapter) are disregarded for purposes of the Section 1061 Regulations.

(2) *Examples.* The following examples illustrate the provisions of this paragraph (a).

(i) *Example 1: API.* (A) A is the general partner of PRS, a partnership, and provides services to PRS. A is engaged in an ATB as defined in § 1.1061–1(a). PRS transfers a PRS profits interest to A in connection with A's performance of substantial services with respect to PRS's ATB. A's interest in PRS is an API.

(B) After 6 years, A retires and is no longer engaged in an ATB and does not perform any services with respect to its ATB and with respect to PRS. However, A retains the API in PRS. PRS continues to acquire new capital assets and to allocate gain to A from the disposition of those assets. Under paragraph (a)(1)(i) of this section, A's interest in PRS remains an API after A retires.

(ii) *Example 2: Contribution of an API to a partnership.* Individuals A, B, and C each directly hold APIs in PRS, a partnership. A and B form a new partnership, GP, and contribute their APIs in PRS to GP. Following the contribution, each of A and B holds an Indirect API because each of A and B now indirectly holds an API in PRS through GP, a Passthrough Entity. Each of A's and B's interests in GP is a Passthrough Interest because each of A's and B's interest in GP represents an Indirect API.

(iii) *Example 3: Passthrough Interest, Indirect API, Passthrough Taxpayer.* Each of A, B, and C provides services to, and is an equal partner in, GP. GP is engaged in an ATB as defined in § 1.1061–1(a), is the general partner of PRS, and provides substantial management services to PRS. In connection with GP's performance of substantial services in an ATB, PRS issues a profits interest to GP. Because GP's PRS interest was received in connection with GP's providing services in an ATB, GP is a Passthrough Taxpayer and GP's interest in PRS is an API. Because A, B, and C are partners in GP, they each hold a Passthrough Interest in GP and an Indirect API in PRS. Each of A, B, and C is treated as an Owner Taxpayer because each is a partner in GP and because each holds an Indirect API in PRS in connection with the performance of its services to GP's ATB.

(iv) *Example 4: S corporation, Passthrough Interest, Indirect API, and Passthrough Taxpayer.* A owns all of the stock of S Corp, an S corporation. S Corp is engaged in an ATB, as defined in § 1.1061–1(a). S Corp is the general partner of PRS, a partnership, and provides substantial management services to PRS. A provides substantial services in S Corp's ATB. In connection with S Corp providing substantial services to PRS, PRS issues a profits interest to S Corp. S Corp's interest in PRS is its only asset. Because S Corp's profits interest in PRS was issued to S Corp in connection with substantial services in an ATB, S Corp is a Passthrough Taxpayer and its interest in PRS is an API. Because A is a shareholder in S Corp, A holds a Passthrough Interest in S Corp and an Indirect API in PRS as a result of S Corp's API in PRS. A is treated as an Owner Taxpayer because A holds an interest in S Corp, a Passthrough Taxpayer, and also indirectly holds an API in PRS in connection with A's services in S Corp's ATB.

(v) *Example 5: Indirect API, Related Person, and Passthrough Taxpayer.* Each of A, B, and C is an equal partner in partnership GP, the general partner of PRS. GP's Specified Actions do not satisfy the ATB Activity Test under § 1.1061–1(a) and as a result, GP's actions do not establish an ATB. Management Company is a Related Person with respect to GP within the meaning of sections 267(b) and 707(b), is engaged in an ATB, and provides substantial management services to PRS that are sufficient to satisfy the ATB Activity Test. Management Company's actions are attributed to GP under paragraphs (a)(1)(iv) and (b)(1)(i)(C) of this section because Management Company is a Related Person to GP. In connection with Management Company's services to PRS, PRS issues a profits interest to GP. Because its PRS profits interest is issued to GP in connection with services provided by Management Company, a Related Person, GP is a Passthrough Taxpayer and its interest in PRS is an API. Unless an exception described in § 1.1061–3 applies, because A, B, and C are partners in GP, they each hold a Passthrough Interest in GP and an Indirect API in PRS. A, B, and C are treated as Owner Taxpayers because they hold an interest in GP, a Passthrough Taxpayer.

(b) *Application of the ATB Activity Test*—(1) *In general.* The ATB Activity Test is satisfied if both Raising and Returning Actions and Investing or Developing Actions are conducted by an Owner Taxpayer, Passthrough Taxpayer, or one or more Related Persons with respect to an Owner Taxpayer or Passthrough Taxpayer, and the total level of activity, including the combined activities of all Related Persons, satisfies the level of activity that would be required to establish a trade or business under section 162.

(i) *Rules for applying the ATB Activity Test*—(A) *Aggregate Specified Actions taken into account.* The determination of whether the ATB Activity Test is satisfied is based on the combined activities conducted that qualify as either Raising or Returning Capital Actions and Investing or Developing Actions. The fact that either Raising or Returning Capital Actions or Investing or Developing Actions are only infrequently taken does not preclude the test from being satisfied if the combined Specified Actions meet the test.

(B) *Raising or Returning Capital Actions and Investing or Developing Actions are not both required to be taken in each taxable year.* Raising or Returning Capital Actions and Investing or Developing Actions are not both required to be taken in each taxable year in order to satisfy the ATB Activity Test. For example, the ATB Activity Test will be satisfied if Investing or Developing Actions are not taken in the current taxable year, but sufficient Raising or Returning Capital Actions are taken in anticipation of future Investing or Developing Actions. Additionally, the ATB Activity Test will be satisfied if no Raising or Returning Capital Actions are taken in the current taxable year, but have been taken in a prior taxable year (regardless of whether the ATB Activity Test was met in the prior year), and sufficient Investing or Developing Actions are undertaken by the taxpayer in the current taxable year.

(C) *Combined conduct by multiple related entities taken into account*—(*1*) *Related Entities.* If a Related Person(s) (within the meaning of § 1.1061–1(a)) solely or primarily performs Raising or Returning Capital Actions and one or more other Related Person(s) solely or primarily performs Investing or Developing Actions, the combination of the activities performed by these Related Persons will be taken into account in determining whether the ATB Activity Test is satisfied.

(*2*) *Actions taken by an agent or delegate.* Specified Actions taken by an agent or a delegate in its capacity as an agent or a delegate of a principal will be taken into account by the principal in determining whether the ATB Activity Test is satisfied with respect to the principal. These Specified Actions are also taken into account in determining whether the ATB Activity test is satisfied with respect to the agent or the delegate.

(ii) *Developing Specified Assets.* Developing Specified Assets takes place if it is represented to investors, lenders, regulators, or other interested parties that the value, price, or yield of a portfolio business may be enhanced or increased in connection with choices or actions of a service provider. Merely exercising voting rights with respect to shares owned or similar activities do not amount to developing Specified Assets.

(iii) *Partnerships.* Investing or Developing Actions directly conducted with respect to Specified Assets held by a partnership are counted towards the ATB Activity Test. Additionally, a portion of the Investing or Developing Actions conducted with respect to the interests in a partnership that holds Specified Assets is counted towards the ATB Activity Test. This portion is the value of the partnership's Specified Assets over the value of all of the partnership's assets. Actions taken to manage a partnership's working capital will not be taken into account in determining the portion of Investing or Developing Actions conducted with respect to the interests in the partnership.

(2) *Examples.* The following examples illustrate the application of the ATB Activity Test described in paragraph (b)(1) of this section.

(i) *Example 1: Combined activities of Raising or Returning Capital Actions and Investing or Developing Actions.* During the taxable year, B takes a small number of actions to raise capital for new investments. B takes numerous actions to develop Specified Assets. B's actions with respect to raising capital and B's actions with respect to developing Specified Assets are combined for the purpose of determining whether the ATB Activity Test is satisfied. These actions cumulatively rise to the level required to establish a trade or business under section 162. Thus, B satisfies the ATB Activity Test.

(ii) *Example 2: Combining Specified Actions in multiple entities.* GP, a partnership, conducts Raising or Returning Capital Actions. Management Company, a partnership that is a Related Person to GP, conducts Investing or Developing Actions. When GP's and Management Company's activities are combined, the ATB Activity Test is satisfied. Accordingly, both GP and Management Company are engaged in an ATB, and services performed by either GP or Management Company are performed in an ATB under paragraph (b)(1) of this section.

(iii) *Example 3: Investing or Developing Actions taken after Raising or Returning Capital Actions that do not meet the ATB Activity Test.* In year 1, PRS engaged in Raising or Returning Capital Actions to fund PRS's investment in Specified Assets. However, PRS' Specified Actions during year 1 did not satisfy the ATB Activity Test because they did not satisfy the level of activity required to establish a trade or business under section 162. Therefore, PRS was not engaged in an ATB in year 1. In year 2, PRS engaged in significant Investing or Developing Actions but did not engage in any Raising or Returning Capital Actions. In year 2, PRS's Investing or Developing Actions rise to the level required to establish a trade or business under section 162. Because PRS has cumulatively engaged in both Investing or Developing Actions and Raising or Returning Capital Actions and because the Specified Actions rise to the level of activity required to establish a trade or business under section 162, PRS is engaged in an ATB in year 2.

(iv) *Example 4: Raising or Returning Capital Actions taken in anticipation of Investing or Developing Actions.* In year 1, A only conducted Raising or Returning Capital Actions. A's Raising or Returning Capital Actions were undertaken to raise capital to invest in Specified Assets with the goal of increasing their value through Investing or Developing Actions and rise to the level of activity required to establish a trade or business under section 162. A did not take Investing or Developing Actions during the taxable year. A's Raising or Returning Capital Actions satisfy the ATB Activity Test because they were undertaken in anticipation of also engaging in Investing or Developing Actions. Therefore, the ATB Activity Test is satisfied, and A is engaged in an ATB in year 1.

(v) *Example 5: Attribution of delegate's actions.* GP is the general partner of PRS. GP is responsible for providing management services to PRS. GP contracts with Management Company to provide management services on GP's behalf to PRS. GP and Management Company are not Related Persons. The Specified Actions taken by Management Company on behalf of GP are attributed to GP for purposes of the ATB Activity Test because the Management Company is operating as a delegate of GP. Additionally, those Specified Actions are taken into account by Management Company for purposes of the ATB Activity Test and whether it is engaged in an ATB.

(vi) *Example 6: ATB Activity Test not satisfied.* A is the manager of a hardware store. Partnership owns the hardware store, including the building in which the hardware business is conducted. In connection with A's services as the manager of the hardware store, a profits interest in Partnership is transferred to A. Partnership's business involves buying hardware from wholesale suppliers and selling it to customers. The hardware is not a Specified Asset. Although real estate is a Specified Asset if it is held for rental or investment purposes, Partnership holds the building for the purpose of conducting its hardware business and not for rental or investment purposes. Therefore, the building is not a Specified Asset as to Partnership. Partnership also maintains and manages a certain amount of working capital for its business, but actions with respect to working capital are not taken into account for the purpose of determining whether the ATB Activity Test is met. Partnership is not a Related Person with respect to any person who takes Specified Actions. Partnership is not engaged in an ATB because the ATB Activity Test is not satisfied. Although Partnership raises capital, its Raising or Returning Capital Actions alone do not satisfy the ATB Activity Test. Further, Partnership takes no Investing or Developing Actions because it holds no Specified Assets other than working capital. Partnership is not in an ATB and the profits interest transferred to A is not an API.

(c) *Applicability date.* The provisions of this section apply to taxable years of Owner Taxpayers and Passthrough Entities beginning on or after January 19, 2021. An Owner Taxpayer or Passthrough Entity may choose to apply this section to a taxable year beginning after December 31, 2017, provided that they apply the Section 1061 Regulations in their entirety to that year and all subsequent years.

§ 1.1061–3 Exceptions to the definition of an API.

(a) *A partnership interest held by an employee of another entity not conducting an ATB.* An API does not include any interest transferred to a person in connection with the performance of substantial services by that person as an employee of another entity that is conducting a trade or business (other than an ATB) and the person provides services only to such other entity.

(b) *Partnership interest held by a corporation*—(1) *In general.* An API does not include any interest directly or indirectly held by a corporation.

(2) *Treatment of interests held by an S corporation or a qualified electing fund.* For purposes of this section, a corporation does not include an entity for which an election was made to treat the entity as a Passthrough Entity. Thus, the following entities are not treated as corporations for purposes of section 1061—

(i) An S corporation for which an election under section 1362(a) is in effect; and

(ii) A passive foreign investment company (PFIC) with respect to which the shareholder has a qualified electing fund (QEF) election under section 1295 in effect.

(c) *Capital Interest Gains and Losses*—(1) *In general.* Capital Interest Gains and Losses are not subject to section 1061 and, therefore, are not included in calculating an Owner Taxpayer's Recharacterization Amount.

(2) *Capital Interest Gains and Losses defined.* For purposes of paragraph (c)(1) of this section, Capital Interest Gains and Losses are Capital Interest Allocations that meet the requirements of paragraph (c)(3) of this section and Capital Interest Disposition Amounts that meet the requirements of paragraph (c)(4) of this section.

(3) *General rules for determining Capital Interest Allocations*—(i) *Commensurate with capital contributed.* An allocation will be considered a Capital Interest Allocation if the allocation to the API Holder with respect to its capital interest is determined and calculated in a similar manner as the allocations with respect to capital interests held by similarly situated Unrelated Non-Service Partners who have made significant aggregate capital contributions as described in paragraph (c)(3)(iv) of this section. For purposes of this paragraph (c)(3), a capital interest is an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value at the time the interest was received and the proceeds were then distributed in a complete liquidation of the partnership.

(ii) *In a similar manner.* For purposes of paragraph (c)(3)(i) of this section, a Capital Interest Allocation to an API Holder will be treated as made in a similar manner if allocations and distribution rights with respect to the capital contributed by an API Holder to which the API Holder's Capital Interest Allocation relates are reasonably consistent with allocation and distribution rights with respect to capital contributed by Unrelated Non-Service Partners where the Unrelated Non-Service Partner requirement is met. For purposes of this paragraph (c)(3)(ii), allocation and distribution rights for an API Holder that are limited to a particular class of partnership capital interests or that are determined with respect to capital contributions invested in a particular partnership investment will be considered as made in a similar manner to allocations and distribution rights of Unrelated Non-Service Partners where the Unrelated Non-Service Partner requirement is met for the applicable interest class or partnership investment.

(A) *Relevant factors.* For purposes of this paragraph (c)(3)(ii), the following factors are not exclusive, but are relevant factors in determining whether allocation and distribution rights with respect to capital contributed by an API Holder are reasonably consistent with allocation and distribution rights of persons meeting the Unrelated Non-Service Partner requirement: The amount and timing of capital contributed, the rate of return on capital contributed, the terms, priority, type and level of risk associated with capital contributed, and the rights to cash or property distributions during the partnership's operations and on liquidation. Accordingly, an allocation to an API Holder will not fail to qualify solely because the allocation is subordinated to allocations made to Unrelated Non-Service Partners, because an allocation to an API Holder is not reduced by the cost of services provided by the API Holder or a Related Person to the partnership, where the cost of services provided includes management fees or API allocations, or because an API Holder has a right to receive tax distributions while Unrelated Non-Service Partners do not, where such distributions are treated as advances against future distributions.

(B) *Clear identification requirement.* For purposes of this paragraph (c)(3)(ii), allocations will be considered made in a similar manner only if the allocations to the API Holder and the Unrelated Non-Service Partners are allocations with respect to, and corresponding to, such partners' contributed capital that are separate and apart from allocations made to the API Holder with respect to its API and where both the partnership agreement and the partnership's contemporaneous books and records clearly demonstrate that the requirements of paragraph (c)(3) of this section have been met.

(iii) *Reinvestment of API Gain.* If an API Holder is allocated API Gain by a Passthrough Entity, to the extent that an amount equal to the API Gain is reinvested in the Passthrough Entity by the API Holder (either as the result of an actual distribution and recontribution of the API Gain amount or the retention of the API Gain amount by the Passthrough Entity), the amount will be treated as a contribution to the Passthrough Entity for a capital interest that may produce Capital Interest Allocations for the API Holder, provided such allocations meet the requirements of this paragraph (c)(3).

(iv) *Unrelated Non-Service Partner requirement.* For purposes of paragraph (c)(3) of this section, the Unrelated Non-Service Partner requirement means that Unrelated Non-Service Partners must have made significant aggregate capital contributions in relation to total capital contributions of all partners. Unrelated Non-Service Partners will be treated as having made significant aggregate capital contributions provided such partners possess five percent or more of the aggregate capital contributed to the partnership at the time the allocations are made. With respect to an API Holder with allocation and distribution rights that are attributable to a particular interest class or partnership investment, the Unrelated Non-Service requirement must be met with respect to that particular interest class or partnership investment.

(v) *Proceeds of certain loans not taken into account for Capital Interest Allocation purposes*—(A) *General rule.* For purposes of the Section 1061 Regulations, an allocation is not a Capital Interest Allocation to the extent the allocation is attributable to the contribution of an amount of capital to a partnership that, directly or indirectly, results from, or is attributable to, any loan or other advance made or guaranteed, directly or indirectly, by the partnership, a partner in the partnership, or any Related Person with respect to such persons, except to the extent a loan or advance is described in paragraph (c)(3)(v)(B) of this section. However, the repayments on a loan described in the preceding sentence are taken into account as capital contributed (and may therefore generate Capital Interest Allocations) as those amounts are paid by the partner, provided that the loan is not repaid with the proceeds of another loan described in the preceding sentence.

(B) *Recourse liability.* Paragraph (c)(3)(v)(A) of this section does not apply with respect to an allocation attributable to a contribution made by an individual service provider that, directly or indirectly, results from, or is attributable to, a loan or advance from another partner in the partnership (or any Related Person with respect to such lending or advancing partner, other than the partnership) to such individual service provider if the individual service provider is personally liable for the repayment of such loan or advance. A contribution made by an individual service provider includes a contribution made by an entity that is wholly owned by, and disregarded as separate from, the individual service provider as described in § 1.1061–2(a)(1)(v), including a contribution attributable to a loan or advance made to the disregarded entity by another partner in the partnership (or any Related Person with respect to such lending or advancing partner, other that the partnership) if the individual service provider is personally liable for the repayment of any and all borrowed amounts that are not repaid by the disregarded entity. For purposes of this paragraph (c)(3)(v)(B), an individual service provider is personally liable for the repayment of a loan or advance made by a partner (or any Related Person, other than the partnership) if—

(*1*) The loan or advance is fully recourse to the individual service provider;

(*2*) The individual service provider has no right to reimbursement from any other person; and

(*3*) The loan or advance is not guaranteed by any other person.

(vi) *Items that are not included in Capital Interest Allocations.* Capital Interest Allocations do not include—

(A) Amounts that are treated as API Gains and Losses and Unrealized API Gains and Losses; or

(B) Items that are not taken into account for purposes of section 1061 under § 1.1061–4(b)(7).

(4) *Capital Interest Disposition Amounts*—(i) *In general.* The term *Capital Interest Disposition Amount* means the amount of long-term capital gain or loss recognized on the sale or disposition of all or a portion of a Passthrough Interest that is treated as Capital Interest Gain or Loss. In general, long-term capital gain or loss recognized on the sale or disposition of a Passthrough Interest is deemed to be API Gain or Loss unless it is determined under paragraph (c)(4)(ii) of this section to be a Capital Interest Disposition Amount.

(ii) *Determination of the Capital Interest Disposition Amount.* If a Passthrough Interest that includes a right to allocations of Capital Interest Gains and Losses is disposed of, the amount of long-term capital gain or loss that is treated as a Capital Interest Disposition Amount is determined under the rules provided in this paragraph (c)(4)(ii).

(A) First, determine the amount of long-term capital gain or loss that would be allocated to the Passthrough Interest (or the portion of the Passthrough Interest sold) if all the assets of the Passthrough Entity (including gain or loss with respect to assets described in § 1.1061–4(b)(7)) were sold for their fair market value in a fully taxable transaction immediately before the disposition of the Passthrough Interest (hypothetical asset sale). For purposes of this paragraph (c)(4)(ii), the assets of the Passthrough Entity include any assets held by a lower-tier Passthrough Entity in which the Passthrough Entity has a direct or indirect interest.

(B) Second, determine the amount from the hypothetical asset sale that would be allocated to the Passthrough Interest (or the portion of the Passthrough Interest sold) as Capital Interest Allocations under paragraph (c)(3) of this section.

(C) Third, if the transferor recognized long-term capital gain upon disposition of the Passthrough Interest and only net short-term capital losses, net long-term capital losses, or both, are allocated to the Passthrough Interest under paragraph (c)(4)(ii)(B) of this section from the hypothetical asset sale, all of the long-term capital gain is API Gain. If the transferor recognized long-term capital loss on the disposition of the Passthrough Interest and only net short-term capital gains, net long-term capital gains, or both, are allocated to the Passthrough Interest under paragraph (c)(4)(ii)(B) of this section, then all the long-term capital loss is API Loss.

(D) If paragraph (c)(4)(ii)(C) of this section does not apply and long-term capital gain is recognized on the disposition of the Passthrough Interest, the amount of long-term capital gain that the transferor of the Passthrough Interest recognizes that is treated as a Capital Interest Disposition Amount is determined by multiplying long-term capital gain recognized on the disposition of the Passthrough Interest by a fraction, the numerator of which is the amount of long-term capital gain determined under paragraph (c)(4)(ii)(B) of this section, and the denominator of which is the amount of long-term capital gain determined under paragraph (c)(4)(ii)(A) of this section, with the percentage represented by the fraction limited to 100 percent. Alternatively, if paragraph (c)(4)(ii)(C) of this section does not apply and long-term capital loss is recognized on the disposition of the Passthrough Interest, the amount of long-term capital loss treated as a Capital Interest Disposition Amount is determined by multiplying the transferor's capital loss by a fraction, the numerator of which is the amount of long-term capital loss determined under paragraph (c)(4)(ii)(B) of this section, and the denominator of which is the amount of long-term capital loss determined under paragraph (c)(4)(ii)(A) of this section, with the percentage represented by the fraction limited to 100 percent.

(E) In applying this paragraph (c)(4)(ii), allocations of amounts that are not included in determining the amount of long-term capital gain or loss recognized on the sale or disposition of the Passthrough Interest are not included. See, for example, section 751(a).

(5) *Capital Interest Allocations made by a Passthrough Entity that is an API Holder.* An allocation made to a Passthrough Entity that holds an API in a lower-tier Passthrough Entity will be considered a Capital Interest Allocation if it meets the principles set forth in paragraphs (c)(3) and (4) of this section (other than paragraph (c)(3)(iv) of this section). For purposes of applying the Capital Interest Allocation rules in this paragraph (c)(5) to a tiered partnership structure, to the extent that a Capital Interest Allocation that is made by a lower-tier partnership to an upper-tier partnership is properly allocated to the upper-tier partnership's partners with respect to their capital interests in the upper-tier partnership in a manner that is respected under 704(b) (taking into account the principles of section 704(c)), such allocation is a Capital Interest Allocation.

(6) *Examples.* The rules of this paragraph (c) are illustrated by the following examples.

(i) *Example 1: Capital Interest Allocations*—(A) *Facts.* Each of A, B, and C contributes $100 to GP and is an equal partner in GP, a partnership that is the general partner of PRS, a partnership. The contributions are not attributable to loans or advances described in paragraph (c)(3)(v)(A) of this section. PRS's other partners are Unrelated Non-Service Partners. Each of GP and PRS makes allocations to its partners in accordance with its partners' interests in that partnership, as described in § 1.704–1(b)(3). GP holds a 20% profits interest in PRS that is an API that GP received in exchange for providing substantial services to PRS in an ATB. GP's API is an Indirect API to each of A, B, and C. GP contributes the $300 of capital contributed by A, B and C to PRS. GP's $300 contribution equals 2% of the contributed capital made by all of PRS's partners ($15,000). PRS's partnership agreement describes its partners' economic distribution rights with respect to its liquidating proceeds as follows: First, liquidating proceeds are proportionately distributed to each of GP and the Unrelated Non-Service Partners equal to the amount necessary to return each of those partners' unreturned capital; second, liquidating proceeds are distributed to GP with respect to its API in PRS; and, finally, any residual liquidating proceeds are distributed, proportionately, 98% to the Unrelated Non-Service Partners and 2% to GP. During its initial taxable year, PRS has $10,000 of net capital gain, causing an increase in PRS's distributable proceeds of $10,000. In accordance with the partners' economic rights as described in PRS's partnership agreement, PRS allocates $2,160 of net capital gain to GP (a $2,000 API allocation plus $160 ($8,000 ($10,000 − $2,000) × 2%), with respect to GP's contributed capital) and $7,840 of net capital gain to the Unrelated Non-Service Partners with respect to their contributed capital. GP allocates $720 ($2,160/3) of this net capital gain to each of A, B, and C in accordance with their interests in GP.

(B) *PRS's Capital Interest Allocation Analysis.* Because PRS's partnership agreement provides for no differences as to the amount and timing of capital contributed, the rate of return on capital contributed, the type and level of risk associated with capital contributed, or the rights to cash or property distributions during the PRS's operations and on liquidation, the allocations and distribution rights with respect the capital contributed by GP are reasonably consistent with the allocation and distribution rights with respect to capital contributed by Unrelated Non-Service Partners. Accordingly, GP's allocation of $160 is a Capital Interest Allocation that is treated as made in a similar manner as the allocations made to the Unrelated Non-Service Partners.

(C) *GP Capital Interest Allocation Analysis.* GP is allocated $2,160 from PRS, consisting of a $2,000 API allocation and a $160 Capital Interest Allocation. The $160 Capital Interest Allocation is allocated equally to A, B, and C based on their capital contributions to GP. Therefore, they qualify as Capital Interest Allocations by GP. See paragraph (c)(5) of this section. The $2,000 of gain allocated by PRS's to GP with respect to GP's API cannot be treated as a Capital Interest Allocation by GP and therefore is subject to section 1061. In summary, A, B, and C are each allocated $720 of capital gain from PRS ($2,160/3). Of this amount, $667 is API Gain ($2,000/3) and $53 is a Capital Interest Allocation ($160/3).

(ii) *Example 2: Sale of a Passthrough Interest*—(A) *Facts.* In Year 1, A, B, and C form GP, a partnership. Each of A, B, and C contributes $100 to GP and is an equal partner in GP. The contributions are not attributable to loans or advances described in paragraph (c)(3)(v)(A) of this section. GP invests the $300 in Asset X in Year 1. GP is also the general partner of PRS, a partnership. PRS's other partners are Unrelated Non-Service Partners. GP holds a 20% profits interest in PRS that is an API that GP received in exchange for providing substantial services to PRS in an ATB. GP's API is an Indirect API to each of A, B, and C. Each of GP and PRS makes allocations to its partners in accordance with its partners' interests in that partnership, as described in § 1.704–1(b)(3). In Year 3, A sells A's interest in GP to an unrelated third party for $800 and recognizes $700 of capital gain on the sale. If PRS had sold its assets in a hypothetical asset sale as required by paragraph (c)(4)(ii)(A) of this section and liquidated immediately before A sold its interest in GP, GP would have been allocated $1,800 of long-term capital gain with respect to GP's API in PRS, and GP would have allocated $600 of this $1,800 to A. If GP sold Asset X for its fair market value and liquidated immediately before A sold its interest in GP, A would have been allocated $100 of long-term capital gain.

(B) *Analysis.* GP does not have a capital interest in PRS. Therefore, its allocations from PRS are allocations with respect to its API which are subject to section 1061. The total gain allocable to A as a result of the hypothetical liquidations would be $700. Under paragraph (c)(4)(ii)(D) of this section, $100 of the $700 of A's interest sale gain is A's Capital Interest Disposition Amount, and is not subject to section 1061.

(iii) *Example 3: Reinvestment of Realized API Gain.* A, B, and C are partners in PRS, a partnership. At the beginning of Year 1, A is issued an API in PRS in exchange for providing substantial services to PRS in an ATB. A has no capital interest in PRS. During Year 1, PRS's assets appreciate by $100. At the end of Year 1, under the terms of its partnership agreement, if PRS were to sell all of its assets at their fair market value and distribute the proceeds in a complete liquidation, A would receive $20 with respect to its API. Thus, at the end of Year 1, A has $20 of Unrealized API Gain. In Year 2, PRS sells Asset X, an asset that PRS owned in Year 1, and allocates $8 of the long-term capital gain to A as API Gain. As a result, $8 of A's $20 of Unrealized API Gain becomes API Gain that is subject to section 1061. A reinvests A's share of the proceeds from the Asset X sale in PRS. As a result, under paragraph (c)(3)(iii) of this section, A has an $8 capital interest in PRS and, provided the requirements of paragraph (c)(3) of this section are met, A may receive future Capital Interest Allocations with respect to the capital interest.

(d) *Partnership interest acquired by purchase by an unrelated person.* If a person (acquirer) acquires an interest in a partnership (target partnership) by taxable purchase for fair market value that, but for the exception set forth in this paragraph (d), would be an API, the transferor of the interest will be treated as selling an API but the acquirer will not be treated as acquiring an API if—

(1) *Acquirer not a Related Person.* Immediately before the purchase, the acquirer is not a Related Person with respect to—

(i) Any person who provides services in the Relevant ATB; or

(ii) Any service providers who provide services to, or for the benefit of, the target partnership or a lower-tier partnership in which the target partnership holds an interest, directly or indirectly.

(2) *Section 1061(d) not applicable.* Section 1061(d) does not apply to the transaction (as provided in § 1.1061–5).

(3) *Acquirer not a service provider.* At the time of the purchase, the acquirer 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 lower-tier partnership in which the target partnership directly or indirectly holds an interest.

(e) [Reserved]

(f) *Applicability date*—(1) *General rule.* Except as provided in paragraphs (f)(2) and (3) of this section, the provisions of this section apply to taxable years of Owner Taxpayers and Passthrough Entities beginning on or after January 19, 2021. An Owner Taxpayer or Passthrough Entity may choose to apply this section to a taxable year beginning after December 31, 2017, provided that they apply the Section 1061 Regulations in their entirety to that year and all subsequent years.

(2) *Partnership interest held by an S corporation.* Paragraph (b)(2)(i) of this section, which provides that the exception under section 1061(c)(1) to the definition of an API does not apply to a partnership interest held by an S corporation with an election under section 1362(a) in effect, applies to

taxable years beginning after December 31, 2017.

(3) *Partnership interest held by a PFIC with respect to which the shareholder has a QEF election in effect.* Paragraph (b)(2)(ii) of this section, which provides that the exception under section 1061(c)(1) to the definition of an API does not apply to a partnership interest held by a PFIC with respect to which the shareholder has a QEF election in effect under section 1295, applies to taxable years of an Owner Taxpayer and Passthrough Entity beginning after August 14, 2020.

§ 1.1061–4 Section 1061 computations.

(a) *Computations*—(1) *Recharacterization Amount.* The Recharacterization Amount is the amount that an Owner Taxpayer must treat as short-term capital gain under section 1061(a). The Recharacterization Amount equals—

(i) The Owner Taxpayer's One Year Gain Amount; less

(ii) The Owner Taxpayer's Three Year Gain Amount.

(2) *One Year Gain Amount and Three Year Gain Amount*—(i) *One Year Gain Amount.* The Owner Taxpayer's One Year Gain Amount is the sum of—

(A) The Owner Taxpayer's combined net API One Year Distributive Share Amount from all APIs held during the taxable year; and

(B) The Owner Taxpayer's API One Year Disposition Amount.

(ii) *Three Year Gain Amount.* The Owner Taxpayer's Three Year Gain Amount is the sum of—

(A) The Owner Taxpayer's combined net API Three Year Distributive Share Amount from all APIs held during the taxable year; and

(B) The Owner Taxpayer's API Three Year Disposition Amount.

(3) *API One Year Distributive Share Amount and API Three Year Distributive Share Amount*—(i) *API One Year Distributive Share Amount.* The API One Year Distributive Share Amount equals—

(A) The API Holder's distributive share of net long-term capital gain or loss from the partnership for the taxable year (including capital gain or loss on the disposition of Distributed API Property by an API Holder that is a Passthrough Entity or the disposition of all or a part of an API by an API Holder that is a Passthrough Entity), with respect to the partnership interest held by the API Holder calculated without the application of section 1061; less

(B) To the extent included in the amount determined under paragraph (a)(3)(i)(A) of this section, the aggregate of—

(*1*) Amounts that are not taken into account for purposes of section 1061 under paragraph (b)(7) of this section; and

(*2*) Capital Interest Gains and Losses as determined under § 1.1061–3(c)(2).

(ii) *API Three Year Distributive Share Amount.* The API Three Year Distributive Share Amount equals the API One Year Distributive Share Amount, less—

(A) Items included in the API One Year Distributive Share Amount that would not be treated as a long-term gain or loss if three years is substituted for one year in paragraphs (3) and (4) of section 1222; and

(B) Any adjustments resulting from the application of the Lookthrough Rule under paragraph (b)(9)(ii) of this section when an API is disposed of by an API Holder that is a Passthrough Entity.

(4) *API One Year Disposition Amount and API Three Year Disposition Amount*—(i) *API One Year Disposition Amount.* The API One Year Disposition Amount is the combined net amount of—

(A) Long-term capital gains and losses recognized during the taxable year by an Owner Taxpayer, including long-term capital gain 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 has been held for more than one year, including a disposition to which the Lookthrough Rule applies;

(B) Long-term capital gain and loss recognized by an Owner Taxpayer due to a distribution with respect to an API during the taxable year that is treated under section 731(a) as gain or loss from the sale or exchange of a partnership interest held for more than one year; and,

(C) Long-term capital gains and losses recognized by an Owner Taxpayer on the disposition of Distributed API Property (taking into account deemed exchanges under section 751(b)) 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, excluding items described in paragraph (b)(7) of this section.

(ii) *API Three Year Disposition Amount.* The API Three Year Disposition Amount is the combined net amount of—

(A) Long-term capital gains and losses recognized during the taxable year by an Owner Taxpayer, including long-term capital gain 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 has been held for more than three years and to which the Lookthrough Rule does not apply;

(B) Long-term capital gains and losses 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 in a transaction to which the Lookthrough Rule in paragraph (b)(9) of this section applies, less any adjustments required under the Lookthrough Rule in paragraph (b)(9)(ii) of this section; and

(C) Long-term capital gains and losses recognized on a distribution with respect to an API during the taxable year that is treated under sections 731(a) as gain or loss from the sale or exchange of a partnership interest held for more than three years.

(b) *Special rules for calculating the One Year Gain Amount and the Three Year Gain Amount*—(1) *One Year Gain Amount equals zero or less.* If an Owner Taxpayer's One Year Gain Amount is zero or results in a loss, the Recharacterization Amount for the taxable year is zero and section 1061(a) does not apply.

(2) *Three Year Gain Amount equals zero or less.* If an Owner Taxpayer's Three Year Gain Amount is less than or equal to $0, the Three Year Gain Amount is zero for purposes of calculating the Recharacterization Amount.

(3) *One Year Gain Amount less than Three Year Gain Amount.* If the One Year Gain Amount and the Three Year Gain Amount are both greater than zero but the One Year Gain Amount is less than the Three Year Gain Amount, none of the One Year Gain Amount is included in the Recharacterization Amount for the taxable year.

(4) *Installment sale gain.* The One Year Gain Amount under paragraph (a)(2)(i) of this section and the Three Year Gain Amount, as determined under paragraph (a)(2)(ii) of this section include long-term capital gains from installment sales. This includes long-term capital gain or loss recognized with respect to an API after December 31, 2017, with respect to an installment sale that occurred on or before December 31, 2017. The holding period of the asset upon the date of disposition is used for purposes of determining whether capital gain is included in the taxpayer's One Year Gain Amount or the Three Year Gain Amount.

(5) *Special rules for capital gain dividends from regulated investment companies (RICs) and real estate investment trusts (REITs)*—(i) *API One Year Distributive Share Amount.* If a RIC or REIT reports or designates a dividend as a capital gain dividend and provides the One Year Amounts

Disclosure as defined in § 1.1061–6(c)(1)(i), the amount provided in the One Year Amounts Disclosure is included in the calculation of an API One Year Distributive Share Amount. If the RIC or REIT does not provide the One Year Amounts Disclosure, the full amount of the RIC's or REIT's capital gain dividend must be included in the calculation of an API One Year Distributive Share Amount.

(ii) *API Three Year Distributive Share Amount.* If a RIC or REIT reports or designates a dividend as a capital gain dividend and provides the Three Year Amounts Disclosure as defined in § 1.1061–6(c)(1)(ii), the amount provided in the Three Year Amounts Disclosure is used for the calculation of an API Three Year Distributive Share amount. If the RIC or REIT does not provide the Three Year Amounts Disclosure, no amount of the RIC's or REIT's capital gain dividend may be used for the calculation of an API Three Year Distributive Share Amount.

(iii) *Loss on sale or exchange of stock.* If a RIC or REIT provides the Three Year Amounts Disclosure as provided in paragraph (b)(5)(ii) of this section, any loss on the sale or exchange of 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 amount of the Three Year Amounts Disclosure from that RIC or REIT.

(6) *Pro rata share of qualified electing fund (QEF) net capital gain*—(i) *One year QEF net capital gain.* The calculation of an API One Year Distributive Share Amount includes an Owner Taxpayer's inclusion under section 1293(a)(1)(B) as limited by section 1293(e)(2) with respect to a passive foreign investment company (as defined in section 1297(a)) for which a QEF election (as described in section 1295(a)) is in effect for the taxable year. The amount of the inclusion may be reduced by the amount of long-term capital gain that is not taken into account for purposes of section 1061 as provided in paragraph (b)(7) of this section and may be reduced by the Owner Taxpayer's share of the excess, if any, of the Capital Interest Gain over Capital Interest Loss with respect to the QEF, provided in each case that the relevant information is provided by the QEF. See § 1.1061–6 for reporting rules.

(ii) *Three year QEF net capital gain adjustment.* For purposes of calculating an Owner Taxpayer's API Three Year Distributive Share Amount, the entire amount determined under paragraph (b)(6)(i) of this section, after any allowed reduction, is included as an item in paragraph (a)(3)(ii)(A) of this section unless the QEF provides information to determine the amount of the inclusion that would constitute net capital gain (as defined in § 1.1293–1(a)(2), as limited by section 1293(e)(2)) if the QEF's net capital gain for the taxable year were calculated under section 1222(11) applying paragraphs (3) and (4) of section 1222 by substituting three years for one year. If such information is provided, the amount included as an item in paragraph (a)(3)(ii)(A) of this section is the amount determined under paragraph (b)(6)(i) of this section that would not be treated as long-term gain if three years were substituted for one year in paragraphs (3) and (4) of section 1222. See § 1.1061–6 for reporting rules.

(7) *Items not taken into account for purposes of section 1061.* The following items of long-term capital gain and loss are excluded from the calculation of the API One Year Distributive Share Amount in paragraph (a)(3)(i) of this section and the API Three Year Distributive Share Amount in paragraph (a)(3)(ii) of this section—

(i) Long-term capital gain and long-term capital loss determined under section 1231;

(ii) Long-term capital gain and long-term capital loss determined under section 1256;

(iii) Qualified dividends included in net capital gain for purposes of section 1(h)(11)(B); 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, such as certain capital gains and losses characterized under the mixed straddle rules described in section 1092(b) and §§ 1.1092(b)–3T, 1.1092(b)–4T, and 1.1092(b)–6.

(8) *Holding period determination*—(i) *Determination of holding period for purposes of the Three Year Gain Amount.* For purposes of computing the Three Year Gain Amount, the relevant holding period of either an asset or an API is determined under all provisions of the Code or regulations that are relevant to determining whether the asset or the API has been held for the long-term capital gain holding period by applying those provisions as if the holding period were three years instead of one year.

(ii) *Relevant holding period.* The relevant holding period is the direct owner's holding period in the asset sold. Accordingly, for purposes of determining an API Holder's Taxpayer's API One Year Distributive Share Amount and API Three Year Distributive Share Amount for the taxable year under paragraph (a)(3) of this section, the partnership's holding period in the asset being sold or disposed of (whether a directly held asset or a partnership interest) is the relevant holding period for purposes of section 1061.

(9) *Lookthrough Rule for certain API dispositions*—(i) *Determination that the Lookthrough Rule applies*—(A) *In general.* The Lookthrough Rule will apply if, at the time of disposition of an API held for more than three years—

(*1*) The API would have a holding period of three years or less if the holding period of such API were determined by not including any period before the date that an Unrelated Non-Service Partner is legally obligated to contribute substantial money or property directly or indirectly to the Passthrough Entity to which the API relates. This paragraph (b)(9)(i)(A) does not apply to the disposition of an API to the extent that the gain recognized upon the disposition of the API is attributable to any asset not held for portfolio investment on behalf of third party investors (as defined in section 1061(c)(5)). Solely for the purpose of this paragraph (b)(9)(i)(A), a substantial legal obligation to contribute money or property is an obligation to contribute a value that is at least 5 percent of the partnership's total capital contributions as of the time of the API disposition; or

(*2*) A transaction or series of transactions has taken place with a principal purpose of avoiding potential gain recharacterization under section 1061(a).

(B) *Determination that the Lookthrough Rule applies to the disposition of a Passthrough Interest.* Paragraph (b)(9)(i)(A) of this section similarly applies with respect to a Passthrough Interest issued by an S corporation or a PFIC to the extent the Passthrough Interest is treated as an API.

(ii) *Application of the Lookthrough Rule.* If the Lookthrough Rule applies, for purposes of applying an Owner Taxpayer's Recharacterization Amount, as described in paragraph (a) of this section—

(A) The Owner Taxpayer must include the entire amount of capital gain recognized on the disposition of an API by the Owner Taxpayer in the Owner Taxpayer's API One Year Disposition Amount; and

(B) The Owner Taxpayer must include in its Three Year Disposition Amount an amount equal its One Year Disposition Amount (determined under paragraph (b)(9)(ii)(A) of this section) reduced by the Owner Taxpayer's share of the amount of any gain, directly or indirectly, from assets held for three years or less that would have been allocated to the Owner Taxpayer (to the extent attributable to the transferred API) by the partnership if the partnership had sold all of its property in a fully taxable transaction for cash in an amount equal to the fair market value of such property (taking into account section 7701(g)) immediately prior to the Owner Taxpayer's transfer of the API.

(C) In the case of an API disposition by an API Holder that is a Passthrough Entity and not an Owner Taxpayer, the principles set forth in paragraph (b)(9)(ii)(A) of this section must be applied to determine the amount to include in the Owner Taxpayer's One Year Distributive Amount and in paragraph (b)(9)(ii)(B) of this section to determine the amounts included in the Owner Taxpayer's Three Year Distributive Share Amount.

(10) *Section 83.* Except with respect to any portion of the interest that is a capital interest under § 1.1061–3(c), this section applies regardless of whether an Owner Taxpayer or Passthrough Entity has made an election under section 83(b) or included amounts in gross income under section 83.

(c) *Examples*—(1) *Recharacterization rules.* The rules of paragraph (a) of this section are illustrated by the following examples. Unless otherwise stated, all gains and losses are long-term capital gains and losses, none of the long-term capital gain or loss in this section is capital gain or loss not taken into account for purposes of section 1061 under paragraph (b)(7) of this section, and neither the Lookthrough Rule nor section 751 is applicable.

(i) *Example 1: Determination of API One Year and Three Year Distributive Share Amounts*—(A) *Facts.* A holds an API in PRS but has no capital interest in PRS and is not entitled to a Capital Interest Allocation with respect to PRS. During the taxable year, PRS allocates to A $20 of long-term capital gain from the sale of capital asset X (which had been held by PRS for two years) and $40 of long-term capital gain from the sale of capital asset Y (which had held by PRS for five years). A has no other items of long-term capital gain or loss with respect to its interest in PRS during the taxable year. A has no other long-term capital gains or losses with respect to any other API during the taxable year.

(B) *Determination of A's API One Year Distributive Share Amount.* Under paragraph (a)(3)(i) of this section, A has an API One Year Distributive Share Amount of $60. This amount is the sum of the $20 of the long-term capital gain allocated to A from PRS's sale of capital asset X and the $40 of long-term capital gain allocated to A from PRS's sale of capital asset Y.

(C) *Determination of A's API Three Year Distributive Share Amount.* (*1*) Under paragraph (a)(3)(ii) of this section, A's API Three Year Distributive Share Amount is equal to A's API One Year Distributive Amount, $60, less the sum of:

(*i*) The items included in the API One Year Distributive Share Amount that would not be treated as a long-term gain or loss if three years is substituted for one year in paragraphs (3) and (4) of section 1222, $20; and

(*ii*) Adjustments resulting from the application of the Lookthrough Rule under paragraph (b)(9)(ii) of this section, which under the facts in paragraph (c)(1)(i)(A) of this section, is inapplicable.

(*2*) Thus, A's Three Year API Distributive Share Amount is $40.

(D) *Determination of A's Recharacterization Amount.* Under paragraph (a)(2)(i) of this section, A's One Year Gain amount is equal to A's API One Year Distributive Share Amount, $60. A's Three Year Gain Amount is equal to A's API Three Year Distributive Share Amount, $40. Under paragraph (a)(1) of this section, A's Recharacterization Amount is A's One Year Gain Amount, minus A's Three Year Gain Amount, or $20.

(ii) *Example 2: API One Year and Three Year Disposition Amounts*—(A) *Facts.* During the taxable year, A disposes of an API that A has held for four years for a $100 gain. Additionally, A sells Distributed API Property for a $300 gain at a time when A has a two-year holding period in such property. A has no other items of long-term capital gain or loss with respect to any API in the year.

(B) *Determination of A's API One Year and Three Year Disposition Amounts.* Under paragraph (a)(4)(i) of this section, A's API One Year Disposition Amount is $400. This amount is the sum of A's $300 of long-term capital gain on A's disposition of the Distributed API Property and A's $100 of long-term capital gain on the disposition of the API. Under paragraph (a)(4)(ii) of this section, A's Three Year Disposition Amount is $100, which is the amount of long-term capital gain that A recognized upon disposition of the API held for more than three years. Under paragraph (a)(2) of this section, A's One Year Gain Amount is $400 and A's Three Year Gain Amount is $100.

(C) *Determination of A's Recharacterization Amount.* Under paragraph (a)(1) of this section, A's Recharacterization Amount is $300, which is the difference between A's One Year Gain Amount and Three Year Gain Amount.

(iii) *Example 3: Determination of One Year Gain Amount, Three Year Gain Amount, and Recharacterization Amount*—(A) *Facts.* A holds an API in each of PRS1 and PRS2. With respect to PRS1, A's API One Year Distributive Share Amount is $100 and A's API Three Year Distributive Share Amount is ($200). With respect to PRS2, A's API One Year Distributive Share Amount is $600 and A's API Three Year Distributive Share Amount is $300. During the taxable year, A also has an API One Year Disposition Amount of $200 of gain. A has no other items of long-term capital gain or loss with respect to an API for the taxable year.

(B) *Determination of A's One Year Gain Amount.* Under paragraph (a)(2) of this section, A's One Year Gain Amount is $900, which is an amount equal to A's $100 API One Year Distributive Share Gain from PRS1 and A's $600 API One Year Distributive Share from PRS2 (a combined net API One Year Distributive Share Amount of $700) plus A's $200 API One Year Disposition Amount.

(C) *Determination of A's Three Year Gain Amount.* Under paragraph (a)(2) of this section, A's Three Year Gain Amount is $100, which is equal to A's combined net API Three Year Distributive Share Amount for the taxable year (A's $200 API Three Year Distributive Share Amount loss from PRS1 plus A's API Three Year Distributive Share Amount Gain of $300 from PRS2). A does not have an API Three Year Disposition Amount.

(D) *Determination of A's Recharacterization Amount.* Under paragraph (a)(1) of this section, A's Recharacterization Amount is $800. (A's One Year Gain Amount of $900 less A's Three Year Gain Amount of $100.)

(2) *Special rules examples.* The principles of paragraph (b) of this section are illustrated by the following examples.

(i) *Example 1: Lookthrough Rule.* On July 1, 2021, A and B form partnership PRS. At the time of PRS's formation, A agrees to provide substantial services to PRS in exchange for a 20% profits interest in PRS, and B, a partner that is an Unrelated Non-Service Partner, contributes $1 million in exchange for an interest in PRS and PRS immediately uses the capital to purchase marketable securities. On July 1, 2023, C, another Unrelated Non-Service Partner becomes legally obligated to contribute capital to PRS ($75 million) for the purposes of investing in and developing Specified Assets and is admitted into PRS. On July 3, 2023, and after C makes a contribution of $75 million, PRS uses this capital to acquire stock in portfolio company Z. On July 1, 2025, when Z has a value of $500 million and the value of the marketable securities is $2 million, A sells its API in PRS for $85.2 million. As a result of this sale, the Lookthrough Rule applies because B's contribution was non-substantial under paragraph (b)(9)(i)(A)(*1*) of this section. Therefore, A includes $85.2 million in its API One Year Disposition Amount and under paragraph (b)(9)(ii)(B) of this section, $200,000 (20% share of $1 million gain in marketable securities) in its API Three Year Disposition Amount. Accordingly, under paragraph (a)(1) of this section, A's Recharacterization Amount is $85 million.

(ii) *Example 2: Installment sale gain.* On December 22, 2021, A disposed of A's API in an installment sale. At the time of the disposition, A had held its API for two years. A received a payment with respect to the installment sale during A's 2022 taxable year causing A to recognize $200 of long-term capital gain. The $200 long-term capital gain recognized in 2022 is subject to section 1061 because it is recognized after December 31, 2017. Accordingly, the $200 of long-term capital gain recognized by A in 2022 is included in A's API One Year Disposition Amount. The $200 of long-term capital gain is not in A's API Three Year Disposition Amount because the API was not held for more than three years at the time of its disposition.

(iii) *Example 3: REIT capital gain dividend.* During the taxable year, A holds an API in PRS. PRS holds an interest in REIT. During the taxable year, REIT distributes a $1,000 capital gain dividend to PRS of which 50% is allocable to A's API. Part of the capital gain dividend for the year results from section 1231 gain. In accordance with § 1.1061–6(c)(1)(i), REIT discloses to PRS the One Year Amounts Disclosure of $400, which is the $1000 capital gain dividend reduced by the $600 of section 1231 capital gain dividend included in that amount. Part of the One Year Amounts Disclosure for the year results from gain from property held for three years or less. In accordance with § 1.1061–6(c)(1)(ii), REIT also discloses the Three Year Amounts Disclosure of $150, which is the $400 One Year Amounts Disclosure reduced by the $250 of gain attributable to property held for three years or less. PRS includes a $200 gain in determining A's API One Year Distributive Share Amount and a $75 gain in determining A's API Three Year Distributive Share Amount. See paragraphs (b)(5)(i) and (ii) of this section.

(d) *Applicability date.* The provisions of this section apply to taxable years of Owner Taxpayers and Passthrough Entities beginning on or after January 19, 2021. An Owner Taxpayer or Passthrough Entity may choose to apply this section to a taxable year beginning after December 31, 2017, provided that they apply the Section 1061 Regulations in their entirety to that year and all subsequent years.

§ 1.1061–5 Section 1061(d) transfers to related persons.

(a) *In general.* If an Owner Taxpayer transfers any API or Distributed API Property, directly or indirectly, to a Section 1061(d) Related Person (as defined in paragraph (e) of this section), the Owner Taxpayer must include in gross income as short-term capital gain, an amount equal to—

(1) The short-term capital gain recognized upon the API transfer without regard to this paragraph (a); and

(2) The lesser of—

(i) The amount of net long-term capital gain recognized by the Owner Taxpayer upon the transfer of such interest; or

(ii) The amount treated as short-term capital gain under paragraph (c) of this section (Section 1061(d) Recharacterization Amount).

(b) *Transfer.* For purposes of this section, the term *transfer* means a sale or exchange in which gain is recognized by the Owner Taxpayer under chapter 1 of the Internal Revenue Code.

(c) *Section 1061(d) Recharacterization Amount.* To the extent an Owner Taxpayer recognizes long-term capital gain upon a transfer of an API to a Section 1061(d) Related Person, the Owner Taxpayer's Section 1061(d) Recharacterization Amount is the amount of net long-term capital gain (excluding amounts not taken into account for purposes of section 1061 under § 1.1061–4(b)(7)) from assets held for three years or less that would have been allocated to the Owner Taxpayer (to the extent attributable to the transferred API) by the partnership if the partnership had sold all of its property in a fully taxable transaction for cash in an amount equal to the fair market value of such property (taking into account section 7701(g)) immediately prior to the Owner Taxpayer's transfer of the API. If only a portion of an Owner Taxpayer's API is transferred, this paragraph (c) shall apply with respect to the portion of gain attributable to the transferred interest.

(d) *Special rules.* For purposes of this section, the following rules are applicable.

(1) An Owner Taxpayer will be treated as transferring the Owner Taxpayer's share of any Indirect API or Distributed API Property if the Indirect API or Distributed API Property is transferred by the API Holder to a person that is a Section 1061(d) Related Person with respect to the Owner Taxpayer.

(2) The rules set forth in paragraphs (a), (b), and (c) of this section apply upon the transfer of a Passthrough Interest issued by an S corporation or PFIC to the extent the Passthrough Interest is treated as an API.

(e) *Section 1061(d) Related Person.* For purposes of this section, the term Section 1061(d) Related Person means—

(1) A person that is a member of the taxpayer's family within the meaning of section 318(a)(1);

(2) A person that performed a service within the current calendar year or the preceding three calendar years in a Relevant ATB to the API transferred by taxpayer; or

(3) A Passthrough Entity to the extent that a person described in paragraph (e)(1) or (2) of this section owns an interest, directly or indirectly.

(f) *Examples.* The following examples illustrate the rules of this section.

(1) *Example 1: Transfer to child by gift.* A, an individual, performs services in an ATB and has held an API in connection with those services for 10 years. The API has a fair market value of $1,000 and a tax basis of $0, and no debt is associated with the API. A transfers all of the API to A's daughter as a gift. A's daughter is a section 1061(d) Related Person but A's gift is not a transfer as described in paragraph (b) of this section thus section 1061(d) does not apply to A's gift. However, the API remains an API in the hands of A's daughter under § 1.1061–2(a)(1)(i).

(2) *Example 2: Transfer of an API to a partnership owned by Section 1061(d) Related Persons*—(i) *Facts.* A, B, and C are equal partners in GP, a partnership. GP holds only one asset, an API in PRS1 which is an Indirect API as to each A, B, and C. A, B, and C each provides services in the ATB in connection with which GP was transferred its API in PRS1. A and B contribute their interests in GP to PRS2 in a Section 721(a) exchange for interests in PRS2.

(ii) *Application of section 1061(d*). Because the contribution by A and B of their interest in GP to PRS2 is an exchange in which no gain is recognized by either A or B, the contribution is not a transfer as described in paragraph (b) of this section thus section 1061(d) does not apply to A and B's contribution. However, the API remains an API in the hands of PRS2 under § 1.1061–2(a)(1)(i).

(3) *Example 3: Transfer of an API to a Section 1061(d) Related Person.* A holds an API in GP, a partnership which A has owned for four years. A transfers the API to a Section 1061(d) Related Person described in paragraph (e) of this section in exchange for $100 of cash, resulting in A recognizing long-term capital gain of $100. Because this is a transfer described in paragraph (b) of this section, section 1061(d) applies to the transfer of A's API and A must determine its Section 1061(d) Recharacterization Amount under paragraph (c) of this section. If, immediately prior to A's transfer of the API, the partnership had sold all of its assets in a fully taxable transaction for cash equal of the fair market value of the assets, A's share of the net long-term capital gain (excluding amounts not taken into account for purposes of section 1061 under § 1.1061–4(b)(7)) from assets held for three years or less would have been $120. Thus, A's Section 1061(d) Recharacterization Amount is $120. As a result, A's $100 long-term capital gain is recharacterized as short-term capital gain under paragraph (a) of this section. The API remains an API in the hands of the Section 1061(d) Related Person under § 1.1061–2(a)(1)(i).

(g) *Applicability date.* The provisions of this section apply to taxable years of Owner Taxpayers and Passthrough Entities beginning on or after January 19, 2021. An Owner Taxpayer or Passthrough Entity may choose to apply this section to a taxable year beginning after December 31, 2017, provided that they apply the Section 1061 Regulations in their entirety to that year and all subsequent years.

§ 1.1061–6 Reporting rules.

(a) *Owner Taxpayer filing requirements*–(1) *In general.* An Owner Taxpayer must file such information with the IRS as the Commissioner of Internal Revenue or the Commissioner's delegate (Commissioner) may require in forms, instructions, or other guidance as is necessary for the Commissioner to determine that the Owner Taxpayer has properly complied with section 1061 and the Section 1061 Regulations. If an Owner Taxpayer requires information from a Passthrough Entity to determine the Capital Interest Disposition Amount or the Section 1061(d) Recharacterization Amount, the Owner Taxpayer must request such information from that entity.

(2) *Failure to obtain information.* Paragraph (b)(1) of this section requires certain Passthrough Entities to furnish an Owner Taxpayer with certain amounts necessary to determine its Recharacterization Amount and meet its reporting requirements under paragraph (a)(1) of this section. To the extent that an Owner Taxpayer is not furnished the information required to be furnished under paragraph (b)(1) of this section in such time and in such manner as required by the Commissioner and the Owner Taxpayer is not otherwise able to substantiate all or a part of these amounts to the satisfaction of the Commissioner, then if the information with respect to the determination of the—

(i) API One Year Distributive Share Amount under § 1.1061–4(a)(3)(i) is not furnished, the API One Year Distributive Share Amount will not be reduced by—

(A) Amounts not taken into account for purposes of section 1061 under § 1.1061–4(b)(7); or

(B) Capital Interest Gains and Losses as determined under § 1.1061–3(c)(2).

(ii) API Three Year Distributive Share Amount determined under § 1.1061–4(a)(3)(ii) is not furnished, all items included in the API One Year Distributive Share Amount are treated as items that would not be treated as long-term capital gain or loss, if three years is substituted for one year in paragraphs (3) and (4) of section 1222.

(b) *Passthrough Entity filing requirements and reporting*—(1) *Requirement to file information with the IRS and to furnish information to API Holder.* A Passthrough Entity must file such information with the IRS as the Commissioner may require in forms, instructions, or other guidance as is necessary for the Commissioner to determine that it and its partners have complied with section 1061 and the Section 1061 Regulations. A Passthrough Entity that has issued an API must furnish to the API Holder, including an Owner Taxpayer, such information at such time and in such manner as the Commissioner may require in forms, instructions, or other guidance as is necessary to determine the One Year Gain Amount and the Three Year Gain Amount with respect to an Owner Taxpayer that directly or indirectly holds the API. A Passthrough Entity that has furnished information to the API Holder must file such information with the IRS, at such time and in such manner as the Commissioner may require in forms, instructions, or other guidance. This information includes:

(i) The API One Year Distributive Share Amount and the API Three Year Distributive Share Amount (as determined under § 1.1061–4);

(ii) Capital gains and losses allocated to the API Holder that are excluded from section 1061 under § 1.1061–4(b)(7);

(iii) Capital Interest Gains and Losses allocated to the API Holder (as determined under § 1.1061–3(c)); and

(iv) In the case of a disposition by an API Holder of an interest in the Passthrough Entity during the taxable year, upon the request of an API Holder, any information required by the API Holder to properly take the disposition into account under section 1061, including—

(A) Information necessary to apply the Lookthrough Rule and to determine the API Holder's Capital Interest Disposition Amount; and

(B) Information necessary to determine an Owner Taxpayer's Section 1061(d) Recharacterization Amount.

(2) *Requirement to request, furnish, and file information in tiered structures*—(i) *Requirement to request information.* If a Passthrough Entity requires information to meet its reporting and filing requirements under this section (in addition to any information required to be furnished to the Passthrough Entity under paragraph (b)(1) of this section) from a lower-tier entity in which it holds an interest, the Passthrough Entity must request such information from that entity.

(ii) *Requirement to furnish and file information.* If information is requested of a Passthrough Entity under paragraph (b)(2)(i) of this section, the Passthrough Entity must furnish the requested information to the person making the request but only to the extent the information is necessary for the requesting Passthrough Entity to meet its reporting and filing requirements under this section or is required by the Commissioner in forms, instructions, or other guidance. If the person requesting the information is an API Holder in the Passthrough Entity, the information is furnished under paragraph (b)(1) of this section. If the Passthrough Entity requesting the information is not an API Holder, the Passthrough Entity must furnish the information to the requesting Passthrough Entity as required by the Commissioner in forms, instructions, or other guidance.

(iii) *Timing of requesting and furnishing information*—(A) *Requesting information.* A Passthrough Entity described in paragraph (b)(2)(i) of this section must request information under paragraph (b)(2)(i) of this section by the later of the 30th day after the close of the taxable year to which the information request relates or 14 days after the date of a request for information from an upper-tier Passthrough Entity.

(B) *Furnishing information*—(*1*) *In general.* Except as provided in paragraph (b)(2)(iii)(B)(*2*) of this section, requested information must be furnished by the date on which the entity is required to furnish information under section 6031(b) or under section 6037(b), as applicable.

(*2*) *Late requests.* Information with respect to a taxable year that is requested by an upper-tier Passthrough Entity after the date that is 14 days prior to the due date for a lower-tier Passthrough Entity to furnish and file information under section 6031(b) or section 6037(b), as applicable, must be furnished and filed in the time and manner prescribed by forms, instructions and other guidance.

(iv) *Manner of requesting information.* Information may be requested electronically or in any manner that is agreed to by the parties.

(v) *Recordkeeping requirement.* Any Passthrough Entity receiving a request for information must retain a copy of the request and the date received in its books and records.

(vi) *Passthrough Entity is not furnished information to meet its reporting obligations under paragraph (b)(1) of this section.* If an upper-tier Passthrough Entity holds an interest in a lower-tier Passthrough Entity and it is not furnished the information described in paragraph (b)(1) of this section, or, alternatively, if it has not been furnished information after having properly requested the information under this paragraph (b)(2), the upper-tier Passthrough Entity must take actions to otherwise determine and substantiate the missing information. To the extent that the upper-tier Passthrough Entity is not able to otherwise substantiate and determine the missing information to the satisfaction of the Commissioner, the upper-tier Passthrough Entity must treat these amounts as provided under paragraph (a)(2) of this section. The upper-tier Passthrough Entity must provide notice to the API Holder and the IRS regarding the application of this paragraph (b)(2) to the information being reported as required in forms, instructions, and other guidance.

(vii) *Filing requirements.* Both the Passthrough Entity requesting the information and the Passthrough Entity furnishing the information must file all information with the IRS as the Commissioner may require in forms, instructions, or other guidance.

(viii) *Penalties.* In addition to the requirement in section 1061(e) that the Secretary shall require reporting (at the time and in the manner prescribed by the Secretary) as is necessary to carry out the purposes of this section, the information required to be furnished under this paragraph (b) is also required to be furnished under sections 6031(b) and 6037(b). Failure to report as required under this paragraph (b) will be subject to penalties under section 6722.

(c) *Regulated investment company (RIC) and real estate investment trust (REIT) reporting*—(1) *Section 1061 disclosures.* A RIC or REIT that reports or designates a dividend, or part thereof, as a capital gain dividend, may, in addition to the information otherwise required to be furnished to a shareholder, disclose two amounts for purposes of section 1061—

(i) *One Year Amounts Disclosure.* The *One Year Amounts Disclosure* of a RIC or REIT is a disclosure by the RIC or REIT of an amount that is attributable to a computation of the RIC's or REIT's net capital gain excluding capital gain and capital loss not taken into account for purposes of section 1061 under § 1.1061–4(b)(7). The aggregate amounts provided in the One Year Amounts Disclosures with respect to a taxable year of a RIC or REIT must equal the lesser of the RIC's or REIT's net capital gain, excluding any capital gains and capital losses not taken into account for purposes of section 1061 under § 1.1061–4(b)(7), for the taxable year or the RIC's or REIT's aggregate capital gain dividends for the taxable year.

(ii) *Three Year Amounts Disclosure.* The *Three Year Amounts Disclosure* of a RIC or REIT is a disclosure by the RIC or REIT of an amount that is attributable to a computation of the RIC's or REIT's One Year Amounts Disclosure substituting ''three years'' for ''one year'' in applying section 1222. The aggregate amounts provided in the Three Year Amounts Disclosures with respect to a taxable year of a RIC or REIT must equal the lesser of the aggregate amounts provided in the RIC's or REIT's One Year Amounts Disclosures substituting ''three years'' for ''one year'' in applying section 1222 for the taxable year or the RIC's or REIT's aggregate capital gain dividends for the taxable year.

(2) *Pro rata disclosures.* The One Year Amounts Disclosure and Three Year Amounts Disclosure made 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.

(3) *Report to shareholders.* A RIC or REIT that provides the section 1061 disclosures described in paragraphs (c)(1)(i) and (ii) of this section must provide those section 1061 disclosures in writing to its shareholders with the statement described in section 852(b)(3)(C)(i) or the notice described in section 857(b)(3)(B) in which the capital gain dividend is reported or designated.

(d) *Qualified electing fund (QEF) reporting.* A passive foreign investment company with respect to which the shareholder has a QEF election (as described in section 1295(a)) in effect for the taxable year that determines net capital gain as provided in § 1.1293–1(a)(2)(i)(A), as limited by section 1293(e)(2), may provide some or all of the information listed in paragraph (b)(1) of this section (and any other relevant information) to its shareholders to enable API Holders to determine the amount of their inclusion under section 1293(a)(1) that would be included in the API One Year Distributive Share Amounts and API Three Year Distributive Share Amounts. To the extent that such information is not provided, paragraph (a)(2) of this section will apply except that Owner Taxpayers are not permitted to separately substantiate the information. An API Holder who receives the additional information described in this paragraph (d) must retain such information as required by § 1.1295–1(f)(2)(ii).

(e) *Applicability date.* The provisions of this section apply to taxable years of Owner Taxpayers and Passthrough Entities beginning on or after January 19, 2021. An Owner Taxpayer or Passthrough Entity may choose to apply this section to a taxable year beginning after December 31, 2017, provided that they apply the Section 1061 Regulations in their entirety to that year and all subsequent years.

■ **Par. 5.** Section 1.1223–3 is amended by:

■ 1. Redesignating paragraph (b)(5) as paragraph (b)(6);

■ 2. Adding a new paragraph (b)(5);

■ 3. Designating *Examples 1* through *8* of paragraph (f) as paragraphs (f)(1) through (8);

■ 4. Adding paragraphs (f)(9) and (10); and

■ 5. Revising the heading and adding a sentence at the end of paragraph (g).

The additions and revision read as follows:

§ 1.1223–3 Rules relating to the holding periods of partnership interests.

* * * * *

(b) * * *

(5) *Divided holding period if partnership interest comprises in whole or in part one or more profits interests*—(i) *In general.* If a partnership interest is comprised in whole or in part of one or more profits interests (as defined in paragraph (b)(5)(ii) of this section), then, for purposes of applying paragraph

(b)(1) of this section, the portion of the holding period to which a profits interest relates is determined based on the fair market value of the profits interest upon the disposition of all, or part, of the interest (and not at the time that the profits interest is acquired). Paragraph (b)(1) of this section continues to apply to the extent that a partner acquires portions of a partnership interest that are not comprised of a profits interest and the value of the profits interest is not included for purposes of determining the value of the entire partnership interest under paragraph (b)(1).

(ii) *Definition of capital interest and profits interest.* For purposes of this paragraph (b)(5), a profits interest is a partnership interest other than a capital interest. A capital interest is an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value at the time the interest was received and then the proceeds were distributed in a complete liquidation of the partnership. A profits interest, for purposes of this paragraph (b)(5), is received in connection with the performance of services to or for the benefit of a partnership in a partner capacity or in anticipation of being a partner, and the receipt of the interest is not treated as a taxable event for the partner or the partnership under applicable Federal income tax guidance.

* * * * *

(f) * * *

(9) *Example 9.* On June 1, 2020, GP contributes $10,000 to PRS for a partnership interest in PRS. On June 30, 2023, GP receives a 20% interest in the profits of PRS that is an Applicable Partnership Interest (API) as defined in § 1.1061–1(a). On June 30, 2025, GP sells its interest in PRS for $30,000. At the time of GP's sale of its interest, the API has a fair market value of $15,000. GP has a divided holding period in its interest in PRS; 50% of the partnership interest has a holding period beginning on June 1, 2020, and 50% has a holding period that begins on June 30, 2023.

(10) *Example 10.* Assume the same facts as in paragraph (f)(9) of this section (*Example 9*), except that on June 30, 2024, GP contributes an additional $5,000 cash to GP prior to GP's sale of its interest in 2025. Immediately after the contribution of the $5,000 on June 30, 2024, GP's interest in PRS has a value of $15,000, not taking into account the value of GP's profits interest in PRS. GP calculates its holding period in the portions not comprised by the profits interest and two-thirds of its holding period runs from June 30, 2020, and one-third runs from June 30, 2024. On June 30, 2025, GP sells its interest for $30,000 and the API has a fair market value of $15,000. Accordingly, on the date of disposition, one-third of GP's interest has a five year holding period from its interest received in 2020 for its $10,000 contribution, one-half of GP's interest has a two year holding period from the profits interest issued on June 30, 2023, and one-sixth of GP's interest has a one year holding period from the contribution of the $5,000.

(g) *Applicability dates.* * * * Paragraphs (b)(5) and (f)(9) and (10) of this section apply to taxable years beginning on or after January 19, 2021.

Sunita Lough,

Deputy Commissioner for Services and Enforcement.

Approved: January 5, 2021.

David J. Kautter,

Assistant Secretary of the Treasury (Tax Policy).

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