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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-107213-18]

RIN 1545-BO81

Guidance under Section 1061; Notice of Proposed Rulemaking

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed 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 proposed

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 in which the applicable partnership interest is held, directly or indirectly.

DATES: Written or electronic comments and requests for a public hearing must be received by **[INSERT DATE 60 DAYS AFTER DATE OF FILING FOR PUBLIC INSPECTION WITH THE OFFICE OF THE FEDERAL REGISTER]**, which is 60 days after the date of filing for public inspection with the Office of the Federal Register.

Requests for a public hearing must be submitted as prescribed in the **"Comments and Requests for a Public Hearing"** section.

ADDRESSES: Commenters are strongly encouraged to submit public comments electronically. Submit electronic submissions via the Federal eRulemaking Portal at www.regulations.gov (indicate IRS and REG-107213-18) by following the online instructions for submitting comments. Once submitted to the Federal eRulemaking Portal, comments cannot be edited or withdrawn. The IRS expects to have limited personnel available to process public comments that are submitted on paper through mail. Until further notice, any comments submitted on paper will be considered to the extent practicable. The Department of the Treasury (Treasury Department) and the IRS will publish for public availability any comment submitted electronically, and to the extent practicable on paper, to its public docket. Send paper submissions to:

CC:PA:LPD:PR (REG-107213-18), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, D.C. 20044.

FOR FURTHER INFORMATION CONTACT: Concerning submissions of comments and/or requests for a public hearing, Regina L. Johnson at (202) 317-5177 (not a toll-free number); Email address: fdms.database@irsounsel.treas.gov; concerning the proposed regulations, Kara K. Altman or Sonia K. Kothari at (202) 317-6850 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background and Overview

This document contains proposed 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 the enactment of 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. This Background and Overview section provides an overview of the statutory provisions and highlights certain critical concepts and terms used in the proposed regulations. The Explanation of Provisions section describes the proposed regulations in greater detail.

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

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. These proposed regulations refer to this difference as the Recharacterization Amount.

The proposed 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). The proposed regulations provide a framework for determining the Recharacterization Amount when an API is held through one or more tiers of Passthrough Entities (tiered structure).

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 proposed 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 proposed regulations refer to long-term capital gains and losses recognized with respect to an API as API Gains and Losses.

Unrealized API Gains and Losses are capital gains and losses with respect to an API that have not yet been realized. In a tiered structure of Passthrough Entities, 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.

The proposed regulations provide that 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). Additionally, API Gains and Losses do not include API Holder Transition Amounts and Capital Interest Gains and Losses. API Holder Transition Amounts are allocations to the holder of an API (API Holder) of long-term capital gain and loss recognized on the disposition of assets held by the partnership for more than three years as of January 1, 2018, if the partnership has elected to treat these amounts as API Holder Transition Amounts. Capital Interest Gains and Losses are long-term capital gains and losses with respect to an API Holder's capital investment in a Passthrough Entity.

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 applicable trade or business (ATB).

An API is an interest in a partnership's profits that is transferred or held in connection with the performance of services. There may be one or more tiers of 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 proposed regulations, that is, each Passthrough Entity is an API Holder. An API Holder may be an individual, 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 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). However, section 1061(c)(1) requires that an API be transferred to a taxpayer in connection with services performed by the taxpayer or by a related person. The proposed regulations provide that the reference to “taxpayer” in section 1061(c)(1) includes not only an Owner Taxpayer, but also includes a Passthrough Taxpayer. The proposed regulations provide that 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 the Passthrough Entity 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 the Passthrough Entity 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 is transferred in connection with the performance of substantial services. The proposed regulations presume that services are substantial with respect to the partnership interest transferred in connection with

those services. This presumption is based on the assumption that the parties have economically equated the services performed with the potential value of the partnership interest transferred. The proposed regulations provide that once a partnership interest is an API, it remains an API and never loses that character, unless one of the exceptions to the definition of an API applies.

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 services in an ATB. An ATB is defined in section 1061(c)(2) as 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. The proposed regulations refer to these actions, respectively, as Raising or Returning Capital Actions and Investing or Developing Actions (referred to as Specified Actions in the aggregate). The proposed 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 proposed regulations provide that, in some cases, it is not necessary for both Raising or Returning Capital Actions and Investing or Developing Actions to occur in a single year for an ATB to exist in that year. Further,

Raising or Returning Capital Actions and Investing or Developing Actions of related persons are aggregated 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 proposed 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.

Section 1061(c)(4): Exceptions

Section 1061(c)(4)(A) provides that an API does not include any interest in a partnership directly or indirectly held by a corporation. In Notice 2018-18 (2018-12 IRB 443, March 19, 2018), the Treasury Department and the IRS provided notice that the regulations under section 1061 would provide that the term "corporation" for purposes of section 1061(c)(4)(A) does not include an S corporation. Any timely comments received on Notice 2018-18 will be considered as part of the Treasury decision adopting these proposed regulations as final regulations.

Section 1061(c)(4)(B) also provides that an API does not include certain capital interests. The proposed regulations implement the capital interest exception by excepting long-term capital gains and losses that represent a return on an API Holder's invested capital in a Passthrough Entity from recharacterization under section 1061.

The proposed regulations refer to these amounts as Capital Interest Gains and Losses. Specifically, under the proposed regulations, Capital Interest Allocations, Passthrough Interest Capital Allocations and Capital Interest Disposition Amounts are treated as Capital Interest Gains and Losses.

Under the proposed regulations, a partner's invested capital in a partnership that maintains capital accounts under §1.704-1(b)(2)(iv) is the 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 in a manner similar to that provided in §1.704-1(b)(2)(iv), those accounts will be treated as capital accounts for purposes of the proposed regulations. In order for an allocation to be treated as a Capital Interest Allocation or a Passthrough Interest Capital Allocation, the allocation must be based on an API Holder's relative capital account balance in the Passthrough Entity. Although Unrealized API Gain or Loss is included in an owner's capital account, the gain or loss will be treated as API Gain or Loss and not as Capital Interest Gain or Loss when recognized. An allocation of API Gain or Loss from a lower-tier entity to an upper-tier entity is always API Gain or Loss when further allocated by the upper-tier entity to its direct interest holders. Capital Interest Gains and Losses never include API Gains and Losses, Unrealized API Gains and Losses, or API Holder Transition Amounts.

If an owner disposes of an interest that is composed of a capital interest and an API, the proposed regulations provide 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.

Other Exceptions

Section 1061(c)(1) provides an exception for certain partnership interests held by employees of entities that are not engaged in an ATB. The proposed regulations track the statutory language. Also, the proposed regulations add an exception for an API that is acquired by a bona fide purchaser who (i) does not provide services, (ii) is unrelated to any service provider, and (iii) acquired the interest for fair market value.

Section 1061(b) provides regulatory authority to establish an exception to section 1061(a) for gain attributable to any assets not held for portfolio investment on behalf of third party investors. The proposed regulations reserve on the exercise of this authority.

Section 1061(d): Transfer of API to a Related Party

Section 1061(d) accelerates the recognition of capital gain on a direct or indirect transfer that would not otherwise be a taxable event and recharacterizes certain long-term capital gain as short-term capital gain. Under section 1061(d), if a taxpayer transfers an API to a related person described in section 1061(d)(2), then, without regard to whether the transfer is otherwise a taxable event, the taxpayer includes in gross income, as short-term capital gain, the excess of (A) the net built-in long-term capital gain in assets attributable to the transferred interest with a holding period of three years or less, over (B) the amount of long-term capital gain treated as short term capital gain under section 1061(a) on the transfer. The proposed regulations provide that the term transfer includes, but is not limited to, contributions, distributions, sales and exchanges, and gifts. A related person for purposes of section 1061(d)(2) 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 proposed regulations, a Passthrough Entity to the extent that a member of the taxpayer's family or a colleague is an owner. The proposed regulations provide that a contribution under section 721(a) to a partnership is not treated as a transfer to a Section 1061(d) Related Person because the proposed regulations require that, under the principles of section 704(c) and §§1.704-1(b)(2)(iv)(f) and 1.704-3(a)(9), all Unrealized API Gains at the time of contribution must be allocated to the API Holder contributing the interest when those gains are recognized by the partnership.

Section 1061(e): Reporting

Section 1061(e) provides that the Secretary of the Treasury or his delegate (Secretary) shall require such reporting as is necessary to carry out the purposes of section 1061. The proposed regulations include rules for providing information required to compute the Recharacterization Amount when there is a tiered structure.

Regulatory Authority

The statute requires that the Secretary 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.

Explanation of Provisions

Section 1.1061-1 provides definitions of the terms used in §§1.1061-1 through 1.1061-6 of these proposed regulations. Section 1.1061-2 provides rules and examples regarding APIs and ATBs. Section 1.1061-3 provides guidance on the exceptions to an API, including the capital interest exception. Section 1.1061-4 provides guidance on the computation of the Recharacterization Amount and 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, these proposed 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 proposed.

I. Sections 1.1061-1 and 1.1061-2: Definitions, Operational Rules, and Examples

Section 1.1061-1 provides definitions of terms used in §§1.1061-1 through 1.1061-6 of these proposed regulations. The definitions in §1.1061-1 combined with the operational rules in §1.1061-2 identify the taxpayer to which section 1061 applies, when an interest is an API, what constitutes an ATB, and who is a related party. These definitions include terms for identifying interests when an API is held through one or more passthrough entities. For purposes of these regulations, a Passthrough Entity is defined as a partnership, an S corporation, or a PFIC with respect to which the shareholder has a QEF election in effect.

A. API, Owner Taxpayer, Passthrough Taxpayer, Indirect API, and Passthrough Interest

1. Definitions

Section 1061(a) refers to a taxpayer in terms of the person whose net long-term capital gains from one or more APIs are recharacterized as net short-term capital gain under the statute. The proposed regulations refer to this amount as the Recharacterization Amount. Section 1061(c) also refers to a taxpayer as the person to whom the API is transferred or who holds the API in connection with the taxpayer's or a related person's services.

Section 1061(c)(1) defines an API as any interest in a partnership which, directly or indirectly, is transferred to (or held by) the taxpayer in connection with the performance of substantial services by the taxpayer, or by any other related person, in any ATB. These proposed regulations also provide that solely for purposes of section 1061, an interest in a partnership 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. API, Owner Taxpayer, and Passthrough Taxpayer

Comments and other commentary (collectively referred to as comments) considered by the Treasury Department and the IRS highlight the importance of the definition of the term "taxpayer" for purposes of section 1061(a) with respect to the determination of the Recharacterization Amount. Additionally, the definition of the term "taxpayer" for purposes of section 1061(c) is important for the determination of whether a partnership interest is an API. These comments describe three potential approaches to the definition of "taxpayer." These approaches are the aggregate approach, the

partial entity approach, and the full entity approach. Under the aggregate approach, both the existence of the API and the Recharacterization Amount are determined solely at the owner level. If the Recharacterization Amount is calculated at the owner level, gains and losses from multiple APIs held by the owner can be combined and netted with each other to determine the Recharacterization Amount. In contrast, under the full entity approach, the Recharacterization Amount and the existence of an API both are determined at the entity level. Additionally, under the full entity approach, the Recharacterization Amount would be calculated for each entity and then netted and combined at the owner level. Under the partial entity approach, the existence of an API is determined at the entity level, but the Recharacterization Amount is determined at the owner level.

The proposed regulations adopt a partial entity approach. To apply this approach, the proposed regulations provide for two definitions of a taxpayer (Owner Taxpayer and Passthrough Taxpayer) for purposes of section 1061. These definitions are provided to define the scope of the term “taxpayer” for purposes of computing the Recharacterization Amount and for purposes of determining whether a partnership interest is an API. The proposed regulations define the term Owner Taxpayer as the person subject to tax on the net gain with respect to the API. Under the proposed regulations, the Recharacterization Amount is determined solely by the Owner Taxpayer. For this purpose, the term Owner Taxpayer includes individuals, simple and complex trusts, and estates. Thus, if an Owner Taxpayer holds one or more APIs indirectly (through one or more Passthrough Entities), amounts subject to section 1061

flow through those entities and are netted at the Owner Taxpayer level to determine the Recharacterization Amount.

The proposed regulations define the term Passthrough Taxpayer as an entity that generally does not pay tax itself, notwithstanding that a Passthrough Taxpayer could be responsible for paying an imputed underpayment calculated based on adjustments to partnership related items under section 6225 (Partnership adjustment by the Secretary) or that a Passthrough Taxpayer that is an electing 1987 partnership (as defined in section 7704(g)(2)) could be responsible for paying the tax set forth in section 7704(g)(3). An Owner Taxpayer and a Passthrough Taxpayer each are treated as a taxpayer for the purpose of determining whether an API exists. In determining whether the elements of an API are present, a Passthrough Taxpayer can be (i) the service provider, (ii) a person related to the service provider, (iii) engaged in an ATB, or (iv) the recipient of an interest in connection with the performance of substantial services in an ATB. If a Passthrough Taxpayer is treated as the recipient (or holder) of a partnership interest, directly or indirectly, for purposes of determining the existence of an API, the ultimate owners of the Passthrough Taxpayer are treated as Owner Taxpayers for the purpose of determining the Recharacterization Amount. Owner Taxpayers do not include owners of a Passthrough Taxpayer who are excepted from the application of section 1061 under §1.1061-3. Additionally, Owner Taxpayers to whom a partnership interest is directly or indirectly transferred in connection with the Owner Taxpayer's or a related party's performance of substantial services in an ATB are also treated as taxpayers for purposes of determining the existence of an API. Section 1.1061-2 of the proposed regulations provides examples of how the existence of an API is determined.

b. Interaction with Revenue Procedures 93-27 and 2001-43

Revenue Procedure 93-27 (1993-2 C.B. 343) defines a profits interest and provides a safe harbor under which the IRS will not treat the receipt of a profits interest as a taxable event for the partner or the partnership if certain requirements are met.

See also Revenue Procedure 2001-43 (2001-2 C.B. 191). Section 1061 applies to all partnership interests that meet the definition of an API, regardless of whether the receipt of the interest is treated as a taxable event under Revenue Procedure 93-27.

Accordingly, taxpayers should not equate an interest that meets the definition of an API with an interest the receipt of which would not be treated as a taxable event under Revenue Procedure 93-27. For example, Revenue Procedure 93-27 applies to a person who receives a profits interest for the provision of services to or for the benefit of a partnership in a partner capacity or in anticipation of being a partner. Section 1061 applies to partnership interests transferred or held in connection with the performance of substantial services in an ATB. Further, these proposed regulations address only the application of section 1061 and should not be interpreted as providing guidance regarding the application of Revenue Procedure 93-27 to transactions in which one party provides services and another party receives a seemingly associated allocation and distribution of partnership income and gain. Lastly, although a financial instrument or contract may be treated as an API under section 1061, a financial instrument or contract is not an interest in a partnership for purposes of Revenue Procedure 93-27, unless it is otherwise a partnership interest for Federal tax purposes. The Treasury Department and the IRS note that arrangements that are not partnership interests for

Federal tax purposes are not eligible for the safe harbor described in Revenue Procedures 93-27 and 2001-43.

c. API Holder

The proposed regulations include the term API Holder to refer to any person who holds an interest in a particular API. An API Holder can include either or both a Passthrough Taxpayer and an Owner Taxpayer.

d. Indirect API

The proposed regulations define an Indirect API as an API that is held through one or more Passthrough Entities.

e. Passthrough Interest

A Passthrough Interest under the proposed regulations is an interest in a Passthrough Entity that represents, in whole or in part, an API.

f. API Gains and Losses and Unrealized API Gains and Losses

API Gains and Losses are long-term capital gains and losses recognized with respect to an API. The proposed regulations provide that API Gains and Losses include long-term capital gain or loss from a deemed or actual disposition of the API (including gain and loss recognized under section 731(a) and section 752(b)) and the holder's distributive share of net long-term capital gain or loss from the partnership under sections 702 and 704 with respect to the API. The proposed regulations also treat long-term capital gain or loss on the disposition of a capital asset distributed from a partnership with respect to an API (Distributed API Property) as API Gain or Loss if the asset is held for more than one year but not more than three years at the time the

distributee-partner disposes of the property. The holding period of the asset in the partner's hands includes the partnership's holding period with respect to the asset.

Unrealized API Gains and Losses include unrealized short-term and long-term capital gains and losses that would be allocated to the API Holder with respect to its API if the partnership sold all of its assets at fair market value and the proceeds were distributed in a complete liquidation of the partnership on any relevant date. For example, Unrealized API Gains and Losses include all capital gains and losses that would be allocated to the API pursuant to a capital account revaluation under §1.704-1(b)(2)(iv)(f) or §1.704-1(b)(2)(iv)(s).

In the case of a Passthrough Entity that contributes property that on disposition would generate capital gain or loss subject to section 1061 to another Passthrough Entity, Unrealized Capital Gains and Losses include the appreciation or depreciation in the value of the property at the time of the contribution. Accordingly, Unrealized API Gains and Losses include the capital gains and losses that would be allocated to the API Holder with respect to the API if the property contributed by the Passthrough Entity to the lower-tier Passthrough Entity were sold immediately before the contribution for the amount that is included in the invested capital of the lower-tier Passthrough Entity (i.e. included in a partnership's capital account or a similar account maintained by another type of Passthrough Entity under §1.1061-3(c)(3)(ii) of these proposed regulations) with respect to the contributed property.

In the case of a revaluation of the property of a partnership that owns an interest in a tiered structure of partnerships or in the case of the contribution of an API to another Passthrough Entity, the proposed regulations provide that Unrealized API Gains

and Losses include capital gains and losses that would be allocated directly or indirectly to the API Holder by lower-tier partnerships determined as if a taxable disposition of the property of each of the lower-tier partnerships also occurred on the date of the revaluation or contribution.

Although the proposed regulations do not require revaluations under section 1.704-1(b)(2)(iv)(f), solely to determine and identify Unrealized API Gains and Losses for purposes of section 1061 upon the occurrence of a revaluation or contribution, these regulations require that a revaluation under the principles of §1.704-1(b)(2)(iv)(f) be made through each relevant tier of partnerships. Thus, the proposed regulations require revaluations of all the properties held by all relevant partnerships in a tiered structure to determine the extent to which the partnership has Unrealized API Gains and Losses. If a partnership is required to revalue its assets for purposes of section 1061, such partnership is permitted to revalue its property for purposes of section 704 as though an event in §1.704-1(b)(2)(iv)(f)(5) had occurred.

Further, the proposed regulations require that Unrealized API Gains and Losses of a partnership be allocated when recognized under principles consistent with §1.704-3(a)(9). Accordingly, if at the time an API Holder contributes an interest in a lower-tier partnership to an upper-tier partnership, and the lower-tier partnership holds property with Unrealized API Gains and Losses that are allocable to the API Holder, those gains and losses when recognized by the lower-tier partnership must be allocated by the upper-tier partnership to the API Holder for purposes of section 1061.

The Treasury Department and the IRS believe that these rules serve two purposes. First, the rules ensure that capital gains and losses that would be API Gains

and Losses are not converted to Capital Interest Gains and Losses by virtue of a revaluation or a contribution. Second, these rules also ensure that Unrealized API Gains and Losses of a partnership when recognized are properly allocated to the correct API Holder in a tiered structure of partnerships. The Treasury Department and the IRS request comments on whether such section 1061 revaluations are necessary or whether there is another mechanism that would ensure that API Gain or Loss is allocated to API Holders when there is a revaluation event in one or more of the tiers of entities. Further, comments are requested on whether the section 704(b) regulations should be amended to specifically include revaluations when such partnership revalues its assets for purposes of section 1061 or to address revaluations through tiers of partnerships for purposes of section 704 more generally.

Unrealized API Gains and Losses that are recognized with respect to an asset or API held for more than one year on the date of its disposition become API Gains and Losses at the time they are recognized and do not lose their character as they are allocated through Passthrough Entities in a tiered structure. API Gains and Losses do not include any amounts that otherwise are treated as ordinary income under any Code section including section 751 and section 1245.

The Treasury Department and the IRS are aware that taxpayers may seek to circumvent section 1061(a) by waiving their rights to gains generated from the disposition of a partnership's capital assets held for three years or less and substituting for these amounts gains generated from capital assets held for more than three years. Alternatively, taxpayers may waive their rights to API Gains and substitute gains that are not taken into account for purposes of determining the Recharacterization Amount.

Some arrangements also may include the ability for an API Holder to periodically waive its right to an allocation of capital gains from all assets in favor of an allocation of capital gains from assets held for more than three years and/or a priority fill up allocation designed to replicate the economics of an arrangement in which the API Holder shares in all realized gains over the life of the fund. These arrangements are often referred to as carry waivers or carried interest waivers. Taxpayers should be aware that these and similar arrangements may not be respected and may be challenged under section 707(a)(2)(A), §§ 1.701-2 and 1.704-1(b)(2)(iii), and/or the substance over form or economic substance doctrines.

g. Related Persons

Section 1061(c)(1) provides that an API includes an interest transferred to or held by a taxpayer in connection with the performance of substantial services by the taxpayer or a related person in an applicable trade or business. Section 1061(d) also provides a rule for transfers of APIs to certain related persons. Section 1061(d)(2) provides a definition of related person that applies solely to transfers subject to section 1061(d) and the proposed regulations refer to that person as a Section 1061(d) Related Person. However, section 1061 does not include a definition of related person for the remainder of section 1061. Accordingly, in defining Related Person, the proposed regulations use the general definition of a person or entity that is related under sections 707(b) or 267(b) of the Code.

2. API Operational Rules

a. An API retains its status as an API

Section 1061 does not contain a provision that would cause an interest to cease to be an API unless and until one of the exceptions to the definition of API applies. Therefore, the proposed regulations clarify that once a partnership interest becomes an API, the partnership interest remains an API unless and until an exception applies, regardless of whether the taxpayer or a Related Person continues to provide services in an ATB. Therefore, even after a partner retires and provides no further services, if the retired partner continues to hold the partnership interest, it remains an API. Similarly, if the partner provides services, but the ATB Activity Test (as defined below) is not met in a later year, the partnership interest will continue to be an API. Further, an API remains an API if it is contributed to another Passthrough Entity or a trust or is held by an estate. As discussed with respect to the definition of API Gains and Losses and further in paragraph I.A.2.b. of this Explanation of Provisions, any unrecognized API Gains and Losses included in a capital account upon contribution of an API to a Passthrough Entity remain subject to section 1061 when they are recognized under the Code.

b. API Gains and Losses and Unrealized API Gains and Losses retain their character

API Gain or Loss retains its character as API Gain or Loss as it is allocated through tiered Passthrough Entities. Similarly, Unrealized API Gain or Loss retains its character even though it is included in the invested capital of a Passthrough Entity (i.e. included in a partnership's capital account or a similar account maintained by another type of Passthrough Entities under §1.1061-3(c)(3)(ii)).

c. Substantial services

Section 1061(c)(1) provides that an interest in a partnership is an API only if the interest is transferred to or held by the taxpayer in connection with the performance of

substantial services by the taxpayer, or by a related person, in an ATB. If a taxpayer provides any services in an ATB and an allocation of a partnership's profits is transferred to or held by the taxpayer in connection with those services, the proposed regulations presume that those services are substantial for purposes of Section 1061. The Treasury Department and the IRS have concluded that if an interest is granted in connection with the performance of services, such services are presumed substantial with respect to the interest transferred. This presumption is appropriate because the parties to the arrangement have economically equated the potential value of the interest granted with the value of the services performed. Therefore, the services provided are presumed to be substantial with respect to the interest transferred.

The Treasury Department and the IRS request comments on this presumption and the specifics of any arrangements in which insubstantial services could be performed in connection with the receipt of a profits interest such that the presumption could be overcome. Those comments also should address how and why Revenue Procedure 93-27 and Revenue Procedure 2001-43 would apply to partnership interests received in exchange for such insubstantial services.

d. Disregarded entities

Entities that are disregarded from their owners (collectively, disregarded entities) under any provision of the Code or regulations, including grantor trusts and qualified subchapter S subsidiaries, are disregarded for purposes of these regulations.

Accordingly, if an API is held by or transferred to a disregarded entity, the API is treated as held by or transferred to the disregarded entity's owner.

B. ATB and the ATB Activity Test

1. Relevant Definitions

The proposed regulations provide that an ATB means any activity for which the ATB Activity Test with respect to Specified Actions is met. The proposed regulations provide that the ATB Activity Test is met if Specified Actions are conducted at a level of activity required for an activity to constitute a trade or business under section 162. For purposes of determining if the ATB Activity Test is met, all of the Specified Actions conducted by Related Persons are combined. If these Specified Actions, all taken together, rise to the level of activity required to establish a trade or business under section 162, then each Related Person is determined to be engaged in the Relevant ATB. A Relevant ATB is the ATB in which services were performed in connection with which the API was transferred. Multiple Related Persons' actions are combined and then attributed to each Related Person. Therefore, a single ATB under section 1061 can include the actions taken by multiple Related Persons. The definition of an ATB is not the same as the definition of activity under section 469 and does not take into account any of the grouping rules under section 469. The definition of an ATB is solely for purposes of section 1061.

Specified Actions include both Raising or Returning Capital Actions and Investing or Developing Actions. The proposed regulations' description of Raising or Returning Capital Actions tracks the statutory language of section 1061(c)(2)(A). Similarly, the proposed regulations' description of Investing or Developing Actions tracks the statutory language of section 1061(c)(2)(B). The proposed regulations also include guidance regarding developing Specified Assets from the Conference Report. Specifically, the Conference Report states that developing specified assets takes place, for example, if it

is represented to investors, lenders, regulators, or others 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 or of others acting in concert with or at the direction of a service provider. However, merely voting shares owned does not amount to development; for example, a mutual fund that merely votes proxies received with respect to shares of stock it holds is not engaged in development. Conference Report at 421. The proposed regulations provide that Raising or Returning Capital Actions do not include Investing or Developing Actions.

The definition of Specified Assets in the proposed regulations generally tracks the statutory definition of specified assets in section 1061(c)(3). Both the statute and the proposed regulations provide that a Specified Asset generally includes a security as defined in section 475(c)(2). Thus, all corporate stock, regardless of the size of the corporation or whether the corporation is publicly traded, is a specified asset. Additionally, the proposed regulations, consistent with the definition of security in section 475(c)(2), provide that an interest in a partnership or a beneficial ownership interest in a trust is a Specified Asset if it is a security described in section 475(c)(2). The proposed regulations follow the statute to provide that options or derivative contracts with respect to any of the foregoing Specified Assets are also Specified Assets. Further, as provided in section 1061(c)(3), an interest in a partnership is also a Specified Asset to the extent that the partnership itself holds Specified Assets. The Blue Book provides an example in which a hedge fund acquires an interest in a partnership that is neither publicly traded nor widely held and whose assets consist of stocks, bonds, positions that are clearly identified hedges with respect to securities, and

commodities. The Blue Book provides that the partnership interest is a specified asset for purposes of the provision. Blue Book at 203. The proposed regulations incorporate this concept as illustrated by the Blue Book. Similar to the statute's treatment of options or derivative contracts of other Specified Assets as Specified Assets, the proposed regulations provide that, solely for purposes of section 1061, Specified Assets also include a derivative of a partnership interest to the extent not otherwise included in the definition of Specified Assets.

2. The ATB Activity Test

a. Actions taken with respect to Specified Assets held by a partnership

In the case of a partnership that directly holds Specified Assets, actions taken with respect to or on account of these assets, as well as a percentage of the actions taken with respect to the partnership interest as a whole, will be taken into account for purposes of the ATB Activity Test. The percentage of the actions taken with respect to the partnership as a whole that are taken into account for the test is the ratio of the value of the partnership's Specified Assets over the value of all of the partnership's assets. Actions taken to manage working capital will not be taken into account for purposes of the ATB Activity Test. The Treasury Department and the IRS request comments on the application of this rule and how it can be tailored to accomplish the purposes of section 1061.

b. Application of the ATB Activity Test

i. Aggregate actions taken into account

The proposed regulations provide that the ATB Activity Test takes into account the aggregate actions conducted with respect to Raising or Returning Capital Actions

and Investing or Developing Actions. In other words, the ATB Activity Test does not require that Raising or Returning Capital Actions and Investing or Developing Actions each individually meet the required activity level for the ATB Activity Test to be satisfied.

ii. Raising or Returning Capital Actions and Investing or Developing Actions are not required to be taken every year

The Treasury Department and the IRS recognize that, in some cases, once sufficient capital to engage in Investing or Developing Actions has been raised, actions involving raising or returning capital may not be taken for a period of time. Additionally, at the beginning and the end of the activity, actions involving the raising or returning of capital may be significant and actions involving investing or developing may not be taken. The ATB Activity Test looks at the actions taken as a whole. Accordingly, the proposed regulations provide that the ATB Activity Test is met if Investing or Developing Actions alone satisfy the ATB Activity Test in the current year if Raising or Returning Capital Actions have been taken in prior years. Additionally, the test is satisfied if Raising or Returning Capital Actions during the year satisfy the ATB Activity Test and Investing or Developing Actions are anticipated but not yet taken.

iii. Actions of Related Persons taken into account

The proposed regulations further provide that in applying the ATB Activity Test, the actions of one or more Related Persons are taken into account, regardless of whether an entity conducts only Raising or Returning Capital Actions or only Investing or Developing Actions.

iv. Interests transferred prior to existence of an ATB

An API arises when an interest in a partnership is transferred or held in connection with services in an ATB. The Treasury Department and the IRS are aware that interests in a partnership may be issued to a service provider in anticipation of the service provider providing services to an ATB, but because an ATB does not exist at the time of the transfer, the interest is not an API. The Treasury Department and the IRS have concluded that once the service provider is providing services in an ATB, the interest becomes an API. Once the interest becomes an API, its status as an API does not depend on whether the ATB continues to meet the ATB Activity Test.

II. Section 1.1061-3: Exceptions to the Definition of API

Section 1061 includes four exceptions to its application. Additionally, these regulations provide an additional exception. First, the statutory definition of an API excepts 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 (non-ATB employee exception). 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 (corporate exception). Third, section 1061(c)(4)(B) provides that an API does not include any capital interest in the partnership (Capital Interest Gains and Losses exception). 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 (Section 1061(b) exception). Lastly, §1.1061-3 introduces a fifth exception that applies to an unrelated purchaser who is a non-service provider (bona fide unrelated purchaser exception).

A. Non-ATB employee exception.

Section 1061(c)(1) provides that an API is not 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. The proposed regulations track the language of the statute.

B. Corporate exception

Section 1061(c)(4)(A) provides that the term API does not include a partnership interest directly or indirectly held by a corporation. On March 19, 2018, the Treasury Department and the IRS issued Notice 2018-18, notifying taxpayers that the Treasury Department and the IRS intended to issue regulations providing that the term corporation as used in section 1061(c)(4)(A) does not include an S corporation. The notice informed taxpayers that the regulations under section 1061 would provide that this rule is effective for taxable years beginning after December 31, 2017 to prevent taxpayers from avoiding the application of section 1061 through the use of an S corporation. See section 7805(b)(3). The Blue Book also provides that the term corporation for purposes of section 1061(c)(4)(A) does not include an S corporation. Blue Book, page 201. Accordingly, these proposed regulations provide that partnership interests held by S corporations are treated as APIs if the interest otherwise meets the API definition.

The Treasury Department and the IRS also have concluded that a partnership interest held by a PFIC with respect to which a taxpayer has a QEF election in effect is treated as an API if the interest meets the API definition. Under section 1291, generally, a U.S. person who owns stock of a PFIC is subject to an interest charge regime in which interest is charged with respect to certain PFIC distributions and dispositions of

PFIC shares. However, the shareholder can avoid the interest charge regime by making an election under section 1295 to treat the PFIC as a QEF. If this election is made, then the holder of the stock generally is not subject to the interest charge regime and instead includes in income each taxable year its pro rata share of the ordinary income and long-term capital gain of the QEF. The Treasury Department and the IRS are concerned that, absent this rule, taxpayers may use PFICs with respect to which they have made QEF elections to avoid the application of section 1061. Such taxpayers would have the benefit of passthrough tax treatment without the application of section 1061. The Treasury Department and the IRS believe it is inappropriate for a PFIC with respect to which the shareholder has elected to receive passthrough treatment to be treated as a corporation for purposes of section 1061. Therefore, the proposed regulations clarify that a PFIC with respect to which the shareholder has a QEF election in effect is not treated as corporation for purposes of section 1061(c)(4)(A). As a result, a partnership interest held by a PFIC with respect to which the shareholder has a QEF election in effect will be treated as an API if the interest otherwise meets the API definition.

Section 1061(f) provides that the Secretary has authority to issue regulations as are 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 Treasury Department and the IRS have concluded that the grant of regulatory authority in section 1061 is sufficient for the government 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. The rule that the exception in section 1061(c)(4)(A) does not apply to a PFIC with respect to which the shareholder has a QEF election in effect applies to all taxable years beginning after the date the proposed regulations are published in the **Federal Register**.

C. Capital Interest Gains and Losses Exception

Section 1061(c)(4)(B) provides that an API does not include a capital interest in the partnership that 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 statutory language creates an exception from recharacterization under section 1061 for capital gains and losses with respect to a capital interest. The Conference Report includes an example in which a partnership agreement provides that a partner's share of the partnership's capital is commensurate with the amount of capital the partner contributed at the time the partnership interest was received compared to the total partnership capital. The reference to the amount of capital contributed in section 1061(c)(4)(B)(i) and a similar reference in the Conference Report indicate that the exception for capital interests should apply only to the extent that a service provider's rights with respect to its contributed capital matches the rights of other non-service partners with respect to their shares of contributed capital. Conference Report at 420-21.

These proposed regulations provide rules for determining if capital gains and losses allocated to an API Holder are treated as allocations with respect to its capital

investment and therefore, excluded from the application of section 1061. As discussed in more detail in section II.C.1, of this Explanation of Provisions, General Rules Applicable to the Determination of Capital Interest Allocations and Passthrough Interest Allocations, an allocation must be made in proportion to the relative value of the API Holder's capital account (including unrealized gains and losses) in the Passthrough Entity in order to be an allocation with respect to a capital investment. The proposed regulations also provide rules for determining the amount of gain or loss recognized on the disposition of a Passthrough Interest that is allocable to the capital interest.

The proposed regulations refer to capital gains and losses with respect to a capital interest as Capital Interest Gains and Losses. Specifically, the proposed regulations provide that Capital Interest Gains and Losses are Capital Interest Allocations, Passthrough Interest Capital Allocations and Capital Interest Disposition Amounts.

1. General Rules Applicable to the Determination of Capital Interest Allocations and Passthrough Interest Capital Allocations

a. In the Same Manner

The proposed regulations provide that allocations based on the partners' capital account balances that have the same terms, the same priority, the same type and level of risk, the same rate of return, the same rights to cash or property distributions during partnership operations and on liquidation will be treated as made in the same manner. The proposed regulations also provide that an allocation to an API Holder will not fail to be treated as a Capital Interest Allocation solely because it is subordinated to an

allocation to Unrelated Non-service Partners or because it is not reduced by the cost of services provided by the API Holder or by a related person.

b. Capital Accounts

In the case of a partnership that maintains capital accounts under §1.704-1(b)(2)(iv), in order for an allocation to qualify as a Capital Interest Allocation or a Passthrough Interest Capital Allocation, the allocation must be based on the capital account determined under §1.704-1(b)(2)(iv). 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 in a manner similar to that provided under §1.704-1(b)(2)(iv), those accounts will be treated as capital accounts under the proposed regulations. These accounts must be used in order for an allocation to qualify as a Capital Interest Allocation or a Passthrough Interest Capital Allocation. To qualify to be treated as a capital account for this purpose, each owner's account must be increased by the money and the net fair market value of property contributed to the Passthrough Entity and income and gain allocated to the owner. Each owner's account must be decreased by any money and the net fair market value of property distributed to the owner and allocations of expenditures, loss, and deduction.

Generally, Passthrough Interest Capital Allocations must be based on each owner's share of the Passthrough Entity's capital account in the partnership making the Capital Interest Allocations to the Passthrough Entity. Passthrough Interest Direct Investment Allocations generally must be based on each owner's share of the capital investment made by the Passthrough Entity. This amount is equal to the capital

account of the owner reduced by that owner's share of a capital account held directly or indirectly by the Passthrough Entity in a lower-tier entity. However, if a Passthrough Entity allocates all Passthrough Interest Capital Allocations for the taxable year in the aggregate, regardless of whether they are Capital Interest Allocations or Passthrough Interest Direct Investment Allocations, the Passthrough Entity may allocate those allocations based on each owner's capital account in the Passthrough Entity, regardless of whether some or all of an owner's capital contribution is included in the capital account of a lower-tier entity.

For purposes of section 1061, a capital account does not include the contribution of amounts directly or indirectly attributable to any loan or other advance made or guaranteed, directly or indirectly, by any other partner or the partnership (or any person related to any such other partner or the partnership). However, the repayments on the loan are included in capital accounts as those amounts are paid (unless the repayments are funded with a similar loan from the partners or the partnership or any person related to such partners or the partnership).

c. Items that are not treated as Capital Interest Allocations or Passthrough Interest Capital Allocations.

Capital Interest Allocations and Passthrough Interest Capital Allocations never include any amounts that are treated as API Gains and Losses or Unrealized API Gains and Losses that are allocated to the Passthrough Entity by a lower-tier Passthrough Entity. Such allocations also exclude Partnership Transition Amounts and other items not taken into account for purposes of section 1061 as described in section III.E of this Explanation of Provisions.

2. Capital Interest Allocations

Capital Interest Allocations can be made only by a partnership that has both API Holders and Unrelated Non-Service Partners. Unrelated Non-Service Partners are partners who do not (and did not) provide services in the Relevant ATB and who are not (and were not) related to an API Holder in the partnership or any person who provides services in the Relevant ATB. Capital Interest Allocations are allocations of long-term capital gain and loss made under the partnership agreement to the API Holder and Unrelated Non-Service Partners based on their respective capital account balances if: (1) the allocations are made to Unrelated Non-Service Partners with a significant aggregate capital account balance; (2) the allocations are made in the same manner to the API Holder and the Unrelated Non-Service Partners; and (3) the terms of the allocations to the API Holder and the Unrelated Non-Service Partners are identified both in the partnership agreement and on the partnership's books and records and the allocations are clearly separate and apart from allocations made with respect to the API.

These proposed regulations provide that allocations made to Unrelated Non-service Partners with an aggregate capital account balance of 5 percent or more of the aggregate capital account balance at the time the allocation is made by the partnership will be treated as significant.

3. Passthrough Interest Capital Allocations

Passthrough Interest Capital Allocations are long-term capital gain and loss allocations made by a Passthrough Entity that holds an API. The proposed regulations provide for two types of Passthrough Interest Capital Allocations: Passthrough Capital Allocations and Passthrough Interest Direct Investment Allocations.

a. Passthrough Capital Allocations

Passthrough Capital Allocations are Capital Interest Allocations made directly or indirectly to the Passthrough Entity from a lower-tier entity with respect to its capital account balance in the lower-tier entity. Passthrough Capital Allocations must be made by the Passthrough Entity to each of its owners in the same manner based on each owner's share of the capital account in the lower-tier entity making the Capital Interest Allocation to the Passthrough Entity.

b. Passthrough Interest Direct Investment Allocations

Allocations are treated as Passthrough Interest Direct Investment Allocations if the allocations are comprised solely of long-term capital gains and losses derived from assets (other than an API) directly held by the Passthrough Entity and not through an allocation from a lower tier Passthrough Entity. Also, if a Passthrough Entity received Distributed API Property from a lower-tier entity and the property is no longer Distributed API Property because it has been held for more than three years, the property is included in the Passthrough Entity's direct investment at that time. Generally, allocations must be made in the same manner to each of the owners of the Passthrough Entity based on each owner's relative investment in the assets held by the Passthrough Entity. An allocation will not fail to qualify to be a Passthrough Interest Direct Investment Allocation if the Passthrough Entity is a partnership and allocations made to one or more Unrelated Non-Service Partners have more beneficial terms than allocations to the API Holders if the allocations to the API Holders are made in the same manner. For example, if an Unrelated Non-Service Partner receives a priority allocation and distribution of 10 percent of net long-term capital gain and loss and the other

partners, including the API Holders, share the remaining 90 percent of the net long-term capital gain from the Passthrough Entity's direct investments, allocations to the API Holders are Passthrough Interest Direct Investment Allocations. Further, allocations made in the same manner to some API Holders by a partnership will not fail to qualify to be treated as a Passthrough Interest Direct Investment Allocation as to those partners despite allocations being made to one or more service providers (or related parties) that are treated as APIs issued by the Passthrough Entity. For example, if (1) all of the partners of the Passthrough Entity are API Holders and one partner manages the Passthrough Entity's direct investments and receives a 20 percent interest in the net long-term capital gains from those investments that is treated as an API as to that partner and (2) the other API Holders share the remaining 80 percent of gain from those investments based on their relative investments in the Passthrough Entity, then (3) the allocation of the 80 percent of net long-term capital gain is a Passthrough Interest Direct Investment Allocation to those partners.

c. Aggregate Passthrough Interest Allocations

Instead of separately accounting for Passthrough Capital Allocations and Passthrough Interest Direct Investment Allocations, owners of the Passthrough Entity may prefer to allocate items of Capital Interest Gain or Loss without regard to whether these items arose from direct investment by the Passthrough Entity or from an investment in a lower-tier Passthrough Entity. Therefore, the proposed regulations permit an upper-tier Passthrough Entity to allocate its Passthrough Capital Allocations and Passthrough Interest Direct Investment Allocations in the same manner to all of its

partners using the partners' capital accounts in such Passthrough Entity unreduced by amounts that are included in a capital account of the lower-tier entity.

4. Request for Comments Regarding Other Allocations

The Treasury Department and the IRS understand that the allocations in the proposed regulations do not include all allocation arrangements. The Treasury Department and the IRS request comments on other allocation arrangements that appropriately could be treated as Capital Interest Gains and Losses under the regulations without inappropriately expanding the capital interest exception, taking into account the statutory requirement that the API Holder's right with respect to its capital interest be commensurate with other partners' rights with respect to their contributed capital.

5. Capital Interest Disposition Amounts

The proposed regulations provide rules for determining the extent to which long-term capital gain or loss recognized on the disposition of a Passthrough Interest comprised of both an API and a capital interest is excluded from section 1061 because it is treated as Capital Interest Gain or Loss. Nothing in section 1061 or these proposed regulations overrides existing law regarding the determination of gain recognized on the disposition of all or a portion of a Passthrough Interest. In particular, in the case of a disposition of a portion of a Passthrough Interest, Revenue Ruling 84-53 (1984-1 C.B. 159) applies and basis must be equitably apportioned between the portion of the interest disposed of and the portion retained. These proposed regulations contain amendments to §1.1223-3 for determining a divided holding period when a partnership interest includes an API and/or a profits interest.

A commenter requested guidance on whether a capital interest can be disposed of separately from an API for purposes of section 1061(a). The disposition of a capital interest will be treated as such under section 1061 and the gain or loss on the disposition is treated as Capital Interest Gain or Loss if the interest being disposed of is clearly identified as a capital interest. However, nothing in section 1061 or these proposed regulations changes the established partnership principle that a partner has a unitary basis in its partnership interest. See Revenue Ruling 84-53. As noted above, the basis must be equitably apportioned to the transferred portion under the principles described in Rev. Rul. 84-53 and the holding period of the interest would be determined under the rules of §1.1223-3. Thus, a partner may dispose of solely a capital interest or an API, but in either case, the partner's basis and holding period (including a split holding period) is apportioned between the interest retained and the interest transferred.

The proposed regulations provide that the amount of long-term capital gain or loss recognized on a disposition that is treated as a Capital Interest Disposition Amount is determined in a multi-step process. Amounts that are treated as ordinary income under section 751(a) or (b) as a result of the disposition are excluded from all steps of the calculation. The computation then proceeds as follows. First, the amount of gain or loss that would be allocated to the Passthrough Interest (or the portion of the Passthrough Interest sold) if all of the assets of the Passthrough Entity were sold for their fair market value in a fully taxable transaction (deemed liquidation) immediately before the disposition is determined (Step One). Second, the amount of gain or loss from the deemed liquidation that is allocable to the Passthrough Interest as a result of Capital Interest Allocations, and Passthrough Interest Capital Allocations is determined

(Step Two). If a transferor recognizes capital gain under section 751(b), any amount that constitutes API Gain or Loss is added to any API Gain or Loss that results from the disposition of the interest.

If gain is recognized under the Code on the disposition of a Passthrough Interest, and the Capital Interest Allocations, Passthrough Interest Capital Allocations, and API Holder Transition Amounts determined under Step Two would result in the allocation of a loss, then all the gain recognized on the disposition will be treated as API Gain. Similarly, if loss is recognized on the disposition of a Passthrough Interest, and the Capital Interest Allocations, Passthrough Interest Capital Allocations, and API Holder Transition Amounts determined under Step Two would result in an allocation of a gain, then all of the loss recognized on the disposition will be treated as an API Loss.

If gain is recognized under the Code on the disposition of a Passthrough Interest and gain would be recognized with respect to the Passthrough Interest under both Step One and Step Two, the API Holder must determine the portion of the gain that is attributable to the capital interest and the portion of the gain that is attributable to the API. To determine these portions, the taxpayer must divide the capital gain that would be allocated to the interest pursuant to Capital Interest Allocations, Passthrough Interest Capital Allocations, and API Holder Transition Amounts on the deemed liquidation of the partnership under Step Two by the total amount of gain that would be allocated to the interest on the deemed liquidation under Step One. This amount, expressed as a percentage, is then multiplied by the total amount of gain recognized on the sale to determine the amount of the gain that is treated as a Capital Interest Disposition Amount. A similar analysis would apply if a loss was recognized on the disposition of

the interest, and both Steps One and Two resulted in a loss. To the extent that the gain or loss is not treated as a Capital Interest Disposition Amount, it is API Gain or Loss and subject to section 1061.

6. Recapitalizations and Divisions

The Treasury Department and the IRS are aware that some taxpayers have taken the position that a recapitalization or division is a capital contribution under section 1061(c)(4)(B) that would allow taxpayers to recharacterize what would be API Gains under these proposed regulations as Capital Interest Gains. Although a recapitalization or a division may be treated as a section 721 contribution, these transactions would not have the effect of recharacterizing API Gains and Losses as Capital Interest Gains and Losses under these proposed regulations. The section 1061 statutory language does not support this position and the Treasury Department and the IRS do not believe it to be a reasonable interpretation of the statute.

D. Section 1061(b) exception

Section 1061(b) provides that to 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). A third party investor is defined in section 1061(c)(5) as a person who holds an interest in the partnership which does not constitute property held in connection with an applicable ATB; and who does not provide substantial services for such partnership or for any applicable trade or business. Comments have suggested that the exception is intended to apply to family offices, that is, portfolio investments made on behalf of the service providers and persons related to

the services providers. The Treasury Department and the IRS generally agree with these comments and believe that the section 1061(b) exception effectively is implemented in the proposed regulations with the exception to section 1061 for Passthrough Interest Direct Investment Allocations. The Treasury Department and the IRS request comments on the application of this provision and whether the proposed regulations' exclusion for Passthrough Interest Direct Investment Allocations properly implements the exception.

E. Bona fide unrelated purchaser exception

The proposed regulations add an exception for unrelated taxpayers who purchase an API. The proposed regulations provide that an interest in a partnership that would be treated as an API but is purchased by an unrelated buyer for the fair market value of the interest is not an API with respect to the buyer if (1) the buyer does not currently and has never provided services in the relevant ATB (or to the Passthrough Entity in which the interest is held, if different), (2) does not contemplate providing services in the future, and (3) is not related to a person who provides services currently or has provided services in the past. However, it should be noted that this exception does not apply to an unrelated non-service provider who becomes a partner by making a contribution to a Passthrough Entity that holds an API and in exchange receives an interest in the Passthrough Entity's API. 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.

III. Section 1.1061-4: Computing the Recharacterization Amount

As noted in section I of this Explanation of Provisions, under the proposed regulations, the amount an Owner Taxpayer must treat as short-term capital gain under section 1061(a) is called the Recharacterization Amount. The Recharacterization Amount is the amount by which the Owner Taxpayer's One Year Gain Amount exceeds the Owner Taxpayer's Three Year Gain Amount. The Owner Taxpayer's One Year Gain Amount is comprised of two components: (1) the Owner Taxpayer's combined net API One Year Distributive Share Amount from all APIs held during the taxable year; and (2) the Owner Taxpayer's API One Year Disposition Amount. The Owner Taxpayer's Three Year Gain Amount is comprised of: (1) its combined net API Three Year Distributive Share Amount from all APIs held during the taxable year; and (2) its API Three Year Disposition Amount. As noted earlier in this preamble, API Gains and Losses retain their character as they flow through each tier of Passthrough Entities and are netted at the Owner Taxpayer level to determine the Recharacterization Amount.

A. Determination of the API One Year Distributive Share Amount

Each Passthrough Entity must calculate an API One Year Distributive Share Amount for each API Holder that directly holds an interest in the Passthrough Entity for the taxable year. Under the proposed regulations, all long-term capital gain and loss allocated to the API Holder by the Passthrough Entity are API Gains and Losses to the API Holder unless an exception applies.

If the Passthrough Entity is a partnership, the Passthrough Entity determines its API One Year Distributive Share Amount in a series of steps. First, the partnership determines the long-term capital gains and losses that are allocated to the API Holder under the partnership agreement under sections 702 and 704. This amount includes

long-term capital gains and losses from the taxable disposition of Distributed API Property by the partnership that was distributed to it from a lower-tier entity. Second, the partnership reduces this amount by amounts that are not taken into account under these proposed regulations for purposes of calculating the Recharacterization Amount. As discussed in section III.E of this Explanation of Provisions, section 1231 amounts, section 1256 amounts, and qualified dividends are excluded from the calculation of the Recharacterization Amount and are not included in the API One Year Distributive Share amount. The same is true for the API Holder Transition Amount, which is also discussed in section III.E of this Explanation of Provisions, and for long-term capital gain or loss from the disposition of property that was once Distributed API Property but that has ceased to be Distributed API property because it was disposed of when the asset had a holding period that was more than three years. Third, the partnership reduces the amount determined under the second step by any amounts that are treated as Capital Interest Gains and Losses under §1.1061-3(c). The resulting amount is the API Holder's One Year Distributive Share Amount and the partnership must report this amount to the API Holder as its API One Year Distributive Share Amount under §1.1061-6. Additionally, under §1.1061-6, the partnership must report to the API Holder the amount of Capital Interest Gains and Losses and API Holder Transition Amounts that have been allocated to the API Holder for the calendar year.

An API One Year Distributive Share Amount must also be calculated by an S corporation that holds an API for each direct API Holder in the S corporation. In this case, the S corporation must report to each API Holder its pro rata share of the API Gains and Losses allocated to the S corporation with respect to its API. Such amounts

also may be calculated and reported by a PFIC with respect to which the shareholder has a QEF election in effect.

B. Determination of the API Three Year Distributive Share Amount

Under the proposed regulations, the API Three Year Distributive Share Amount is equal to an API Holder's One Year Distributive Share Amount less amounts that would not be treated as long-term capital gain and loss if such amount were computed by applying paragraphs (3) and (4) of section 1222 and substituting three years for one year in those paragraphs. In addition, if the Passthrough Entity sold an API during the taxable year and the Lookthrough Rule applies, the API Holder's One Year Distributive Share Amount is further reduced by the adjustment required by the Lookthrough Rule as described in section III.E of this Explanation of Provisions. These amounts must be calculated by the Passthrough Entity and reported to the API Holder under §1.1061-6.

C. Determination of the API One Year Disposition Amount and the API Three Year Disposition Amount

The API One Year Disposition Amount includes the long-term capital gains and losses that the Owner Taxpayer recognizes from the direct taxable disposition of an API, including gain or loss under sections 731(a) and 752(b), that has been held for more than one year. The API One Year Disposition Amount also includes long-term capital gain or loss recognized on the disposition of Distributed API Property by an Owner Taxpayer. The API Three Year Disposition Amount includes only the long-term capital gain or loss from the direct taxable disposition of an API held by the Owner Taxpayer for more than three years. However, if the Lookthrough Rule, as described in §1.1061-4(b)(9) and discussed further in section III.E.7 of this Explanation of Provisions,

applies, the API Three year Disposition Amount is further reduced by the adjustment required by the Lookthrough Rule.

Section 751(b) provides that in the case of certain disproportionate distributions, a partner may be treated as engaging in a sale or exchange of property with the partnership. To the extent that such an exchange results in long-term capital gain with respect to an API under section 751(b), it is included in the One Year Disposition Amount and additionally, if appropriate, amounts may be included in the Three Year Disposition Amount. See §1.751-1(b)(2).

D. Determination of the One Year Gain Amount and Three Year Gain Amount

In determining the One Year Gain Amount and Three Year Gain Amount, all amounts are netted at the Owner Taxpayer level. If an Owner Taxpayer holds more than one API, the Owner Taxpayer combines and nets its API Distributive Share Amounts from each API that it held during the taxable year to determine its combined net API One Year Distributive Share Amount and net API Three Year Distributive Share Amount. Additionally, the taxpayer must take into account its API One Year Disposition Amount and its API Three Year Disposition Amount. If the One Year Gain Amount is zero or less than zero, section 1061 does not apply because there is no gain to recharacterize. Further, in applying section 1(h) of the Code, the Owner Taxpayer determines its net capital gain for the taxable year taking into account section 1061. Comments are requested regarding the calculation of collectibles gain and loss under section 1(h)(5) and unrecaptured section 1250 gain in section 1(h)(6) in cases where collectibles gain or unrecaptured section 1250 gain is included in the Recharacterization Amount under section 1061(a) and under section 1061(d).

E. General calculation rules

This section discusses general rules included in the proposed regulations for calculating the One Year Gain Amount and Three Year Gain Amount.

1. Items not Taken into Account for Purposes of Section 1061(a)

Section 1061(a) applies to assets that produce capital gains or losses that are treated as long-term capital gain under paragraphs (3) and (4) of section 1222. 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 proposed regulations provide that long-term capital gains determined under section 1231 or section 1256 are excluded from both the One Year and Three Year Gain Amounts. For similar reasons, amounts treated as qualified dividends under section 1(h)(11) and any capital gain that is characterized as long term or short term without regard to the holding period rules in section 1222, such as capital gains characterized under the identified mixed straddle rules described in section 1092(b) and §§1.1092(b)-3T, 1.1092(b)-4T, and 1.1092(b)-6, are also excluded.

2. API Holder Transition Amounts

As described in the discussion of Capital Interest Gains and Losses, section 1061(c)(4) provides an exception with respect to certain capital interests. Prior to the enactment of section 1061, taxpayers had no reason to track what portion of the unrealized appreciation in partnership assets was attributable to capital interests. Therefore, the Treasury Department and the IRS are aware that partnerships may not have information readily available to enable them to comply with these regulations with

respect to property that the partnership held for more than three years as of the effective date of section 1061. Accordingly, the proposed regulations provide a transition rule for partnership property that was held by the partnership for more than three years as of the effective date of section 1061. Under these proposed regulations, a partnership that was in existence as of January 1, 2018 may irrevocably elect to treat all long-term capital gains and losses from the disposition of all assets, regardless of whether they would be API Gains or Losses in prior periods, that were held by the partnership for more than three years as of January 1, 2018 as Partnership Transition Amounts. Partnership Transition Amounts that are allocated to the API Holder (API Holder Transition Amounts) are not taken into account for purposes of determining the Recharacterization Amount. Rather, they are treated as long-term capital gains and losses and are not subject to recharacterization under section 1061 and these proposed regulations.

For amounts to be treated as Partnership Transition Amounts, the partnership must make a signed and dated election (election statement) by the due date, including extensions, of the Form 1065, "U.S. Return of Partnership Income," for the first partnership taxable year in which it treats amounts as Partnership Transition Amounts. The election statement must be identified as an election under §1.1061-4(b)(7)(iii) and filed with the IRS as an attachment to the Form 1065 filed for the partnership's taxable year in which it is making the election. By the due date of the election, the partnership must clearly and specifically identify all of the assets held by the partnership for more than three years as of January 1, 2018 in the partnership's books and records. The election applies to the year for which the election is made and all subsequent years.

Taxpayers may rely on these proposed regulations to make the election for taxable years beginning in 2020 or in a later year before the final regulations apply.

As noted above, Partnership Transition Amounts that are allocated to the API Holder are called API Holder Transition Amounts under the proposed regulations. The API Holder Transition Amount in any year is the amount of the Partnership Transition Amount for the year that is included in the amount of long-term capital gains and losses allocated to the API Holder under sections 702 and 704 with respect to its interest in the partnership under the current partnership agreement. However, the amount allocated to the API Holder in any taxable year under the preceding sentence cannot exceed the amount of the Partnership Transition Amount that would have been allocated to the API Holder with respect to its partnership interest under the partnership agreement for the 2017 taxable year to the extent it was amended on or before March 15, 2018. The partnership must retain an executed copy of the partnership agreement in effect for the 2017 taxable year to the extent amended on or before March 15, 2018 as part of its books and records.

A Passthrough Entity that receives an allocation of API Holder Transition Amounts from a lower-tier entity cannot allocate more of the Passthrough Entity's API Holder Transition Amount to the Passthrough Entity's direct API Holders than the amount of Partnership Transition Amounts the API Holders would have been allocated by the Passthrough Entity under the Passthrough Entity's governing documents in effect for the calendar year ending December 31, 2017 to the extent amended on or before March 15, 2018. Further, the amount allocated to the Passthrough Entity's direct API

Holders cannot exceed the amount of the Passthrough Entity's API Holder Transition Amounts the Passthrough Entity was allocated by the lower-tier Passthrough Entity.

Unlike other provisions of the proposed regulations, API Holders and Passthrough Entities may elect and treat amounts as Partnership Transition Amounts and API Holder Transition Amounts for taxable years beginning in 2020 or a later taxable year without following all of the provisions of the proposed regulations provided that the partnership consistently treats long-term capital gains and losses from identified assets as Partnership Transition Amounts and API Holder Transition Amounts for the year in which the election is made and all subsequent taxable years beginning before the final regulations are published in the Federal Register. The Treasury Department and IRS request comments on whether a transition rule is needed and whether the Partnership Transition Amount Rule is useful or whether another approach would be more helpful in easing transition difficulties.

3. Installment Sale Gain

The proposed regulations provide that the Owner Taxpayer's One Year Gain Amount and Three Year Gain Amount include gains from installment sales, regardless of whether the installment sale occurred before the effective date of section 1061. The proposed regulations also make clear that the holding period of the asset on the date of its disposition is used for purposes of applying section 1061. Accordingly, if an API was sold on November 30, 2017 and, at the time of its sale, it had a holding period of two years, gain recognized on or after January 1, 2018 is subject to section 1061 even though the disposition occurred before the effective date of section 1061.

This rule is consistent with the manner in which installment sales are treated under existing law. See, e.g., Snell v. Commissioner, 97 F.2d 891 (5th Cir. 1938) (the tax laws in effect for the year the installment gain is recognized apply to the gain); see also Estate of Kearns v. Commissioner, 73 T.C. 1223 (1980); Klein v. Commissioner, 42 T.C. 1000 (1964); Revenue Ruling 79-22 (1979-1 C.B. 275). The holding period of the asset disposed of is the holding period on the date of disposition because section 453 defers gain recognition, not gain realization, and thus section 1061(a) applies to each year in which gain is recognized after 2017, even if the gain is recognized more than three years after the date of sale. Estate of Henry H Rodgers v. Commissioner, 143 F.2d 695, 696-697 (1944).

4. Regulated Investment Company (RIC) and Real Estate Investment Trust (REIT) Capital Gain Dividends

Section 852(b)(3)(C)(i) provides generally that a RIC capital gain dividend is any dividend, or part thereof, which is reported by the RIC as a capital gain dividend in written statements furnished to its shareholders. Similarly, section 857(b)(3)(B) provides generally that a REIT capital gain dividend is any dividend, or part thereof, which is designated by the REIT as a capital gain dividend in a written notice mailed to its shareholders. The aggregate amount of capital gain dividends paid by a RIC or REIT for a taxable year, however, may not exceed the net capital gain of the RIC or REIT for that taxable year.

Section 852(b)(3)(B) provides that a RIC capital gain dividend shall be treated by the shareholders as a gain from the sale or exchange of a capital asset held for more than one year. Similarly, section 857(b)(3)(A) provides that a REIT capital gain dividend

shall be treated by the shareholders as a gain from the sale or exchange of a capital asset held for more than one year.

The Treasury Department and the IRS are aware that taxpayers are concerned that section 1061(a)(2) might be read to prevent RIC and REIT capital gain dividends received by partnerships from being treated as long-term capital gains by taxpayers that hold APIs in those partnerships. Specifically, taxpayers are concerned that these dividends may not meet the three-year holding period requirement under section 1061(a) because of the specification in sections 852(b)(3)(B) and 857(b)(3)(A) that these dividends are treated as a gain from the sale or exchange of a capital asset held for more than one year. The Treasury Department and the IRS agree that long-term capital gain treatment should be available to the extent that the capital gain dividend is attributable to capital assets held for more than three years or is attributable to assets that are not subject to section 1061.

The proposed regulations address this issue by allowing a RIC or REIT to disclose two additional amounts for purposes of section 1061. The two additional amounts to be disclosed are 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 §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 §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.

The proposed regulations provide that partnerships that receive either or both of these additional capital gain dividend disclosures from a RIC or REIT must use each additional disclosed amount in calculating API distributive share amounts. The first additional disclosed amount is used for the calculation of an API One Year Distributive Share Amount. The second additional disclosed amount is used for the calculation of an API Three Year Distributive Share Amount. However, the proposed regulations provide that the full amount of the RIC's or REIT's capital gain dividend must be used for the calculation of an API One Year Distributive Share Amount if the first additional amount is not disclosed, and 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 if the second additional amount is not disclosed.

To prevent the avoidance of section 1061, the proposed regulations also provide that each of the two additional disclosed amounts provided to each shareholder of a RIC or REIT must be proportionate to the share of capital gain dividends reported or designated to that shareholder for the taxable year. Cf. Section 857(g)(2) and Rev. Rul. 89-81, 1981-1 C.B. 226.

Additionally, in accordance with sections 852(b)(4) and 857(b)(8), the proposed regulations provide that with respect to any shares of RIC or REIT stock with respect to which a partnership receives a capital gain dividend distribution and the second additional disclosed amount that is used to calculate the API Three Year Distributive

Share Amount, any loss on the sale or exchange of such shares held for less than six months will be treated as capital loss on assets held for more than three years to the extent of the second additional disclosed amount that is included in the calculation of an API Three Year Distributive Share Amount.

5. Distributed API Property

Generally, the distribution of property with respect to an API does not accelerate the recognition of gain under section 1061 or these proposed regulations. However, if Distributed API Property is disposed of by the distributee-partner when the holding period is three years or less (inclusive of the partnership's holding period), gain or loss with respect to the disposition is API Gain or Loss. Distributed API Property retains its character as it is passed from one tier to the next. However, at the time that Distributed API Property is held for more than three years, it loses its character and is no longer Distributed API Property. If Distributed API Property is distributed from one Passthrough Entity to another and the upper-tier entity disposes of the property, the long-term capital gain or loss is included in the upper-tier entity's long-term capital gain or loss as API Gain or Loss. If the property is distributed to an Owner Taxpayer and the Owner Taxpayer disposes of the property, the capital gain or loss is included in the Owner Taxpayer's API One Year Disposition Gain or Loss. This rule is necessary to prevent the avoidance of section 1061 because, absent such a rule, section 1061 could be circumvented by the partnership's distribution of an asset to the API Holder prior to the sale of the asset in situations in which the asset has been held by the partnership for three years or less.

6. Holding Periods Used for Applying Section 1061

The Treasury Department and the IRS considered different approaches to the holding period rules. As one commentator pointed out, there are a number of different approaches that can be considered. These approaches include: (1) using the holding period of the owner of the asset sold (whether the asset disposed of is the API itself or is an underlying capital asset held by the partnership); (2) using the Owner Taxpayer's holding period in its interest; (3) using the partnership's holding period in its assets; or (4) using the lesser of the holding period of the partnership in the assets or the Owner Taxpayer's holding period in the interest. If the holding period of the owner of the asset applies, then the partnership's holding period in the asset or the partner's holding period in the API applies (whichever is disposed of).

The proposed regulations adopt the approach that the holding period of the owner of the asset sold controls. The Treasury Department and the IRS have adopted this approach because it is the approach most consistent with subchapter K of chapter 1 of the Code and the intended application of section 1061. Additionally, this approach is also the most administrable for taxpayers and the government.

To this end, the proposed regulations provide that if a partnership disposes of an asset, it is the partnership's holding period in the asset that controls. This includes the disposition of an API by the partnership. This result is consistent with the application of section 702(b) and Revenue Ruling 68-79 (1968-1 C.B. 310) which ruled that when a partnership sells a capital asset held by the partnership for over 6 months (the then-required holding period for long-term capital gains), a new partner takes into account his distributive share of gain from the sale as long-term capital gain notwithstanding that the

partner has not held its interest in the partnership long enough to qualify for long-term capital gain treatment if the partnership interest itself had been sold.

Section 741 provides that gain or loss on the sale of a partnership interest is considered as gain or loss from the sale or exchange of a capital asset except as otherwise provided in section 751. Therefore, the sale of a partnership interest generally follows an entity approach, as opposed to an aggregate approach. Following this approach, the proposed regulations provide that, except to the extent that the Lookthrough Rule described in §1.1061-4(b)(9) and section III.E.7 of this Explanation of Provisions, applies, the holding period that an API Holder has in an API is the applicable holding period upon the disposition of an API.

The proposed regulations also provide that 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 an asset or API has been held for the long-term holding period by applying those provisions as if the applicable holding period were three years instead of one year.

These proposed regulations also amend §1.1223-3 to clarify how to calculate the holding period of an API when the API comprises a portion of the partnership interest and the partnership interest has a divided holding period under §1.1223-3. This clarification applies to the calculation of all profits interests and all APIs. Section 1.1223-3(a) provides that a partnership has a divided holding period if portions of the interest are acquired at different times or the partner acquired portions of the partnership interest in exchange for property transferred at the same time but resulting

in different holding periods. The general rule in §1.1223-3(b)(1) is that the portion of the interest to which the holding period relates is determined by reference to a fraction, the numerator of which is the fair market value of the portion of the partnership interest received in the transaction to which the holding period relates, and the denominator of which is the fair market value of the entire partnership interest determined immediately after the acquisition transaction. In the case of the portion of a partnership interest that is comprised in part by one or more APIs or profits interests, the proposed regulations clarify the timing of this determination as to that portion to the time immediately before the disposition (as compared to the acquisition) of all or a part of the interest.

Accordingly, in the case of a partnership interest that has a divided holding period and the partnership interest includes a profits interests, the relative fair market of the profits interest is determined at the time of the interest's disposition (or partial disposition). The holding period of the portion of the interest that does not include the profits interest continues to be determined under §1.1223-3(b)(1). No inference is intended with respect to the valuation of a profits interest that fails to meet the safe harbor under Revenue Procedure 93-27 (as clarified in Revenue Procedure 2001-43).

7. Lookthrough Rule on Sale of APIs

Generally, these proposed regulations do not look through a partnership to its assets on the sale of a partnership interest. However, the proposed regulations include a limited Lookthrough Rule that may apply to the sale of an API with a holding period of more than three years for capital gain. In the case of a disposition of a directly held API with a holding period of more than three years, the Lookthrough Rule applies if the assets of the partnership in which the API is held meet the Substantially All Test. 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 for a gain and either 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 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 Lookthrough Rule does not apply to the disposition of an API if section 1061(d) applies.

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 §1.1061-4(b)(6) if disposed of by the partnership and have a holding period of three years or less. The determination of whether the substantially all test is met is made by expressing the value of a fraction as a percentage. The numerator of the fraction is equal to the aggregate fair market value of the partnership's assets that would produce capital gain or loss that is not described in §1.1061-4(b)(6) if disposed of by the partnership and that have a holding period of three years or less to the partnership as of the date of disposition of the API. The denominator is equal to the aggregate fair market value of the partnership's assets. Cash, cash equivalents, unrealized receivables under section 751(c), and inventory items under section 751(d) are not taken into account for purposes of the Substantially All Test.

In the case of a disposition of an API by an API Holder that is an Owner Taxpayer, all of the long-term capital gain recognized on the disposition is included in

the API One Year Disposition Amount. The amount included in the API Three Year Disposition Amount with respect to the disposition is the amount included in the API One Year Disposition Amount reduced by any adjustment amount required by the Lookthrough Rule. In the case of a disposition of an API by an API Holder that is a Passthrough Entity to which the Lookthrough Rule applies, the long-term capital gain recognized on the sale is included in the API One Year Distributive Share Amount calculated for the API Holders of the Passthrough Entity. Section 1.1061-4(a)(3) provides that the API Three Year Distributive Share Amount is reduced by the adjustment amount required by the Lookthrough Rule. The adjustment amount required by the Lookthrough Rule is either the capital gain recognized on the disposition of the API that is attributable to the assets whose fair market value is included in the numerator of the fraction used for the Substantially All Test, or, in the case of an API indirectly held through a Passthrough Entity for three years or less, the gain attributable to the API.

IV. Transfers to Related Parties

A. Recognition and Recharacterization

Under section 1061(d), if a taxpayer transfers an API to a related person described in section 1061(d)(2) in a transfer that would not otherwise be a taxable event, the taxpayer must include certain capital gain in gross income as short-term capital gain. The amount of gain required to be included as short-term capital gain is the excess of the net built-in long-term capital gain in assets held for three years or less attributable to the transferred interest, over the amount of long-term capital gain recognized on the transfer that is treated as short term capital gain under section

1061(a). If the transfer is otherwise taxable, section 1061(d) recharacterizes all or a portion of the capital gain otherwise recognized on the transfer as short-term capital gain. If the amount of capital gain otherwise recognized by the taxpayer on a taxable transfer is less than the amount required to be included under section 1061(d), the taxpayer must include the difference as short-term capital gain under section 1061(d). The proposed regulations refer to a related person described in section 1061(d)(2) as a Section 1061(d) Related Person.

One commentator suggested that the Treasury Department and the IRS suspend the application of section 1061(d) until Congress clarifies its application. The Treasury Department and the IRS do not believe a suspension is necessary. Rather, the Treasury Department and the IRS interpret section 1061(d)(1) to require that gain equal to the amount described in that section be recognized and included in income as short-term capital gain on the transfer of an API to a Section 1061(d) Related Person even if the transfer is not a transaction in which gain is otherwise recognized under the Code. The term transfer under the proposed regulations includes, but is not limited to, contributions, distributions, sales and exchanges, and gifts.

B. Section 1061(d) Related Person

Section 1061(d)(2) defines a related person to be a member of the taxpayer's family within the meaning of section 318(a)(1) or a person who performed a service within the current calendar year or the preceding three calendar years in any ATB in which or for which the taxpayer performed a service. The Conference Report describes a Section 1061(d) Related Person as a family member or colleague (or recent former colleague). Conference Report at 422. For these purposes, a taxpayer is the same

taxpayer used for computation purposes (as opposed to the taxpayer used for determining whether the elements of an API are met), that is, an Owner Taxpayer. The proposed regulations clarify that for a service provider to be treated as a Section 1061(d) Related Person, the service provider must provide services or have provided services in the same ATB to which the transferred API relates, that is, in the Relevant ATB. The proposed regulations also include within the definition of Section 1061(d) Related Person any Passthrough Entity to the extent that a Section 1061(d) Related Person holds an interest. The Treasury Department and the IRS request comments on how to calculate section 1061(d) gain when a Passthrough Entity is only partially a Related Person.

The proposed regulations provide that a contribution under section 721(a) to a partnership is not treated as a transfer to a Section 1061(d) Related Person because the proposed regulations require that under the principles of section 704(c) and §§1.704-1(b)(2)(iv)(f) and 1.704-3(a)(9) all Unrealized API Gains that would be directly or indirectly allocated to the API Holder at the time of contribution must be allocated to the API Holder contributing the interest when they are recognized. The Treasury Department and the IRS request comments on transfers other than section 721(a) contributions that satisfy the foregoing standard and that therefore should be excluded from section 1061(d).

The proposed regulations use the term “person” as the term is generally used under section 7701(a)(1). Section 7701(a)(1) defines “person” to include an individual, trust, estate, partnership, association, company, or corporation. Under the section 7701(a)(1) definition of person, for example, a management company could qualify as a

related person under section 1061(d)(2) because the management company would have performed a service in the same ATB in which the taxpayer had performed a service in the three years preceding the transfer.

C. Gain recharacterized by section 1061(d)

Section 1061(d)(1) requires the taxpayer to include as short-term capital gain the excess of the taxpayer's long-term capital gain with respect to such interest for such taxable year attributable to the sale or exchange of any asset held for not more than three years as is allocable to such interest over any amount treated as short-term capital gain with respect to the transfer of the interest under section 1061(a).

The proposed regulations provide that the long-term capital gain with respect to the transferred API attributable to the sale or exchange of any asset held not more than three years is the long-term capital gain that would be allocated to the transferred API if, immediately before the transfer, the partnership that issued the API had sold all of its assets held for three years or less for fair market value in a hypothetical sale. If the result is negative, the result is deemed to be zero and section 1061(d) does not apply.

The proposed regulations provide that if the basis of the transferred API in the transferee's hands is determined in whole or in part by the basis of the API in the transferor's hands before application of section 1061(d), then the basis of the transferred API shall be increased (before the application of section 1015(d), if applicable) by the capital gain included in gross income by the transferor solely by reason of section 1061(d). If an Owner Taxpayer transfers only a portion of an API, section 1061(d) applies only to the portion transferred.

V. Securities Partnerships

The proposed regulations include an amendment to §1.704-3(e)(3). Section 1.704-3(e)(3)(i) provides that for purposes of making reverse section 704(c) allocations, a securities partnership may aggregate gains and losses from financial assets using any reasonable approach that is consistent with the purpose of section 704(c). The proposed regulations amend §1.704-3(e)(3) to provide that an approach will not be considered reasonable if it fails to take into account the application of section 1061. Additionally, the proposed regulations provide that if the partnership aggregates gains and losses with respect to capital assets held for more than one year, for the partial netting approach in §1.704-3(e)(3)(iv) and the full netting approach in §1.704-3(e)(3)(v) to be considered reasonable, the partnership must establish separate accounts (1) for taking into account each API Holder's share of book API Gains and Losses and book Capital Interest Gains and Losses and (2) for determining each API Holder's share of tax API Gains and Losses and tax Capital Interest Gains and Losses. The proposed regulations do not include rules for dividing existing accounts to determine API Gains and Losses and Capital Interest Gains and Losses. However, the proposed regulations provide that the manner in which such accounts are apportioned must be reasonable. One method that the Treasury Department and the IRS have concluded is reasonable is to apportion existing accounts based on the relative API Gain or Loss amounts and Capital Interest Gain or Loss amounts that would be allocated to the API Holder as a result of a deemed liquidation of the partnership. The Treasury Department and the IRS request comments on whether further guidance on this issue is necessary for securities partnerships using the aggregation rules in §1.704-3(e)(3).

VI. Reporting Requirements

These proposed regulations provide that an Owner Taxpayer must report any information the Commissioner may require in forms, instructions or other guidance to evidence the taxpayer's compliance with section 1061. Under the proposed regulations, a Passthrough Entity in which an Owner Taxpayer holds its interest is required to provide the information needed by the Owner Taxpayer to comply with section 1061 and to determine its Recharacterization Amount. The Passthrough Entity is required to provide the Owner Taxpayer with the API One Year Distributive Share Amount and the API Three Year Distributive Share Amount. Additionally, the Passthrough Entity must provide the Owner Taxpayer with the adjustments that must be made to the Owner Taxpayer's distributive share of long-term capital gain or loss that would allow the Owner Taxpayer to independently calculate its API One Year Distributive Share Amount and its API Three Year Distributive Share amount. Consistent with §1.6001-1(a) and (e), if an Owner Taxpayer is not furnished its API One Year Distributive Share Amount, the IRS will treat the amount of the adjustments necessary to independently calculate the API One Year Distributive Share as zero and will also treat the API Three Year Distributive Share as zero to the extent information is not provided to the Owner Taxpayer and the Owner Taxpayer is not able to otherwise substantiate all or a part of those amounts to the satisfaction of the Secretary. For example, if the Owner Taxpayer is not furnished its API One Year Distributive Share Amount, the IRS will not take into account amounts that are excluded from section 1061 under §1.1061-1(b)(6) unless the Owner Taxpayer is furnished information regarding this amount or the Owner Taxpayer is otherwise able to substantiate this amount. Similarly, if the Owner Taxpayer is not furnished its API Three Year Distributive Share Amount, to the extent that the Owner

Taxpayer is also not furnished information regarding items that are not treated as long term capital gain or loss if paragraphs (3) and (4) of section 1222 required a three year holding period for long-term capital gain treatment, the IRS will treat the API Three Year Distributive Share Amount as zero if the taxpayer cannot otherwise substantiate this amount. An Owner Taxpayer that takes a position that is inconsistent with the information provided to it by a Passthrough Entity may have to attach Form 8082, "Notice of Inconsistent Treatment or Administrative Adjustment Request (AAR)," to its federal income tax return.

A Passthrough Entity that has an API Holder must report information to the API Holder to enable the API Holder to comply with the regulations under section 1061 as the Commissioner may require in forms, instructions, or other guidance. It is contemplated that the Passthrough Entity generally will be required to provide this information as an attachment to the Schedule K-1 furnished to the API Holder for the taxable year. The proposed regulations provide that this information includes (i) the API One Year Distributive Share Amount and the API Three Year Distributive Share Amount; (ii) long-term capital gains and losses allocated to the API Holder that are excluded from section 1061 under § 1.1061-4(b)(6); (iii) Capital Interest Gains and Losses allocated to the API Holder; (iv) API Holder Transition Amounts; and (v) in the case of a disposition by an API Holder of an interest in the Passthrough Entity during the taxable year, any information required by the API Holder to properly take the disposition into account under section 1061, including information regarding the application of Lookthrough Rule and information necessary to determine its Capital Interest Disposition Amount. Penalties will apply to a Passthrough Entity that fails to

comply with the reporting rules in these proposed regulations and as further required in forms, instructions or other guidance. See e.g., section 6698 (Failure to File Partnership Returns), section 6699 (Failure to File S Corporation Return), section 6722 (Failure to Furnish Correct Payee Statements).

A Passthrough Entity that holds an interest in a lower-tier entity may need information from the lower-tier entity to meet its reporting obligations under the proposed regulations. In this case, the Passthrough Entity must request information from any lower-tier entities in which it owns an interest by the later of the 30th day of the close of the calendar year or within 14 days after having received a request for information from an API Holder. The lower-tier entity must respond by the due date (including extensions) of the Schedule K-1 for the taxable year. The proposed regulations provide guidance regarding an upper-tier Passthrough Entity's reporting requirements if the lower-tier Passthrough Entity fails to report the required information to the upper-tier Passthrough Entity.

VII. Applicability Date

The proposed regulations generally provide that the final regulations apply to taxable years of Owner Taxpayers and Passthrough Entities beginning on or after the date final regulations are published in the **Federal Register**. However, except for the rules in the proposed regulations regarding Partnership Transition Amounts and API Holder Transition Amounts, Owner Taxpayers and Passthrough Entities may rely on the proposed regulations for taxable years beginning before the date final regulations are published in the **Federal Register** provided they follow the proposed regulations in their entirety) and in a consistent manner. In contrast, taxpayers may rely on the rules in the

proposed regulations regarding Partnership Transition Amounts and API Holder Transition Amounts for taxable years beginning in 2020 and subsequent taxable years beginning before the date final regulations are published in the **Federal Register**, and may do so without consistently following all of the rules provided in §§1.1061-1 through 1.1061-6 of these proposed regulations if the partnership treats capital gains and losses from the identified assets as Partnership Transition Amounts and API Holder Transition Amounts for the year in which the election is made and all subsequent taxable years beginning before the date final regulations are published in the **Federal Register**.

As indicated in section 4 of Notice 2018-18, proposed §1.1061-3(b)(2)(i), which provides that the term corporation does not include an S corporation, is proposed to apply to taxable years beginning after December 31, 2017. See section 7805(b)(3). Additionally, proposed §1.1061-3(b)(2)(ii), which provides that the term corporation does not include a PFIC with respect to which the shareholder has a QEF election under section 1295 in effect, is proposed to apply for taxable years beginning after [INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE **FEDERAL REGISTER**].

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 section 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 that has a year end 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)(1).

VIII. Request for Comments for Smaller Partnerships

Comments are requested on whether a simplified method for determining and calculating the API gain or loss should be provided for smaller partnerships and if so, the criteria that should be used to determine which partnerships should be eligible to use the simplified method. These comments should include comments and suggestions for a simplified method.

Special Analyses

I. Regulatory Planning and Review– Economic Analysis

Executive Orders 13771, 13563, and 12866 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, reducing costs, harmonizing rules, and promoting flexibility. The Executive Order 13771 designation for any final rule resulting from these proposed regulations will be informed by comments received. The preliminary Executive Order 13771 designation for this proposed rule is regulatory.

The proposed regulations have been designated by the Office of Information and Regulatory Affairs (OIRA) as subject to review under Executive Order 12866 pursuant

to the Memorandum of Agreement (MOA, April 11, 2018) between the Treasury Department and the Office of Management and Budget regarding review of tax regulations. It has been determined that the proposed rulemaking is significant under section 1(b) of the Memorandum of Agreement and thereby subject to review.

Accordingly, the proposed regulations have been reviewed by OMB.

A. Background

Section 1061 of the Internal Revenue Code, enacted by the TCJA, recharacterizes certain long-term capital gains recognized with respect to an API as short-term capital gains. Short-term capital gains are taxed at the ordinary income rate whereas long-term capital gains are generally taxed at a lower rate.

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 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 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.

B. Overview of the Proposed Regulations

The proposed regulations provide taxpayers with definitional and computational guidance regarding the application of section 1061. In particular, the proposed regulations provide a number of important 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 proposed regulations also provide rules for calculating the recharacterized gain amount and provide for a lookthrough rule with respect to the sale of APIs.

C. Economic Analysis

1. Baseline

The Treasury Department and the IRS have assessed the benefits and costs of the proposed regulations relative to a no-action baseline reflecting anticipated Federal income tax-related behavior in the absence of these proposed regulations.

2. Summary of Economic Effects

The proposed 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 proposed 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. Thus, lack of certainty may dissuade economically beneficial actions. An economic loss may also arise if all taxpayers have identical interpretations of the tax treatment of particular income streams under the statute but are more conservative (or less conservative) regarding the interpretation than Congress intended for these income streams. In this case, guidance provides value by bringing economic decisions closer in line with the intents and purposes of the statute.

The Treasury Department and the IRS solicit comments on the economic analysis of the proposed regulations. The Treasury Department and the IRS particularly solicit comments that provide data, other evidence, or models that could enhance the rigor of the analysis.

3. Economic Analysis of Specific Provisions

a. 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 1061.¹ 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 proposed 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 proposed 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 proposed 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 Treasury Department and the IRS estimate that approximately 22,750 Owner Taxpayers will be required to adjust Schedule D filings. There may be others who meet the definition of Owner Taxpayer but face no burden because they receive no capital gains allocations in relation to their API holdings. The proposed 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

¹ See comments from the American Bar Association available at: <https://www.americanbar.org/content/dam/aba/administrative/taxation/policy/032219comments.pdf>

loss to its owners. The Treasury Department and the IRS estimate there are approximately 30,000 Passthrough Taxpayers required to provide information to owner taxpayers who hold an API. 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 proposed 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.

b. 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 proposed 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 proposed regulations reduce uncertainty and compliance burdens for taxpayers entering into these transactions. The Treasury Department and the IRS have determined this exception is consistent with the purpose of section 1061, which applies to service providers and persons related to service providers and 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 is inconsistent with the purpose of section 1061 as unrelated purchasers did not receive their interest in connection with the performance of substantial services. Relative to the no-action baseline, the proposed guidance also provides clarity for taxpayers, improving economic efficiency as discussed in the Summary of Economic Effects.

c. 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.” Comments received by the Treasury Department and the IRS identify two sources of ambiguity with regard to this capital interest exception (see footnote 1).

First, there is uncertainty among taxpayers whether unrealized capital gains with respect to an API (unrealized API gains) can be converted to gains that would qualify for the capital interest exception. The proposed regulations clarify that unrealized API gains cannot be converted to gains that qualify for the capital interest exception. In the absence of this regulation, a significant share of taxpayers could potentially avoid section 1061 recharacterization when capital gains with respect to an API are realized if the partnership revalues assets prior to realization, and unrealized API gains are converted to gains that would qualify for the capital interest exception. A majority of owner taxpayers could use this avoidance strategy if it were available. The availability of this avoidance strategy would distort taxpayer behavior, incentivizing complex tiered ownership strategies, and distorting decisions to revalue assets. Furthermore, allowing this avoidance strategy would be contrary to the purposes of section 1061. The statute requires that the Secretary issue such regulations or other guidance as is necessary or appropriate to carry out the purposes of section 1061. Both the Conference Report and the Joint Committee on Taxation’s background on 1061, Joint Committee on Taxation, General Explanation of Public Law 115-97 (JCS-1-18) at 125 FN 542 (Dec. 20, 2018), specifically state that the statute requires that the Secretary issue regulations or other guidance to address the prevention of abuse of the purpose of the provision.

Second, 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. Comments received by the Treasury Department and the IRS identify this as a source of confusion among taxpayers with respect to section 1061 (see footnote 1). The proposed regulations clarify that allocations are deemed commensurate with capital contributed if they are made with respect to the taxpayer's capital account. The taxpayer's capital account includes realized but undistributed gains on contributed capital, and any contributions to capital made after the interest was received. In the absence of these regulations, taxpayers who have made capital contributions after the interest was initially received, or taxpayers who made a capital contribution that appreciated in value, might face confusion regarding their ability to include the additional contribution when determining the value of their capital interest. Further, partners with realized gains would be incentivized to engage in a series of inefficient transactions, first receiving a distribution reflecting those gains and then contributing the distributed amount back into the partnership in order to minimize tax.

The Treasury Department and the IRS considered alternative interpretations of "commensurate with capital contributed," including a narrow interpretation of the statute to mean only the value of capital contributed on the date the interest was initially received. However, it was determined that the interpretation presented in the proposed regulations is the only viable interpretation that accurately reflects the value of capital. Therefore, the proposed regulations provide helpful guidance and certainty for taxpayers but are not expected to result in any other economic effects.

d. 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. Comments received by the Treasury Department and the IRS highlight significant ambiguity, outlining multiple interpretations that would result in different amounts of gain recharacterized by taxpayers (see footnote 1).

Pursuant to its regulatory authority to prevent inappropriate avoidance of section 1061, the proposed regulations include a limited lookthrough rule that is applied to the sale of an API that has been held for more than three years at the time of the disposition. The Lookthrough Rule only applies if 80 percent or more of the value of the assets held by the partnership at the time of the API disposition are 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 applies, a percentage of the gain or loss on the disposition of the API that is included in the one year disposition amount is not included in the three year disposition amount.

The calculations required by the Lookthrough Rule will impose some additional compliance burden on individual taxpayers selling an API. The rules requiring

partnerships to furnish taxpayers with the relevant information to perform the calculations will also impose additional burden on the relevant partnerships. The Treasury Department and the IRS believe only a small fraction of API holders will be affected by these requirements in any year. This rule has limited applicability because it only applies to taxpayers that sell their interest during the taxable year and that at the time of the sale have held their API more than three years. Additionally, 80 percent of the value of the assets of the partnership in which the API being sold is held must have a holding period to the partnership that is three years or less. The Treasury Department and the IRS have determined that the Lookthrough Rule is necessary to prevent inappropriate avoidance of section 1061.

The Treasury Department and the IRS considered and rejected alternative approaches outlined in received comments, including applying an interest approach with no Lookthrough Rule, and an underlying assets approach. The interest approach with no Lookthrough Rule looks solely to the holding period in the API, regardless of the holding period of the assets held by the partnership that would produce capital gain or loss on disposition. This approach would 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. 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 held an asset that it sold.

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 proposed regulations only apply the Lookthrough Rule if substantially all of the partnership's assets by value are assets held for three years or less and that would produce on disposition capital gain or loss not described in §1.1061-4(b)(6). The underlying asset approach would be more difficult (and burdensome) for taxpayers to apply 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. We anticipate many taxpayers would be able to avoid burdensome valuation of assets and identification of holding periods under the limited Lookthrough rule but would be required to value each asset under the full Lookthrough rule.

II. Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking is in §1.1061-4(b)(7) and §1.1061-6.

A. Collection of Information regarding election to exclude Partnership Transition

Amounts in § 1.1061-4(b)(7)

The collection of information in proposed §1.1061-4(b)(7) requires a partnership that chooses to elect to exclude Partnership Transition Amounts from section 1061 to complete a statement making the election and to file the election with its federal tax return for the first taxable year that it treats amounts as Partnership Transition Amounts. It also requires the partnership, by the due date of the election, to clearly and

specifically identify in its books and records the assets held by the partnership for more than three years as of the effective date of section 1061. This information is necessary for the IRS to determine whether the partnership has made the election and whether the partnership is correctly reporting capital gains and losses from all of the assets subject to the election.

1. Collection of information on an existing form

The partnership is required to attach the election statement to the Form 1065 filed for the partnership for the first taxable year that the partnership treats amounts as partnership transition amounts. For purposes of the Paperwork Reduction Act, the reporting burden associated with filing the election will be reflected in the Paperwork Reduction Act Submissions associated with Form 1065 (OMB 1545-0123).

2. Collection of Information not on an existing form

A partnership that elects to exclude Partnership Transition Amounts must maintain adequate books and records to verify that (i) the partnership's list of identified assets properly includes all assets that it has held for more than three years as of December 31, 2017; (ii) the partnership has treated all capital gains and losses from the sale of the identified assets consistent with proposed §1.1061-4(b)(7); and, (iii) amounts allocated to API Holders have been determined consistent with §1.1061-4(b)(7). This collection of information in §1.1061-4(b)(7) is mandatory for taxpayers seeking to treat certain long-term capital gains as Partnership Transition Amounts. Partnerships seeking to rely on the exception from section 1061 for Partnership Transition Amounts are generally hedge funds and private equity funds that would have held one or more capital assets more than three years as of December 31, 2017. The making a list of

assets subject to the election is a one-time requirement. Annually, the partnership must maintain sufficient records to demonstrate that long-term capital gains and losses from the disposition of the identified assets have been treated consistent with the requirements of §1.1061-4(b)(7) and that API Holder Transition Amounts have been determined as provided in §1.1061-4(b)(7). The information required to be maintained will be used by the IRS for tax compliance purposes. Estimates with respect to this recordkeeping burden are --

Estimated total annual reporting burden: 34,375 hours

Estimated average annual burden hours per respondent: 2.75

Estimated average cost per respondent (in 2017 dollars): \$261.31

Estimated number of respondents: 12,500

Estimated annual frequency of responses: Once

Based on these estimates, the annual three-year reporting burden for those electing to exclude Partnership Transition Amounts from section 1061 is \$261.31 (in 2017 dollars).

These estimates are based on the assumption that only a small number of hedge funds would have held assets more than three years as of December 31, 2017. We anticipate that the majority of private equity funds that were in existence for three years as of December 31, 2017 will make the election. Private equity funds that were not in existence as of December 31, 2017 will not need to make the election. Once the election is made, electing funds will have to retain records to evidence compliance with §1.1061-4(b)(7).

Comments on the collection of information that results from the recordkeeping requirement in § 1.1061-4(b)(7) should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T: SP, Washington, DC 20224.

Comments on the collection of information should be received by **[INSERT DATE 60 DAYS AFTER THE DATE OF THE FILING OF THIS DOCUMENT FOR PUBLIC INSPECTION WITH THE OFFICE OF THE FEDERAL REGISTER.]**

Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the performance of duties of the IRS, including whether the information will have practical utility;

The accuracy of the burden estimate associated with the proposed collection of information (including underlying assumptions and methodology);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance and purchase of services to provide information.

B. Collection of information in § 1.1061-6(a) on the Owner Taxpayer is on existing forms

The collection of information in proposed §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 §§1.1061-1 through 1.1061-5 of the proposed 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 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 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 will be 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 proposed regulations. No burden estimates specific to the proposed 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 proposed regulations. Those estimates would capture both changes made by the TCJA and those that arise out of discretionary authority exercised in the proposed 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 the proposed regulations. In addition, when available, drafts of IRS forms are posted for comment at www.irs.gov/draftforms.

Form	Type of Filer	OMB Number(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 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.

C. Collection of information on Passthrough Entities in § 1.1061-6(b) and (c) on existing forms

1. Passthrough Entities

The collection of information in proposed §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)(6); (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 to apply the Lookthrough Rule and to determine its Capital Interest Disposition Amount. The proposed 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 proposed 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 proposed 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 proposed 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 proposed 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 3.157 billion hours and total estimated monetized costs of \$58.148 billion (in 2017 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 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 proposed regulations.

With the exception of the burden estimate provided with respect to the recordkeeping requirement related to the Partnership Transition amount election in §1.1061-4(b)(7), no burden estimates specific to the proposed 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 proposed regulations. Those estimates would capture both changes made by the TCJA and those that arise out of the discretionary authority exercised in the proposed 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 proposed 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 Number(s)	Status
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	Type of Filer	OMB Number(s)	Status
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.
			Link: https://www.federalregister.gov/documents/2018/05/23/2018-10981/proposed-collection-comment-request-for-form-1099-div

D. 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 above, 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 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

E. 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

It is hereby certified that these 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 (5 U.S.C. chapter 6). 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 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.

Even if a substantial number of small entities are affected, the economic impact of these regulations on small entities is not likely to be significant. The proposed 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 held 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 tax year. 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.

Notwithstanding this certification, the Treasury Department and the IRS invite comments on any impact this rule would have on small entities.

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.

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>.

Comments and Requests for a Public Hearing

Before these proposed amendments to the regulations are adopted as final regulations, consideration will be given to comments that are submitted timely to the IRS as prescribed in the preamble under the “**ADDRESSES**” section. The Treasury

Department and the IRS request comments on all aspects of the proposed regulations. Any electronic comments submitted, and to the extent practicable any paper comments submitted, will be made available at www.regulations.gov or upon request.

A public hearing will be scheduled if requested in writing by any person who timely submits electronic or written comments. Requests for a public hearing are also encouraged to be made electronically. If a public hearing is scheduled, notice of the date and time for the public hearing will be published in the Federal Register.

Announcement 2020-4, 2020-17 IRB 1, provides that until further notice, public hearings conducted by the IRS will be held telephonically. Any telephonic hearing will be made accessible to people with disabilities.

Drafting Information

The principal author of these proposed regulations is Kara Altman 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.

Proposed Amendment to the Regulations

Accordingly, 26 CFR Part 1 is proposed to be amended as follows:

PART 1-- INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding entries in numerical order to read in part as follows:

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

Sections 1.1061-0 through 1.1061-6 are added under 26 U.S.C. 1061(f). * * *

Par. 2. Section 1.702-1 is amended by adding a new sentence at the end of paragraph (a)(2) to read as follows.

§1.702-1 Income and credits of partner.

(a) * * * * *

(2) * * * Each partner subject to section 1061 shall take into account gains and losses from sales of capital assets held for more than one year as provided in that section and §§1.1061-0 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 the date the Treasury decision adopting these proposed regulations as final regulations is published in the **Federal Register**.

Par. 3. Section 1.704-3 is amended by:

1. Redesignating paragraphs (e)(3)(vii), (viii), and (ix) as paragraphs (e)(3)(viii), (ix), and (x), respectively;
2. Adding new paragraph (e)(3)(vii);
3. Revising the heading and first sentence of paragraph (f) and adding a new sentence to the end of paragraph (f).

The additions and revisions read as follows:

§1.704-3 Contributed property.

* * * * *

(e) * * *

(3) * * *

(vii) Application of section 1061--(A) In general. A partnership that is combining gains and losses from qualified financial assets under this paragraph (e)(3) will not be considered to be using a reasonable method if that method fails to take into account the application of section 1061 in an appropriate manner. If a partnership uses the partial netting approach described in paragraph (e)(3)(iv) of this section or the full netting approach described in paragraph (e)(3)(v) of this section (or another otherwise reasonable approach), the approach will not be considered reasonable if it does not appropriately take into account the application of section 1061 to any person who directly or indirectly holds an applicable partnership interest (API) (as defined in §1.1061-1(a)). To this end, if a partnership uses the partial or full netting approach, the partnership must establish appropriate accounts for the purpose of taking into account its book Unrealized API Gains and Losses and API Gains and Losses (as defined in §1.1061-1(a)) separate from the book Capital Interest Gains and Losses (as defined in §1.1061-1(a)) of an API Holder (as defined in §1.1061-1(a)) and determining the API Holder's share of taxable gains and losses that are API Gains and Losses and Capital Interest Gains and Losses.

(B) Transition Rule. If an API Holder holds an interest in a partnership as of January 1, 2018, the partnership may use any reasonable method to apportion existing accounts for the purpose of determining an API Holder's share of book Unrealized API Gains and Losses, API Gains and Losses, and book Capital Interest Gains and Losses and for determining an API Holder's share of tax API Gains and Losses and tax Capital Interest Gains and Losses.

* * * * *

(f) Applicability dates. With the exception of paragraphs (a)(1), (a)(8)(ii), (a)(8)(iii), (a)(10), (a)(11), and (e)(3)(vii) 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 restatements pursuant to §1.704-1(b)(2)(iv)(f) on or after December 21, 1993. * * * Paragraph (e)(3)(vii) of this section applies to taxable years beginning on or after the date the Treasury decision adopting these proposed regulations as final regulations is published in the **Federal Register**.

Par. 4. Sections 1.1061-0 through 1.1061-6 are added to read as follows:

§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 as an API.

(ii) Unrealized API Gains and Losses.

(A) Long-term Unrealized API Gains and Losses become API Gains and Losses.

(B) Requirement to determine 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 each 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 and Passthrough Interest Capital Allocations.

(i) Allocations made in the same manner.

(ii) Capital accounts.

(A) In general.

(B) Tiers.

(C) Proceeds of partnership or partner loans not included in capital account.

(iii) Items that are not included in Capital Interest Allocations or Passthrough Interest Capital Allocations.

(4) Capital Interest Allocations.

(5) Passthrough Interest Capital Allocations.

(i) In general.

(ii) Passthrough Capital Allocations.

(iii) Passthrough Interest Direct Investment Allocations.

(6) Capital Interest Disposition Amounts.

(i) In general.

(ii) Determination of the Capital Interest Disposition Amount.

(7) Examples.

(d) Partnership interest acquired by purchase by an unrelated taxpayer.

(1) Taxpayer is not a Related Person.

(2) Section 1061(d) not applicable.

(3) Taxpayer not a service provider.

(e) Application of section 1061(b). [Reserved]

(f) Applicability date.

(1) General rule.

(2) Section 1.1061-3(b)(2)(i) exception.

(3) Section 1.1061-3(b)(2)(ii) exception.

§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 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 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) Installment sale gain.

- (4) 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
- (5) 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.
- (6) Items not taken into account for purposes of section 1061.
- (7) API Holder Transition Amounts not taken into account.
 - (i) In general.
 - (ii) API Holder Transition Amount.
 - (iii) Partnership Transition Amounts and Partnership Transition Amount Election.
- (8) Holding period determination.
 - (i) Determination of holding period for purposes of Three Year Gain Amount.
 - (ii) Relevant holding period.
- (9) Lookthrough Rule for certain API dispositions.
 - (i) Determination that the Lookthrough Rule Applies.
 - (ii) Application of the Lookthrough Rule.
- (10) Section 83.
 - (c) Examples.
 - (1) Computation examples.
 - (2) Special rules examples.

(d) Applicability date.

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

(a) In general.

(b) Transfer.

(c) Application of paragraph (a) of this section.

(1) Determination of amounts included in paragraph (a)(1) of this section.

(2) Application to an otherwise taxable transfer.

(d) Basis of interest increased by additional gain recognized

(e) Section 1061(d) Related Person

(1) In general.

(2) Exception.

(f) Examples.

(g) Applicability date.

§1.1061-6 Reporting rules.

(a) Owner Taxpayer Filing Requirements.

(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.

(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) 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.

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, 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.

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

- (1) The API One Year Distributive Share Amount as defined in §1.1061-4(a)(3)(i);
- (2) The API Three Year Distributive Share Amount as defined in §1.1061-4(a)(3)(ii);
- (3) The API One Year Disposition Amount as defined in §1.1061-4(a)(4)(i);
- (4) The API Three Year Disposition Amount as defined in §1.1061-4(a)(4)(ii); and
- (5) Capital gains or losses from the disposition of Distributed API Property.

API Holder is a person who holds an API.

API Holder Transition Amount has the meaning provided in §1.1061-4(b)(7)(ii).

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 Interest Allocations has the meaning provided in §1.1061-3(c)(4).

Capital Interest Disposition Amount has the meaning provided in §1.1061-3(c)(6).

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--

(1) Investing in (or disposing of) Specified Assets (or identifying Specified Assets for such investing or disposition), or

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

Lookthrough Rule has the meaning provided 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).

Partnership Transition Amount has the meaning provided in §1.1061-4(b)(7)(iii).

Passthrough Capital Allocations has the meaning provided in §1.1061-3(c)(5)(ii).

Passthrough Entity means a partnership, an 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 Interest Capital Allocations has the meaning provided in §1.1061-3(c)(5)(i).

Passthrough Interest Direct Investment Allocations has the meaning provided in §1.1061-3(c)(5)(iii).

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) Related Person has the meaning provided in §1.1061-5(e).

Specified Actions means Raising or Returning Capital Actions and Investing or Developing Actions.

Specified Assets means--

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

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

(3) Real estate held for rental or investment;

(4) Cash or cash equivalents; and

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

(6) Specified Assets include options or derivative contracts with respect to any of the foregoing.

Substantially All Test has the meaning provided in §1.1061-4(b)(9)(i)(C).

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

Unrealized API Gains and Losses means 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. Unrealized API Gains and Losses include--

(1) Unrealized capital gains and losses that are allocated to the API Holder with respect to the API pursuant to a capital account revaluation under §1.704-1(b)(2)(iv)(f) or §1.704-1(b)(2)(iv)(s);

(2) In the case of a Passthrough Entity that contributes property to another Passthrough Entity, unrealized capital gains and losses that would be allocated to the API Holder with respect to the API if the property contributed by the upper-tier Passthrough Entity to the lower-tier Passthrough Entity were sold immediately before the contribution for the amount that is included in the lower-tier partnership's capital account or, in the case of another type of lower-tier Passthrough Entity, a similar account maintained under §1.1061-3(c)(3)(ii) with respect to the contributed property; and

(3) In the case of a revaluation of the property of a partnership that is the owner of a tiered structure of partnerships or in the case of the contribution of an API to another Passthrough Entity, an API Holder's Unrealized API Gains or Losses at the time of the revaluation or contribution include those capital gains or losses that would be

allocated directly or indirectly to the API Holder by the lower-tier partnerships as if a taxable disposition of the property of each of the lower-tier partnerships also occurred on the date of the revaluation or contribution under the principles of §1.704-1(b)(2)(iv)(f). See §1.1061-2(a)(1)(ii)(B).

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

(b) Applicability date. The provisions of this section apply to taxable years of Owner Taxpayers and Passthrough Entities beginning on or after the date the Treasury decision adopting these regulations as final regulations is published in the **Federal Register**.

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

(a) API rules and examples--(1) Rules--(i) An API remains as 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) Unrealized API Gains and Losses--(A) Long-term Unrealized API Gains and Losses become API Gains and Losses. Long-term 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.

(B) Requirement to determine Unrealized API Gains and Losses. In the case of a revaluation of the property of a partnership that owns a tiered structure of partnerships, or in the case of the contribution of an API to another Passthrough Entity, Unrealized API Gains and Losses included in the fair market value of the property held by all relevant partnerships in the tiered structure as of the date of the revaluation or contribution that are directly or indirectly allocable to the API Holder must be determined under principles similar to §1.704-1(b)(2)(iv)(f). If a partnership is required to revalue its assets for purposes of section 1061 under this paragraph, such partnership is permitted to revalue its property for purposes of section 704 as though an event in §1.704-1(b)(2)(iv)(f)(5) had occurred. Unrealized API Gains and Losses of a partnership that become API Gains and Losses under paragraph (a)(1)(ii)(A) of this section must be allocated to the API Holder under principles similar to §1.704-3(a)(9).

(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.

(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 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 Code or any part of 26 CFR (including §301.7701-3 of this chapter) are disregarded for purposes of §§1.1061-1 through 1.1061-6.

(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 an interest in the net profits of PRS to A in connection with A's performance of services in A's ATB and with respect to PRS. 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. 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, A and B each hold an Indirect API because A and B now indirectly hold their APIs 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 interests in GP represents an indirect interest in an API. See §1.1061-5 regarding the potential application of section 1061(d) to this example.

(iii) Example 3. Passthrough Interest, Indirect API, Passthrough Taxpayer. A, B, and C each provide services to and are equal partners of GP. GP is the general partner of PRS. GP is engaged in an ATB, as defined in §1.1061-1(a), and provides management services to PRS. In connection with GP's performance of services in an ATB, an interest in the net profits of PRS is transferred to GP. Because its interest in PRS's net profits was transferred to GP in connection with GP's services in an ATB, GP is a Passthrough Taxpayer. Therefore, 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 as a result of GP's API in PRS. A, B, and C are treated as the Owner Taxpayers because they are partners in GP, a Passthrough Taxpayer, and also because they indirectly hold an API in PRS in connection with the performance of their 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 provides substantial management services to PRS, a partnership. Additionally, S Corp is the general partner

of PRS. A provides substantial services in S Corp's ATB. In connection with S Corp's performance of services to PRS, an interest in the net profits of PRS is transferred to S Corp. S Corp's interest in PRS is its only asset. Because its interest in PRS's net profits was transferred 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 Party and Passthrough Taxpayer. A, B, and C are equal partners of GP, a partnership. GP is the general partner of PRS. GP's Specified Actions by themselves do not satisfy the ATB Activity Test under §1.1061-1(a) and as a result, GP's actions do not establish an ATB. GP is required under PRS's partnership agreement to provide management services to PRS, either by itself or through a delegate. GP enters into an agreement with Management Company, a partnership, to provide services to PRS, and Management Company is paid reasonable compensation for such services. Management Company is related to GP within the meaning of sections 267(b) and 707(b). Management Company provides management services on behalf of GP to PRS and is engaged in an ATB. GP also is in an ATB because Management Company's actions are attributed to GP as GP's delegate. An interest in the net profits of PRS is transferred to GP in connection with Management Company's services to PRS. Because its interest in the net profits of PRS is transferred 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. See also §§1.1061-2(b)(1)(i)(C)(2) and 1.1061-2(b)(2)(v), Example 5.

(b) Application of the ATB Activity Test--(1) In general. 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.

(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 by 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.

(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 Party 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.

(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 alone satisfy the ATB Activity Test. Therefore, 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 spent all of A's time on 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. A did not take Investing or Developing actions during the taxable year. A's Raising or Returning Capital Actions alone satisfy the ATB Activity Test. 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 the 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 the date the Treasury decision adopting these regulations as final regulations is published in the **Federal Register**.

§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. Except as provided in paragraph (b)(2) of this section, 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)(4) of this section, Passthrough Interest Capital Allocations that meet the requirements of paragraph (c)(5) of this section, and Capital Interest Disposition Amounts that meet the requirements of paragraph (c)(6) of this section.

(3) General rules for determining Capital Interest Allocations and Passthrough Interest Capital Allocations--(i) Allocations made in the same manner. Only allocations that are made in the same manner to all partners can be Capital Interest Allocations or Passthrough Interest Capital Allocations. In general, allocations will be considered to be made in the same manner if, under the partnership agreement, the allocations are based on the relative capital accounts of the partners (or owners in the case of a Passthrough Entity that is not a partnership) receiving the allocation and the terms, priority, type and level of risk, rate of return, and rights to cash or property distributions during the partnership's operations and on liquidation are the same. 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. Further, an allocation to an API

Holder will not fail to qualify because it is not reduced by the cost of services provided by the API Holder or a Related Person to the partnership.

(ii) Capital accounts—(A) In general. Capital Interest Allocations and Passthrough Interest Capital Allocations must be based on an API Holder's relative capital account balance in a Passthrough Entity. In the case of a partnership that maintains capital accounts under §1.704-1(b)(2)(iv), the allocation must be tested under paragraph (c)(3)(i) of this section based on that 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), the account will be treated as a capital account for purposes of this paragraph (c) and an allocation must be tested under paragraph (c)(3)(i) of this section based on those accounts.

(B) Tiers—(1) Passthrough Capital Allocations. Generally, Passthrough Capital Allocations must be based on each owner's share of the Passthrough Entity's capital account in the entity making the Capital Interest Allocations described under paragraph (c)(4) of this section to the Passthrough Entity unless the exception in paragraph (c)(3)(ii)(B)(3) of this section applies.

(2) Passthrough Interest Direct Investment Allocations. Generally, Passthrough Interest Direct Investment Allocations must be based on each Owner Taxpayer's or Passthrough Taxpayer's relative capital account balance in the Passthrough Entity holding the investments, reduced by that owner's share of a capital account held directly

or indirectly by the Passthrough Entity in a lower-tier entity unless the exception in paragraph (c)(3)(ii)(B)(3) of this section applies.

(3) Aggregate Allocation of Passthrough Interest Capital Allocations. A Passthrough Entity that allocates all Passthrough Interest Capital Allocations for the taxable year in the aggregate regardless of whether they are Passthrough Capital Allocations or Passthrough Interest Direct Investment Allocations may make those allocations based on each Owner Taxpayer's or Passthrough Taxpayer's relative capital account balance in the Passthrough Entity rather than under paragraph (c)(3)(ii)(B)(1) and (2) of this section.

(C) Proceeds of partnership or partner loans not included in capital account. For purposes of §§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 or the partnership (or any Related Person with respect to any such other partner or the partnership). However, the 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 loan described in this paragraph.

(iii) Items that are not included in Capital Interest Allocations or Passthrough Interest Capital Allocations. Capital Interest Allocations and Passthrough Interest Capital Allocations do not include –

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

(B) Partnership Transition Amounts described in §1.1061-4(b)(7)(iii); or

(C) Items that are not taken into account for purposes of section 1061 under §1.1061-4(b)(6).

(4) Capital Interest Allocations. Capital Interest Allocations are allocations of long-term capital gain or loss made under the partnership agreement to an API Holder and to Unrelated Non-Service Partners based on their respective capital account balances that meet the requirements in paragraph (c)(4)(i), (ii), and (iii) of this section.

(i) Allocations are made in the same manner to API Holders and Unrelated Non-Service Partners;

(ii) The allocations are made to Unrelated Non-Service Partners with a significant aggregate capital account balance. An aggregate capital account balance equal to 5 percent or more of the aggregate capital account balance of the partnership at the time the allocations are made will be treated as significant. Allocations to more than one Unrelated Non-Service Partner may be aggregated for determining significance if such allocations are made in the same manner to each of the Unrelated Non-Service Partners; and

(iii) The allocations to the API Holder and the Unrelated Non-Service Partners are clearly identified both under the partnership agreement and on the partnership's books and records as separate and apart from allocations made to the API Holder with respect to its API, and both the partnership agreement and the partnership's books and records clearly demonstrate that the requirements of paragraphs (c)(3) and (c)(4) of this section have been met.

(5) Passthrough Interest Capital Allocations—(i) In general. Passthrough Interest Capital Allocations are made by Passthrough Entities that hold an API in a lower-tier

Passthrough Entity. Passthrough Interest Capital Allocations can be either Passthrough Capital Allocations as determined under paragraph (c)(5)(ii) of this section or Passthrough Interest Direct Investment Allocations as determined under paragraph (c)(5)(iii) of this section.

(ii) Passthrough Capital Allocations. Passthrough Capital Allocations are Capital Interest Allocations that are made directly or indirectly to the Passthrough Entity by a lower-tier entity and that are allocated by the Passthrough Entity among its direct owners in the same manner (as provided in paragraph (c)(3)(i) of this section) with respect to each owner's capital account as determined under paragraph (c)(3)(ii) of this section.

(iii) Passthrough Interest Direct Investment Allocations. Allocations are treated as Passthrough Interest Direct Investment Allocations if--

(A) The allocations solely are comprised of long-term capital gain and loss derived from assets (other than an API) directly held by the Passthrough Entity; and

(B) Allocations are made in the same manner (as provided in paragraph (c)(3)(i) of this section) based on each direct owner's capital account as determined under paragraph (c)(3)(ii) of this section.

(6) Capital Interest Disposition Amounts--(i) In general. The term Capital Interest Disposition Amount means the amount of long-term capital gain and loss recognized on the sale or disposition of all or a portion of a Passthrough Interest that may be treated as Capital Interest Gain or Loss. The amount of long-term capital gain or loss that is recognized on the sale or disposition is determined under federal tax law (see, for example, sections 741 and 751, and §1.61-6) and the holding period of the Passthrough

Interest is determined as provided in §1.1061-4(b)(8). 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 these rules 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.

(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 were sold for their fair market value in a fully taxable transaction (deemed liquidation) immediately before the disposition of the Passthrough Interest. To calculate this in tiered entities, determine the long-term capital gain or loss from a lower-tier Passthrough Entity.

(B) Second, determine the sum of the amount of Capital Interest Gain or Loss from the deemed liquidation that is allocated to the Passthrough Interest (or the portion of the Passthrough Interest sold) as Capital Interest Allocations under paragraph (c)(4) of this section and Passthrough Interest Capital Allocations under paragraph (c)(5) of this section. To calculate this in tiered entities, determine the capital gain or loss from a lower-tier Passthrough Entity .

(C) If the transferor recognized long-term capital gain upon disposition of the Passthrough Interest and only capital losses are allocated to the Passthrough Interest under paragraph (c)(6)(ii)(B) of this section from the deemed liquidation, then 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 capital gain is allocated to the Passthrough Interest under paragraph (c)(6)(ii)(B) of this section, then all the long-term capital loss is API Loss.

(D) If paragraph (c)(6)(ii)(C) of this section does not apply, 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)(6)(ii)(B) of this section, and the denominator of which is the amount of long-term capital gain determined under paragraph (c)(6)(ii)(A) of this section. Alternatively, if 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)(6)(ii)(B) of this section, and the denominator of which is the amount of long-term capital loss determined under paragraph (c)(6)(ii)(A) of this section.

(E) In applying these rules, 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).

(7) Examples. The rules of this paragraph (c) are illustrated by the following examples. For purposes of these examples, unless stated otherwise, A, B, and C are

equal partners of GP, a partnership. GP is the general partner of PRS, a partnership. The other partners of PRS are Unrelated Non-Service Partners. GP's and PRS's partnership agreements both require that the partnership determine and maintain capital accounts under §1.704-1(b)(2)(iv). GP holds an API in PRS that entitles GP to 20 percent of PRS's net profits. GP's API in PRS is an Indirect API as to each of A, B, and C. In addition, A, B, and C contributed \$100 each to GP in exchange for their interests in GP.

(i) Example 1. Capital Interest Allocations--(A) Facts. GP contributed 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. PRS's partnership agreement allocates 20% of its net profits to GP with respect to its API (20% API allocation). The partnership agreement allocates the 80% of net profits remaining after the 20% API allocation to the partners pro rata (including GP) based on their relative capital account balances (Investment Allocations). Under PRS's partnership agreement, Investment Allocations to the partners, both to GP and to the Unrelated Non-service Partners, have the same priority, type and level of risk, and rate of return. Additionally, all of the partners have the same rights to cash or property distributions with respect to the Investment Allocations during the partnership's operations and on liquidation. GP's capital account balance comprises 2% of PRS's total capital account balance and the capital accounts of the Unrelated Non-service Partners receiving the Investment Allocations comprise the other 98% of PRS's total capital account balance. During the taxable year, PRS has \$10,000 of net capital gain. It allocates \$2,000 of net capital gain to GP based on its API allocation providing for a 20% interest in net profits ($\$10,000 \times 20\%$). Additionally, GP receives a 2% Investment Allocation from PRS, or \$160 of net capital gain ($\$8,000 (\$10,000 - \$2,000) \times 2\%$). In total, PRS allocates \$2,160 of net capital gain to GP for the taxable year. GP allocates \$720 ($\$2,160/3$) of this net capital gain to each of A, B, and C. The allocation received by GP from PRS is allocated among the partners of GP pro rata based on their share of the capital account that GP has in PRS.

(B) Capital Interest Allocations Analysis. GP's 2% Investment Allocation of \$160 of net capital gain is a Capital Interest Allocation. Other than GP, PRS's partners are Unrelated Non-Service Providers. GP is an API Holder. Under PRS's partnership agreement, the Investment Allocation is made pro rata to GP (an API Holder) and each of the Unrelated Non-Service Partners based on their relative capital account balances and the allocations are made in the same manner. Further, because allocations are made in the same manner with respect to each Unrelated Non-Service Partner's capital account, the capital account balances of the Unrelated Non-service Partners can be aggregated to determine if the allocations to the Unrelated Non-Service Partners are

significant. The capital accounts of the Unrelated Non-Service Partners are significant because they equal 98% of the aggregate capital account balance of PRS at the time the allocations are made. Accordingly, the Investment Allocation to GP, the API Holder, is treated as a Capital Interest Allocation. GP's API allocation of \$2,000 of net capital gain is not a Capital Interest Allocation because it is made irrespective of the balance of GP's capital account. Therefore, the API allocation is not made in the same manner as any allocation to an Unrelated Non-Service Partner.

(C) Passthrough Interest Capital Allocation Analysis. GP is allocated \$160 of Capital Interest Allocations by PRS. This amount is allocated to A, B, and C pro rata and in the same manner based on their shares of GP's capital account in PRS. As such, they qualify as Passthrough Capital Allocations by GP. In addition, GP holds an API in PRS and is allocated \$2,000 gain from PRS with respect to its API. This gain is API Gain when allocated by GP to its partners and cannot be treated as a Passthrough Capital Allocation by GP. In summary, A, B, and C are each allocated \$720 of long-term capital gain from PRS ($\$2,160/3$). Of this amount, \$667 is API Gain ($\$2,000/3$) and \$53 is a Passthrough Interest Capital Allocation ($\$160/3$).

(ii) Example 2. Passthrough Interest Direct Investment Allocation—(A) Facts. The facts are the same as in Example 1, except that GP does not contribute any of the \$300 contributed to GP by A, B, and C to PRS. Thus, GP's capital account in PRS is \$0. Each of A, B, and C have a \$100 capital account balance in GP. GP invests the contributed \$300 in assets held directly by GP. Under the terms of GP's partnership agreement, long-term capital gains and losses from assets (other than an API) held directly by GP are allocated in the same manner to the partners of GP based on their relative capital accounts in GP less amounts that are included in the capital account of a lower-tier Passthrough Entity in which GP holds an interest. For the taxable year, GP receives an allocation of \$2,000 of net capital gain with respect to the API GP holds in PRS. Additionally, GP earns \$30 on the assets it holds directly. GP allocates \$677 to each of A, B, and C for the taxable year.

(B) Analysis. Of the \$677 allocated to each of A, B, and C, \$667 is an allocation of API Gain because it is an allocation of gain received with respect to GP's API in PRS. The remaining \$10 allocated to A, B, and C was earned from assets which GP, a Passthrough Entity, holds directly. The \$30 was allocated in the same manner, based on the respective capital account balances of A, B, and C in GP, as determined under paragraph (c)(3)(ii) of this section. Thus, the \$10 allocated to each of A, B, and C is treated as a Passthrough Interest Direct Investment Allocation.

(iii) Example 3. Aggregate Allocation of Passthrough Interest Capital Allocations--(A) Facts. The facts are the same as in Example 2, except that C is not a partner. A and B each contribute \$100 to GP. GP contributes the \$200 contributed by A and B to PRS, which entitles GP to a 1.5% Investment Allocation in PRS. One month later, C contributes \$100 to GP for a one-third interest in GP. GP does not contribute the \$100 contributed by C to PRS but instead invests the \$100 directly. GP's partnership agreement allocates all items to the partners pro rata, based on their percentage

interests, as represented by their capital account balances in GP. For the taxable year, GP receives an allocation of \$2,000 of net capital gain with respect to the API GP holds in PRS. Additionally, GP receives an Investment Allocation from PRS of \$120 of net capital gain. In sum, GP is allocated \$2,120 of net capital gain from PRS. GP earns \$30 on the assets it holds directly.

(B) Analysis. GP allocates \$667 of the API Gain to each of A, B, and C, which remains an allocation of API Gain. GP allocates \$150 (\$120 Capital Interest Allocation which GP received from PRS, plus the \$30 GP earned on its investment made with C's capital contribution) to each of A, B, and C, based on their percentage interests as represented by their capital accounts in GP. Thus, of the \$150 of net capital gain that did not arise from GP's API in PRS, GP allocates to each of A, B, and C \$50. Because GP allocates all Passthrough Interest Capital Allocations in the aggregate pro rata based on its partners' capital accounts in GP, the \$50 allocated to each of A, B, and C is a Passthrough Interest Capital Allocation.

(iv) Example 4. Sale of a Passthrough Interest. A, B, and C form GP in Year 1 and contribute \$100 each. GP invests the \$300 in Asset X in Year 1. 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. GP does not have a capital account in PRS and is not entitled to Capital Interest Allocations from PRS. GP is entitled to allocations of API Gain and Loss in PRS. If PRS had sold its assets in a taxable transaction for their fair market value and liquidated immediately before A transferred its interest in GP, GP would have been allocated \$1,800 of long-term capital gain with respect to GP's API in PRS. Of this \$1,800, GP would have allocated \$600 to A. If GP sold all of its assets for fair market value immediately before A's sale of the interest in GP and liquidated, A would have received a Passthrough Interest Direct Investment Allocation of \$100. Accordingly, total gain allocable to A as a result of the hypothetical liquidation would be \$700. The percentage of the total gain of \$700 that is comprised of a Passthrough Interest Direct Investment Allocation is \$100/\$700 or approximately 14.286%. Accordingly, 14.286% of A's \$700 gain, or \$100, is A's Capital Interest Disposition Amount, and not subject to section 1061.

(v) Example 5. Sale of a portion of a Passthrough Interest—(A) Facts. A, B, and C each hold a one-third interest in GP's profits and capital. PRS's ownership interests are divided into two classes, Class A and Class B. The PRS partnership agreement provides for 10 Class A units which each represent a 2% interest in the net profits of PRS, for a total of 20% of the total net profits. Additionally, the PRS partnership agreement provides for 100 Class B units. Each Class B unit represents a 1% interest in the capital and a 0.8% interest in the profits of PRS, for a total of 80% of the total net profits. PRS does not have any outstanding indebtedness. In Year 1, PRS transferred the 10 Class A units to GP in connection with GP's performance of substantial services to PRS. GP is engaged in an ATB. Additionally, on the same date, PRS transferred 2 Class B units in exchange for GP's capital contribution of \$2,000 to PRS. The balance of the Class B units were issued to Unrelated Non-Service Partners for contributions of \$1,000 per unit. In Year 3, when the fair market value of the Class A units is \$7,000,

GP sells its Class B units to an Unrelated Non-Service Partner for \$3,000. At the time of the sale, GP's basis in its partnership interest in PRS is \$2,000. Additionally, if all of the assets of PRS were sold in a taxable transaction immediately before the Class B units were sold, GP would be allocated \$1,000 of capital gain with respect to GP's Class B units.

(B) Treatment of the Class A and Class B Units under Section 1061. GP's class A units represent an API as to GP because they were transferred to GP in connection with the performance of substantial services in an ATB. Class A units do not provide for allocations that meet the requirements to be treated as either Capital Interest Allocations or Passthrough Interest Capital Allocations. GP's Class B units entitle GP to Capital Interest Allocations. Allocations of gain made by PRS with respect to the Class B units are treated as Capital Interest Allocations because the allocations are made to GP as a holder of an API with respect to GP's capital account in the same manner as allocations are made to Unrelated Non-Service Partners with respect to their capital accounts. Additionally, 98% of the Class B units representing 98% of the capital account balance in PRS are held by Unrelated Non-Service Partners. Thus, their interest in PRS is significant.

(C) Calculation of GP's gain on the sale of the Class B Units. Although GP's interest in PRS is represented by units of different classes and some of those units may constitute a right to API Gains and Losses and other units may constitute a right to Capital Interest Allocations, under the provisions of subchapter K, chapter 1 of the Code, GP has a single partnership interest in PRS and a single tax basis and section 704(b) book capital account in that partnership interest. GP's basis in its partnership interest is \$2,000. To determine GP's gain on the disposition of the Class B units, GP's tax basis in its partnership interest must be equitably apportioned between GP's Class A and Class B units. See §1.61-6(a). At the time of the sale, the fair market value of the Class A Units is \$7,000 and the fair market value of the Class B Units is \$3,000. GP's overall fair market value in its interest in PRS is equal to \$10,000. Of this amount, the value of the Class B Units is \$3,000, or 30%, of the fair market value of the entire interest. Accordingly, GP apportions 30% of its tax basis to the Class B units. This amount is \$600 (30% x \$2,000). Accordingly, GP's long-term capital gain on the sale of the Class B units is \$2,400 (\$3,000 less \$600).

(D) Determination of Capital Interest Disposition Amount. To determine the percentage of the long-term capital gain that is treated as a Capital Interest Disposition Amount, GP determines the amount of long-term capital gain that would be allocated to the portion of GP's interest sold if PRS sold all of its assets for fair market value and liquidated immediately before the disposition. Because Class B units are only entitled to allocations that are Capital Interest Allocations and are not entitled to allocations of API Gain or Loss, all of the \$2,400 long-term capital gain is Capital Interest Disposition Gain.

(vi) Example 6. Contribution of an API to a Passthrough Entity with an Unrelated Non-Service Partner. A and B form partnership GP and are equal partners in GP. A

contributes an API in PRS with a fair market value of \$200 and a tax basis of \$0 to GP. B, an Unrelated Non-Service Partner, contributes \$200 cash to GP. GP invests the \$200 cash contributed by B in assets held for investment by GP. Because A contributes an API in PRS to GP, PRS revalues its assets to determine the Unrealized API Gains and Losses that are allocable to A's interest in PRS at the time A contributes its interest in A to GP. See §1.1061-2(a)(1)(ii)(B). At the time of the contribution of the API to GP, PRS holds two assets each with \$100 of Unrealized API Gains that are allocable to the API. PRS sells one of its assets and allocates long-term capital gain of \$100 to GP with respect to the API contributed to GP by A. This gain is API Gain and is first allocated to GP and then solely to A as required under §1.1061-2(a)(1)(ii)(B). The Unrealized API Gain included in A's capital account in GP retains its character as Unrealized API Gain and is not converted to Capital Interest Gain or Loss because it is included A's capital account in GP. Thus, this gain is API Gain as to A when recognized.

(d) Partnership interest acquired by purchase by an unrelated taxpayer. If a taxpayer 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 taxpayer will not be treated as acquiring an API if, immediately before the purchase--

(1) Taxpayer not a Related Person. The taxpayer is not a Related Person (within the meaning of § 1.1061-1(a)) 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); and

(3) Taxpayer not a service provider. The taxpayer did not and does not now provide services, 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) Application of section 1061(b). [Reserved]

(f) Applicability date--(1) General rule. Except as provided in paragraphs (f)(2) and (f)(3) of this section, the provisions of this section apply to taxable years of Owner Taxpayers and Passthrough Entities beginning on or after the date the Treasury decision adopting these regulations as final regulations is published in the **Federal Register**.

(2) Section 1.1061-3(b)(2)(i) exception. Section 1.1061-3(b)(2)(i), 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, is applicable for taxable years beginning after December 31, 2017.

(3) Section 1.1061-3(b)(2)(ii) exception. Section 1.1061-3(b)(2)(ii) 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 is applicable to taxable years of an Owner Taxpayer and Passthrough Entity beginning after [INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE **FEDERAL REGISTER**].

§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 and not as long-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. An Owner Taxpayer's Three Year Gain Amount is equal to–

(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 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 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

(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 excluded from section 1061 under paragraph (b)(6) of this section;

(2) The API Holder's Transition Amount for the taxable year; and

(3) 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--

(A) The API One Year Distributive Share Amount; less

(B) Items included in paragraph (a)(3)(ii)(A) of this section 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, if the Lookthrough Rule applies to the disposition of all or a part of an API, the adjustment required under paragraphs (b)(9)(ii)(B) and (C) of this section.

(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 had been held for more than one year, including a disposition to which the Lookthrough Rule applies;

(B) Long-term capital gain and loss recognized on a distribution with respect to an API during the taxable year that is treated under sections 731(a) (and 752(b) if applicable) as gain or loss from the sale or exchange of a partnership interest held for more than one year;

(C) Long-term capital gains and losses recognized on the disposition of Distributed API Property during the taxable year that has a holding period of more than one year but not more than three years to the distributee Owner Taxpayer on the date of disposition; and

(D) Long-term capital gain or losses recognized as a result of the application of section 751(b).

(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 had 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 less any adjustments required under the Lookthrough Rule in paragraphs (b)(9)(ii)(B) and (C) of this section.

(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) (and section 752(b) if applicable) as gain or loss from the sale or exchange of a partnership interest held for more than three years; and

(D) Long-term capital gains and losses recognized as a result of the application of section 751(b) that is treated as derived from an asset held for more than three years.

(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 zero or results in a loss, the Three Year Gain Amount shall be zero for purposes of calculating the Recharacterization Amount.

(3) 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. See paragraph (b)(8) of this section for rules governing the holding period of APIs.

(4) 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)(4)(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.

(5) 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 share of an inclusion under section 1293(a)(1) of a pro rata share of the net capital gain (as defined in §1.1293-1(a)(2)) of 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)(6) of this section. See §1.1061-6 for reporting rules.

(ii) Three year QEF net capital gain. The calculation of an API Three Year Distributive Share Amount includes an Owner Taxpayer's share of an inclusion under section 1293(a)(1) of a pro rata share of the net long-term capital gain (as defined in §1.1293-1(a)(2)) of a QEF determined for purposes of paragraph (b)(5)(i) of this section if the QEF provides information to determine the amount of the inclusion that would constitute net long-term capital gain (as defined in §1.1293-1(a)(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. See §1.1061-6 for reporting rules.

(6) 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.

(7) API Holder Transition Amounts not taken into account--(i) In General. An API Holder Transition Amount is not taken into account for purposes of determining the Recharacterization Amount.

(ii) API Holder Transition Amount. An API Holder Transition Amount is the amount of long-term gain or loss that is treated as a Partnership Transition Amount and that is included in the allocation of long-term capital gains and losses under sections 702 and 704 to the API Holder for the taxable year with respect to the API Holder's interest in the Passthrough Entity. The API Holder Transition Amount for any taxable year cannot exceed the amount of Partnership Transition Amount that would have been allocated to the API Holder with respect to its interest in the partnership under the partnership agreement in effect on March 15, 2018, with respect to the calendar year ending December 31, 2017.

(iii) Partnership Transition Amounts and Partnership Transition Amount Election. A partnership that was in existence as of January 1, 2018, may 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. To treat amounts as Partnership Transition Amounts --

(A) The partnership must attach a signed and dated copy of a statement that the partnership is making an election in accordance with this paragraph (b)(7)(iii)(A) to the timely filed return (including extensions) filed by the partnership with the IRS under section 6031(a) for the first taxable year the partnership treats amounts as Partnership Transition Amounts;

(B) The partnership must maintain a copy of the election made under paragraph (b)(7)(iii)(A) of this section and by the due date of the election must clearly and specifically identify the assets held for more than three years as of January 1, 2018, in the partnership's books and records;

(C) The partnership must keep sufficient books and records to demonstrate to the satisfaction of the Secretary of the Treasury or his delegate that the identified assets had been held by the partnership for more than three years as of January 1, 2018, and that long-term capital gain or loss on the disposition of each asset has been treated as a Partnership Transition Amounts; and

(D) The partnership must keep an executed copy of its partnership agreement in effect as of March 15, 2018, and must have sufficient books and records to demonstrate that the API Holder Transition Amounts allocated to an API Holder in any taxable year do not exceed the amounts that would have been allocated to the API Holder with respect to its API under the partnership agreement in effect as of March 15, 2018, for the year ending December 31, 2017.

(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) Directly held API. The Lookthrough Rule applies if an API Holder disposes of a directly held API in a taxable transaction to which section 1061(d) does not apply and recognizes capital gain, the API Holder's holding period in the API is more than three years, and the assets of the partnership meet the Substantially All Test described in paragraph (b)(9)(i)(C) of this section.

(B) Indirectly held API. In the case of a tiered structure in which the API Holder holds its API through one or more Passthrough Entities, the Lookthrough Rule applies if an API Holder disposes of a Passthrough Interest held for more than three years in a taxable transaction to which section 1061(d) does not apply and recognizes capital gain, and either—

(1) the Passthrough Entity, through which the API is directly or indirectly held, has a holding period in the API of three years or less; or

(2) the Passthrough Entity, through which the API is directly or indirectly held, has a holding period in the API of more than three years and the assets of the partnership in which the API is held meet the Substantially All Test described paragraph (b)(9)(i)(C) of this section.

(C) Substantially All Test—(1) In general. The Substantially All Test is met if 80 percent or more of the assets of the partnership in which the API is held are assets that would produce capital gain or loss that is not described in paragraph (b)(6) of this section if disposed of by the partnership and have a holding period of three years or less to the partnership. The determination of whether this test is met is based on fair market value and is made by dividing the amount determined under paragraph (b)(9)(i)(C)(1)(i) of this section (the numerator) by the amount determined under paragraph (b)(9)(i)(C)(1)(ii) of this section (the denominator) and expressing the result as a percentage. Cash, cash equivalents, unrealized receivables under section 751(c), and inventory items under section 751(d) are not taken into account for purposes of determining the numerator or the denominator.

(i) Numerator. For purposes of determining the fraction described in paragraph (b)(9)(i)(C)(1) of this section, the numerator is equal to the aggregate fair market value of the partnership's assets that would produce capital gain or loss that is not described in paragraph (b)(6) of this section if disposed of by the partnership as of the date of disposition of the API and that have a holding period of three years or less.

(ii) Denominator. For purposes of determining the fraction described in paragraph (b)(9)(i)(C)(1) of this section, the denominator is equal to the aggregate fair market value of all of the partnership's assets as of the date of disposition of the API.

(2) Applying the Substantially All Test in tiered arrangements. In applying the Substantially All Test, if a partnership has held an interest in a lower-tier Passthrough Entity for more than three years, the partnership must increase the amount calculated for the numerator under paragraph (b)(9)(i)(C)(1)(i) of this section by the partnership's

share of the value of the assets held by the lower-tier Passthrough Entity that would be included in the numerator under paragraph (b)(9)(i)(C)(1)(i) of this section by the lower-tier Passthrough Entity, if the lower-tier Passthrough Entity was calculating the numerator under paragraph (b)(9)(i)(C)(1)(i) of this section.

(ii) Application of the Lookthrough Rule. If the Lookthrough Rule applies--

(A) The Owner Taxpayer must include the entire amount of capital gain recognized on the sale of the API in the API One Year Disposition Amount (see paragraph (a)(4)(i)(A) of this section) and in the case of an API Holder that is a Passthrough Entity and not an Owner Taxpayer, the entire amount of the capital gain recognized on the sale is included in the One Year Distributive Share Amount determined with respect to the API Holders of the Passthrough Entity (see paragraph (a)(3)(i)(A) of this section); and

(B) The Owner Taxpayer must include the amount of gain included in the API One Year Disposition Amount with respect to the disposition of the API reduced by the adjustment determined under paragraph (b)(9)(ii)(C) of this section (see paragraph (a)(4)(ii)(B) of this section) in the API Three Year Disposition Amount, and in the case of an API Holder that is a Passthrough Entity and not an Owner Taxpayer, the API Three Year Distributive Share Amount is reduced by the adjustment determined under paragraph (b)(9)(ii)(C) of this section as provided in paragraph (a)(3)(ii)(B) of this section.

(C) Adjustment required by the Lookthrough Rule. The adjustment required by the Lookthrough Rule equals--

(1) If the Lookthrough Rule applies under paragraph (b)(9)(i)(A) or paragraph (b)(9)(i)(B)(2) of this section, the adjustment is equal to the capital gain recognized on the disposition of the API that is attributable to assets included in the numerator under paragraph (b)(9)(i)(C)(1)(i) of this section. This amount is calculated by multiplying the capital gain recognized on the sale of the API by a fraction, expressed as a percentage. The numerator of the fraction is equal to the total net capital gain the partnership would recognize if the partnership disposed of the assets the value of which was included in the numerator under paragraph (b)(9)(i)(C)(1)(i) of this section for fair market value immediately before the disposition of the API. The denominator is equal to the total net capital gain the partnership would recognize if the partnership disposed of the assets the value of which was included in the denominator under paragraph (b)(9)(i)(C)(1)(ii) of this section for fair market value immediately prior to the disposition of the API. If the numerator is zero or less, the adjustment in this paragraph (b)(9)(ii)(C) is zero. If the numerator is greater than zero and the denominator is zero or less, the adjustment is the entire amount of gain recognized on the sale of the API.

(2) If the Lookthrough Rule applies under paragraph (b)(9)(i)(B)(1) of this section, the adjustment is equal to the gain attributable to the API directly or indirectly held by the Passthrough Entity.

(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 has made an election under section 83(b) or included amounts in gross income under section 83.

(c) Examples--(1) Computation examples. The rules of paragraph (a) of this section are illustrated by the following examples. Unless otherwise stated, 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, as provided in paragraph (b)(6) of this section.

(i) Example 1. Calculation of the API One Year Distributive Share Amount and the API Three Year Distributive Share Amount--(A) Facts. A holds an API in PRS. A does not have a capital account in PRS for purposes of §1.1061-3(c)(3)(ii). During the taxable year, A is allocated \$20 of long-term capital gain recognized by PRS on the sale of capital asset X held by PRS for two years. A is allocated \$40 of long-term capital gain from the sale of capital asset Y held by PRS for five years. Assume A has no other items of long-term capital gain or loss with respect to its interest in PRS during the taxable year. Accordingly, A is allocated \$60 of long-term capital gain from PRS under §1.702-1(a)(2) for the taxable year. A has no other long-term capital gains or losses with respect to an API during the taxable year.

(B) Calculation of A's API One Year Distributive Share Amount. A has an API One Year Distributive Share Amount for PRS of \$60 of long-term capital gain. This amount is equal to A's \$60 distributive share from PRS under §1.702-1(a)(2) because no items that are described in paragraph (b)(6) or (7) of this section reduce that amount.

(C) Calculation of A's API Three Year Distributive Share Amount. A has an API Three Year Distributive Share Amount of \$40 of long-term capital gain. A calculates this amount by subtracting the \$20 allocated to A from the sale of capital asset X from the API One Year Distributive Share Amount of \$60 calculated in paragraph (B) of this Example 1. A subtracts the gain allocated to A as a result of the sale of capital asset X because PRS had only held capital asset X for two years prior to its disposition and this gain would not be treated as long-term capital gain if three years were substituted for one year in paragraphs (3) and (4) of section 1222. Only the \$40 gain allocated to A on the sale of capital asset Y which was held by PRS for five years prior to its disposition is included in A's API Three Year Distributive Share Amount.

(D) Calculation of A's Recharacterization Amount. A's One Year Gain amount equals \$60 (A's API One Year Distributive Share Amount, plus an API One Year Disposition Amount of \$0). A's Three Year Gain Amount equals \$40 (A's API Three Year Distributive Share Amount, plus an API Three Year Disposition Amount of \$0). A's Recharacterization Amount is \$20, the difference between A's One Year Gain Amount of \$60, and A's Three Year Gain Amount of \$40.

(ii) Example 2. Calculation of the API One Year Distributive Share amount when Capital Interest Allocations are present--(A) Facts. A holds a Passthrough Interest in PRS. A holds an API in PRS and, under the terms of the partnership agreement, is entitled to Capital Interest Allocations from PRS. During the taxable year, A receives a

\$130 allocation of long-term capital gain under §1.702-1(a)(2) with respect to its interest in PRS as a result of the sale of asset X that PRS had held for 5 years. Of this amount, \$50 is treated as a Capital Interest Allocation described in §1.1061-3(c)(4). A has no other long-term capital gains and losses with respect to an API during the taxable year.

(B) Calculation. A's distributive share of long-term capital gain from PRS is \$130. A's API One Year Distributive Share Amount is \$80. This is calculated by subtracting A's \$50 Capital Interest Allocation from A's distributive share of long-term capital gain determined for purposes of §1.702-1(a)(2). A's API Three Year Distributive Share Amount is also \$80 because the \$80 would be treated as long-term capital gain if three years were substituted for one year in paragraphs (3) and (4) of section 1222.

(C) Recharacterization Amount. A has a One Year Gain Amount of \$80 (A's \$80 API One Year Distributive Share Amount, plus a One Year Disposition Amount of \$0). A has a Three Year Gain Amount of \$80 (A's \$80 API Three Year Distributive Share Amount, plus a Three Year Disposition Amount of \$0). Accordingly, A's Recharacterization Amount is \$0, the difference between A's One Year Gain Amount and Three Year Gain Amount.

(iii) Example 3. API One Year Disposition Amount--(A) Facts. During the taxable year, A disposes of an API that A has held for four years as of the date of disposition for a \$100 gain. The Lookthrough Rule is not applicable to the sale. Additionally, A sells Distributed API Property at a \$300 gain when such property had a two year holding period in A's hands. A has no other items of long-term capital gain or loss with respect to an API in that year.

(B) Calculation of A's API One Year Disposition Amount. A's API One Year Disposition Amount is \$400. This amount equals A's \$300 long-term capital gain on A's disposition of its Distributed API Property and \$100 long-term capital gain on the disposition of A's API. A's Three Year Disposition Amount is \$100, the amount of long-term capital gain A recognized upon disposition of A's API held for more than three years.

(C) Calculation of A's Recharacterization Amount. A's One Year Gain Amount is \$400. A's Three Year Gain Amount is \$100. A's Recharacterization Amount is \$300, the difference between A's One Year Gain Amount and Three Year Gain Amount.

(iv) Example 4. Calculation of One Year Gain Amount, Three Year Gain Amount, and Recharacterization Amount--(A) Facts. During the taxable year, A held an API in PRS1 and an API in PRS2 for the entire year. With respect to PRS1, A's API One Year Distributive Share Amount is \$100 of long-term capital gain and A's API Three Year Distributive Share Amount is (\$200) of long-term capital loss. With respect to PRS2, A's API One Year Distributive Share Amount is \$600 of long-term capital gain and A's API Three Year Distributive Share Amount is \$300 of long-term capital gain. For 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) Calculation of A's One Year Gain Amount. A's One Year Gain Amount is \$900. This amount is calculated by combining A's \$100 API One Year Distributive Share Gain from PRS1, the \$600 API One Year Distributive Share from PRS2 (for a combined net API One Year Distributive Share Amount of \$700 of long-term capital gain), and the \$200 API One Year Disposition Amount.

(C) Calculation of A's Three Year Gain Amount. A's Three Year Gain Amount is \$100. This amount is calculated by first determining A's combined net API Three Year Distributive Share Amount for the taxable year. This amount is arrived at by combining and netting A's \$200 API Three Year Distributive Share Amount loss from PRS1 with A's API Three Year Distributive Share Amount Gain of \$300 from PRS2. A's combined net Three Year Distributive Share Amount is \$100 of long-term capital gain. Because A does not have an API Three Year Disposition Amount, the Three Year Gain Amount is equal to A's API Three Year Distributive Share Amount of \$100 of gain.

(D) Calculation of A's Recharacterization Amount. A's Recharacterization Amount is \$800, which is the amount by which A's One Year Gain Amount of \$900 exceeds 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--(A) Facts. A is a partner in GP. GP is a partnership and holds an API in PRS, which GP has held for 2 years. A's interest in GP includes both an indirect interest in GP's API in PRS and a capital account in GP that entitles A to Capital Interest Gains and Losses from GP. A has held its interest in GP for 4 years. During the taxable year, A sold its interest in GP for a \$200 gain in a transaction to which section 1061(d) did not apply. After the application of § 1.1061-3(c)(6), A determined that \$100 of A's capital gain on the disposition of its interest in GP is a Capital Interest Disposition Amount and \$100 of A's capital gain is API Gain.

(B) Determination of Whether the Lookthrough Rule Applies. A's disposition of an interest in GP is a disposition of a Passthrough Interest held for more than three years with respect to which A recognized capital gain. GP is the Passthrough Entity in which A holds its Passthrough Interest and GP has a two year holding period in its API in PRS. Thus, under paragraph (b)(9)(i)(B)(1) of this section, the Lookthrough Rule applies to A's disposition of A's Indirect API.

(C) Effect of the Application of the Lookthrough Rule. A is an Owner Taxpayer. Under paragraph (b)(9)(ii)(A) of this section, A must include the \$100 of API Gain in A's One Year Disposition Amount. Under paragraph (b)(9)(ii)(B) of this section, the amount A includes in the Three Year Disposition Amount is the amount A included in the One Year Disposition Amount, reduced by the adjustment required under paragraph (b)(9)(ii)(C)(2) of this section. This amount is A's gain attributable to the sale of its

Indirect API, or \$100. Therefore, A includes none of the \$100 of API Gain from the sale of A's Indirect API in A's Three Year Disposition Amount.

(ii) Example 2. Lookthrough Rule—(A) Facts. Assume the same facts as Example 1 except that GP has held its API in PRS for 4 years and all of the assets of PRS are securities that are subject to an election under section 475.

(B) Determination of whether the Lookthrough Rule applies. A's disposition of an interest in GP is a disposition of a Passthrough Interest held for more than three years with respect to which A recognized capital gain. GP is the Passthrough Entity in which A holds its Passthrough Interest and GP has a four year holding period in its API. Thus, under paragraph (b)(9)(i)(B)(2) of this section, the Lookthrough Rule will apply if the assets of PRS meet the Substantially All Test in paragraph (b)(9)(i)(C) of this section. The determination of whether the test is met is made by dividing the aggregate fair market value of the assets of PRS that would produce capital gain or loss not described in paragraph (b)(6) of this section if disposed of by PRS as of the date of disposition of the API and that have a holding period of three years or less (the numerator as determined under paragraph (b)(9)(i)(C)(1)(i) of this section); by, the aggregate fair market value of all of the partnerships assets as of the date of disposition (the denominator as determined under paragraph (b)(9)(i)(C)(1)(ii) of this section). Because all of the assets of the partnership are assets subject to an election under section 475 and thus would produce ordinary income or loss on disposition, the numerator as determined under paragraph (b)(9)(i)(C)(1)(i) of this section is 0. As a result, the Substantially All Test is not met, and the Lookthrough Rule does not apply.

(iii) Example 3. – (A) Facts. Assume that same facts in Example 2, except that GP disposed of its API in PRS for a capital gain of \$480. GP's API entitles it to 20% of PRS' net profits. A is allocated \$120 of gain from the sale. At the time of GP's disposition of its interest in PRS, PRS held the following assets--

(1) \$1,000 cash;

(2) Asset X, an asset that would produce capital gain or loss that is not described in paragraph (b)(6) of this section if disposed of by PRS, which has a fair market value of \$100, a basis of \$100, and a holding period of 4 years;

(3) Asset Y, an asset that would produce capital gain or loss that is not described in paragraph (b)(6) of this section if disposed of by PRS, which has a fair market value of \$1,600, a basis of \$1,000, and a holding period of 2 years;

(4) Asset Z, an asset that would produce capital gain or loss that is described in paragraph (b)(6) of this section if disposed of by PRS, which has a value of \$300, a basis of \$100, and a holding period of 2 years; and

(5) A 20% interest in the profits and capital of partnership PRS2. The total fair market value of PRS2 is \$10,000. The interest PRS holds in PRS 2 has a fair market value of \$2,000, a basis of \$400, and a holding period of 4 years.

(6) PRS2 holds two assets that would produce capital gain or loss that is not described in paragraph (b)(6) of this section if disposed of by PRS2, Asset S and Asset T. Asset S has a fair market value of \$8,000, a basis of \$1,000, and a holding period of 2 years. Asset T has a fair market value of \$2,000, a basis of \$1,000, and a holding period of 4 years.

(B) Determination of Whether the Lookthrough Rule Applies—(1) In general. Because GP recognized capital gain on the disposition of an API that GP held directly that had a holding period of more than three years, paragraph (b)(9)(i)(A) of this section governs whether the Lookthrough Rule applies. To determine whether the Lookthrough Rule applies under paragraph (b)(9)(i)(A) of this section, it must be determined whether the assets of PRS meet the Substantially All Test in paragraph (b)(9)(i)(C) of this section. To make this determination, the numerator under paragraph (b)(9)(i)(C)(1)(i) of this section and the denominator under paragraph (b)(9)(i)(C)(1)(ii) of this section of the fraction described in paragraph (b)(9)(i)(C)(1) of this section must be determined. The value of cash, cash equivalents, unrealized receivables described in section 751(c), and inventory items described in section 751(d) is excluded from this determination.

(2) Calculation of the denominator under paragraph (b)(9)(i)(C)(1)(ii) of this section. The denominator under paragraph (b)(9)(i)(C)(1)(ii) of this section is equal to the aggregate fair market value of the assets of PRS on the date of disposition of the API and is \$4,000 (\$100 (Asset X) + \$1,600 (Asset Y) + \$300 (Asset Z) + \$2,000 (PRS2)).

(3) Calculation of the numerator under paragraph (b)(9)(i)(C)(1)(i) of this section. The numerator in paragraph (b)(9)(i)(C)(1)(i) of this section equals the aggregate fair market value of assets of PRS that would produce capital gain or loss that is not described in paragraph (b)(6) of this section if disposed of by PRS as of the date GP disposes of its API in PRS and that have a holding period of three years or less to PRS. Based on the following, this amount is equal to \$3,200 (the value of Asset Y (\$1,600) and PRS's share of the value of Asset S (\$1,600) held by PRS2).

(i) The \$1000 of cash is not taken into account for purposes of the Substantially All Test.

(ii) The fair market value of Asset X is excluded from the calculation of the numerator under paragraph (b)(9)(i)(C)(1)(i) of this section because it has a 4 year holding period to PRS.

(iii) Asset Y would produce capital gain or loss that is not described in paragraph (b)(6) of this section if disposed of by PRS and Asset Y has a holding period of 2 years.

Accordingly, the \$1,600 fair market value of asset Y is included in calculating the numerator under the paragraph (b)(9)(i)(C)(1)(i) of this section.

(iv) Although Asset Z has a holding period of 2 years to GP, capital gain or loss on the disposition of Asset Z is described paragraph (b)(6) of this section so its value is not included in calculating the numerator under paragraph (b)(9)(i)(C)(1)(i) of this section.

(v) PRS holds a 20% capital and profits interest in PRS2 and has a holding period of 4 years in its interest. Under paragraph (b)(9)(i)(C)(2) of this section, PRS's share of the fair market value of the assets held by PRS2 for three years or less is included in the GP's calculation of the amount under paragraph (b)(9)(i)(C)(1)(i) of this section. Asset S has a holding period of 2 years and a value of \$8,000. PRS's share of the \$8,000 is \$1,600 ($\$8,000 \times 20\% = \$1,600$). Asset T has a holding period of more than 3 years and is not included in the amount determined under paragraph (b)(9)(i)(C)(1)(i) of this section. The amount included in the calculation under paragraph (b)(9)(i)(C)(2) of this section with respect to the interest PRS holds in PRS2 is \$1,600, PRS' share of the fair market value of Asset S.

(4) Fraction. Because \$3,200 (the amount calculated under paragraph (b)(9)(i)(C)(1)(i) of this section) divided by \$4,000, expressed as a percentage, is equal to 80%, the Lookthrough Rule applies.

(C) Effect of application of the Lookthrough Rule—(1) In general. The API Holder is GP, which is a Passthrough Entity and not an Owner Taxpayer. Thus, the application of the Lookthrough Rule affects the calculation of the API One Year Distributive Share Amount and API Three Year Distributive Share Amounts of GP's API Holders.

(2) Calculation of the API One Year Distributive Share Amount. All of GP's gain is API Gain and GP must include the entire \$480 of GP's long-term capital gain in the API One Year Distributive Share Amount of its API Holders. For A, this amount is \$120.

(3) Calculation of the adjustment to the API Three Year Distributive Share Amount—(i) Adjustment calculation. To determine the amount by which the API Three Year Distributive Share Amount calculated under paragraph (a)(3)(ii)(B) of this section is reduced as a result of the application of the Lookthrough Rule, the adjustment described in paragraph (b)(9)(ii)(C) of this section must be determined. The adjustment is equal to the capital gain recognized on the disposition of the API in PRS by GP that is attributable to assets included in the numerator under paragraph (b)(9)(i)(C)(1)(i) of this section. This amount is calculated by multiplying the capital gain recognized on the sale by a fraction, expressed as a percentage. The numerator of the fraction is equal to total net capital gain that would be generated by the assets included in calculating the numerator under paragraph (b)(9)(C)(1)(i) of this section if PRS disposed of the assets for fair market immediately before the disposition of the API. The denominator of the fraction is equal to the total net capital gain that would be attributable to the assets included in the denominator under paragraph (b)(9)(C)(1)(ii) of this section if PRS

disposed of all of its assets for fair market value immediately before the disposition of the API.

(ii) Total net gain that would be recognized on a hypothetical sale of the assets included in the denominator under paragraph (b)(9)(i)(C)(1)(ii) of this section. The total amount of capital gain that would be recognized on a hypothetical disposition of the assets that were included in the denominator under paragraph (b)(9)(i)(C)(1)(ii) of this section is \$2,400 (\$0 gain on Asset X + \$600 gain on Asset Y + \$200 gain on Asset Z and \$1,600 gain on the interest in PRS2).

(iii) Total net gain that would be recognized on a hypothetical sale of the assets included in the numerator under paragraph (b)(9)(i)(C)(1)(i) of this section. The full fair market value of Asset Y and PRS's 20% share of the fair market value Asset S held by PRS2 were included in the amount determined under paragraph (b)(9)(C)(1)(i) of this section. Asset Y has been held for 2 years and would produce \$600 of gain if sold immediately before GP's disposition of its API in PRS. If Asset S were disposed of immediately before GP disposed of its interest in PRS, GP would be allocated gain of \$1,400 (\$8,000 fair market value less \$1,000 basis equals gain of \$7,000 and 20% of \$7,000 equals \$1,400). Accordingly, the amount of gain that would be recognized on the disposition of the assets included in paragraph (b)(9)(i)(C)(1)(i) of this section is \$2,000.

(iv) Adjustment. The amount of the adjustment is calculated by multiplying \$480, the amount of gain recognized on the disposition of the API by a fraction, expressed as a percentage. The numerator of the fraction is \$2,000, the amount of gain attributable to assets included in the computation under paragraph (b)(9)(i)(C)(1)(i) of this section. The denominator of the fraction is equal to \$2,400, the amount of gain that would be recognized on the hypothetical sale of PRS's assets included in the denominator under paragraph (b)(9)(ii)(C)(1)(ii) of this section. The fraction is equal to \$2000 divided by \$2,400, expressed as a percentage, or 83.3 percent. The capital gain recognized by GP on the sale, \$480 is multiplied by 83.3 percent to arrive at the gain attributable to the assets included in paragraph (b)(9)(i)(C)(1)(i) of this section or \$399.84. A's share of the gain is \$99.96. To compute A's API Three Year Distributive Share Amount, A's API Three Year Distributive Share Amount calculated under paragraph (a)(3)(ii) of this section is reduced by \$99.96 as a result of the application of the Lookthrough Rule.

(iv) Example 4. Installment sale gain. On December 22, 2017, 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 2018 taxable year causing A to recognize \$200 of long-term capital gain. The \$200 long-term capital gain recognized in 2018 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 2018 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.

(v) Example 5. Partnership Transition Amounts and API Holder Transition Amounts--(A) Facts. A and B formed GP on January 1, 2012, by contributing \$150 each. GP contributed the \$300 to PRS. GP has a calendar taxable year. GP's capital contribution to PRS is equal to 10% of the aggregate capital account balance of GP which is \$3000. In 2012, PRS also issued GP an API in PRS. Under the terms of the partnership agreement, GP is allocated 20% of all net capital gain or loss earned by PRS with respect to its API. GP also earns a pro rata allocation of the remaining 80% of net capital gain or loss. In 2012, PRS acquired Asset X and Asset Y for \$1500 each. Following a revaluation event, PRS increased the capital accounts of A and B to reflect a revaluation of the partnership property as of that date under § 1.704-1(b)(2)(iv)(f). As of January 1, 2018, PRS continued to hold Asset X and Asset Y. PRS also purchases Asset U for \$1000 on December 31, 2019. GP's capital account balance continues to equal 10% of the aggregate capital account balance of PRS. As of the due date of PRS's federal income tax return for the 2021 taxable year, the first year PRS treats amounts as Partnership Transition Amounts, PRS elected to treat the long-term capital gain or loss recognized on the disposition of all of PRS's assets held for more than three years as of January 1, 2018, as Partnership Transition Amounts. PRS identified Asset X and Asset Y as assets held for more than three years as of January 1, 2018, and subject to the election. PRS retained sufficient records to demonstrate that Asset X and Asset Y had been held for more than three years as of January 1, 2018.

(B) Calculation of Partnership Transition Amounts. On December 31, 2021, when its holding period in Asset U was two years, PRS disposed of Asset U for a gain of \$2000. PRS also disposed of Asset X for a gain of \$2,000 and Asset Y for a gain of \$3,000 on the same date. PRS did not dispose of any other assets during the calendar year. Thus, PRS recognized a total of \$7,000 of net long-term capital gain from the sale of Asset U, Asset X, and Asset Y (\$2000 + \$2000 + \$3000). Because Asset X and Asset Y are assets identified by PRS as having been held for three years as of January 1, 2018, the long-term gain from the disposition of these assets is treated as a Partnership Transition Amount by PRS pursuant to its election. Based on its API, GP is entitled to 20% of the total net long-term capital gain of \$7,000, or \$1,400. The remainder of the gain, \$5,600, is split between the partners according to their partnership interests. GP is entitled to 10% of the \$5,600. GP's distributive share of long-term capital gain for 2019 from PRS is \$1960 ((20% x \$7,000) + (10% x \$5,600)). Of this amount, \$1,400 is attributable to gain from Asset X ((20% x \$2,000) + (10% x \$1,600)) and Asset Y ((20% x \$3,000) + (10% x \$2,400)), and is treated as an API Holder Transition Amount as to GP. After the \$1960 allocated to GP is reduced by the \$1400, \$560 of the original distributive share of long-term capital gain to GP remains. Of this amount, \$160 is a Capital Interest Allocation from PRS to GP with respect to the capital account GP holds in PRS. This amount is also subtracted from the amount of the original distributive share, leaving a \$400 API One Year Distributive Share Amount for the taxable year. Because PRS has only held Asset U for two years, the API Three Year Distributive Share Amount for the taxable year is 0. GP, in allocating the API Holder Transition Amounts allocated to GP by PRS to A and B, must allocate those amounts to A and B consistently with the partnership agreement in effect for GP as of March 15, 2018, for the year ending December 31, 2017. Because A and B have

always been 50% partners, 50% of the API Holder Transition Amount allocated to GP by PRS can be allocated by GP to each A and B.

(vi) Example 6. 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 designates a \$1000 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 less than three years. 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 less than three years. 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 paragraph (b)(4)(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 the date the Treasury decision adopting these regulations as final regulations is published in the **Federal Register**

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

(a) In general. If an Owner Taxpayer transfers any API, or any Distributed API Property, directly or indirectly, or if a Passthrough Entity in which an Owner Taxpayer holds an interest, directly or indirectly, transfers an API to a Section 1061(d) Related Person, as defined in paragraph (e) of this section, regardless of whether gain is otherwise recognized on the transfer under the Internal Revenue Code, the Owner Taxpayer shall include in gross income as short-term capital gain, the excess (if any) of—

(1) The Owner Taxpayer's net long-term capital gain with respect to such interest for such taxable year determined as provided in paragraph (c) of this section, over

(2) Any amount treated as short-term capital gain under §1.1061-4 with respect to the transfer of such interest (that is, any amount included in the Owner Taxpayer's API One Year Disposition Gain Amount and not in the Owner Taxpayer's Three Year Disposition Gain Amount with respect to the transferred interest).

(b) Transfer. For purposes of section 1061(d), the term transfer includes, but is not limited to, contributions, distributions, sales and exchanges, and gifts.

(c) Application of paragraph (a) of this section--(1) Determination of amounts included in paragraph (a)(1) of this section.—(A) In general. An Owner Taxpayer's net long-term capital gain with respect to a transferred API for the taxable year for the purpose of paragraph (a)(1) of this section is the amount of net long-term capital gain from assets held for three years or less (including any remedial allocations under §1.704-3(d)) that would have been allocated to the partner (to the extent attributable 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 (taking into account section 7701(g)) immediately prior to the partner's transfer of the API. If the amount calculated pursuant to this paragraph (c) is negative or zero, then the amount calculated under paragraph (a) of this section shall be zero, and section 1061(d) shall not apply. If only a portion of a partnership interest is so transferred, then only the portion of gain attributable to the transferred interest shall be included in gross income.

(B) Tiered entities. If the Owner Taxpayer transfers an Indirect API and is subject to this section, the computation described in paragraph (c)(1) of this section must be applied at the level of any lower-tier Passthrough Entities.

(2) Application to an otherwise taxable transfer. In the case of a transfer that is otherwise a taxable event, paragraph (a) of this section characterizes the capital gain recognized on the transfer as short-term capital gain to the extent that the gain is required to be included in gross income as short-term capital gain under paragraph (a) of this section. If the amount of capital gain otherwise recognized on the transfer is less than the amount that is required to be included under paragraph (a) of this section, the Owner Taxpayer must include in gross income the difference between the amount of gain otherwise recognized and the gain required to be included under paragraph (a) of this section as short term capital gain.

(d) Basis of transferred interest increased by additional gain recognized. If the basis of a transferred API or, in the case of a transfer of an Indirect API, the basis of a transferred Passthrough Interest in the transferee's hands is determined, in whole or in part, by reference to the basis of the transferred API or Passthrough Interest in the transferor's hands before application of this section, and capital gain is required to be recognized because of the application of this section, then, immediately before the transfer, the basis of the API or Passthrough Interest shall (before any increase permitted under section 1015(d), if applicable) be increased by the capital gain the transferor included in gross income solely by reason of this section.

(e) Section 1061(d) Related Person--(1) In general. For purposes of this section, the term Section 1061(d) Related Person means--

(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) of this section owns an interest, directly or indirectly.

(2) Exception. A contribution under section 721(a) to a partnership is not a transfer to a Section 1061(d) Related Person under this paragraph (e) because, as provided in §1.1061-2(a)(1)(ii)(B), for purposes of section 1061 the principles of section 704(c) and §§1.704-1(b)(2)(iv)(f) and 1.704-3(a)(9) apply to allocate all applicable Unrealized API Gains and Losses subject to section 1061(a) at the time of transfer to the API Holder contributing the interest.

(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. A transfers all of the API to A's daughter as a gift. A's daughter is a Section 1061(d) Related Person. Immediately before the gift, if the partnership that issued the API had sold all of its assets for fair market value, A would have been allocated \$700 of net long-term capital gain from assets held by the partnership for three years or less. Therefore, the amount described in (a)(1) of this section is \$700. A did not recognize any gain on the transfer for federal income tax purposes before application of this section, which means that the amount described in (a)(2) of this section is \$0. A includes the difference between the amounts described in (a)(1) and (a)(2) of this section, or \$700 and \$0, in gross income as short-term capital gain. A includes \$700 in gross income as short-term capital gain. A's daughter increases her basis in the API by the \$700 of gain recognized by A on the transfer under paragraph (d) of this section.

(2) Example 2. Taxable transfer to child for fair market value. The facts are the same as in Example 1, except that A sells the API to A's daughter for \$1,000, the API's fair market value and recognizes \$1,000 of capital gain. A's API One Year Disposition Amount and API Three Year Disposition Amount are both \$1,000. Therefore, the amount described in (a)(2) of this section is \$0. The amount described in (a)(1) is \$700. The difference between the amount described in (a)(1) of this section (\$700) and the amount described in (a)(2) of this section (\$0) is \$700. Because A recognized gain greater than the amount required under paragraph (a) of this section, there is no gain to accelerate and up to \$700 of A's long-term capital gain will be recharacterized as short-

term gain. Three hundred dollars of A's gain is not recharacterized under section 1061(d). The balance of \$700 of long-term capital gain is entirely recharacterized as short-term capital gain. Accordingly, A includes \$300 of gain in gross income as long-term capital gain and \$700 as short-term capital gain. Because A's daughter does not determine her basis in the API by reference to A's basis, paragraph (d) of this section does not apply.

(3) Example 3. Contribution of an API to a Passthrough Entity owned by Section 1061(d) Related Persons--(i) Facts. A, B, and C are equal partners in GP. 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 provide 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 exchange for interests in PRS2. Under the terms of the partnership agreement of PRS2, all Unrealized API Gain or Loss allocable to A and B in the property held by GP and PRS1 as of the date of the contribution by A and B when recognized will continue to be allocated to each A and B by PRS2. As provided in §1.1061-2(a)(1)(ii)(B), as a result of the contribution by A and B of their interests in GP to PRS2, PRS1 and GP must revalue their assets under the principles of §1.704-1(b)(2)(iv)(f).

(ii) Application of section 1061(d). The contribution by A and B of their interest in GP to PRS2 is a potential transfer to a Section 1061(d) Related Person as to both A and B under paragraph (e)(1)(iii) of this section to the extent that the other is an owner of PRS2. However, because paragraph (e)(2) of this section provides that a contribution under section 721(a) to a partnership is not a transfer to a Section 1061(d) Related Person for purposes of this section, section 1061(d) does not apply to A and B's contribution.

(g) Applicability date. The provisions of this section apply to taxable years of Owner Taxpayers and Passthrough Entities beginning on or after the date the Treasury decision adopting these regulations as final regulations is published in the **Federal Register**.

§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 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 §§1.1061-1 through 1.1061-6 of these regulations.

(2) Failure to obtain information. Paragraph (b)(1) of this section requires 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 Secretary of the Treasury or his delegate (Secretary), then--

(i) With respect to the determination of the API One Year Distributive Share Amount under § 1.1061-4(a)(3)(i) if not furnished, the amount calculated under §1.1061-4(a)(3)(i)(B) does not include--

(A) Amounts excluded from section 1061 under §1.1061-4(b)(6);

(B) API Holder Transition Amounts; and

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

(ii) With respect to the determination of the API Three Year Distributive Share Amount determined under §1.1061-4(a)(3)(ii) if not furnished, 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 the section 1061 and §§1.1061-1 through 1.1061-6. 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)(6);

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

(iv) API Holder Transition Amounts (as determined under §1.1061-4(b)(7)); and

(v) In the case of a disposition by an API Holder of an interest in the Passthrough Entity during the taxable year, any information required by the API Holder to properly take the disposition into account under section 1061, including information to apply the Lookthrough Rule and to determine its Capital Interest Disposition Amount.

(2) Requirement to request, furnish, and file information in tiered structures--(i) Requirement to request information. If Passthrough Entity requires information to meet its reporting and filing requirements under this §1.1061-6 (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. 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. Additionally, the Passthrough Entity must file the requested information with the IRS as the Commissioner may require 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 Secretary, 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) Penalties. In addition to the requirement to section 1061(e), the information required to be furnished under this paragraph (b) is also required to be furnished under sections 6031(b) and 6037(b), and 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)(6). 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)(6), 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 paragraph (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)(A) may provide additional 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. If such information is not provided, an API Holder must include all amounts of long-term capital gain from the QEF in its API One Year Distributive Share Amounts and no amounts in its API Three Year Distributive Share

Amount. 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 the date the Treasury decision adopting these regulations as final regulations is published in the **Federal Register**.

Par. 5. Section 1.1223-3 is amended by:

1. Redesignating paragraph (b)(5) as paragraph (b)(6);
2. Adding new paragraph (b)(5);
3. Designating Example 1 through Example 8 of paragraphs (f) as paragraphs (f)(1) through (f)(8);
4. Adding new paragraphs (f)(9) and (f)(10); and
5. Adding a sentence at the end of paragraph (g).

The additions 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 that paragraph.

(ii) Definition of 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 received a 20% interest in the profits of PRS that is an applicable partnership interest (API), as defined in §1.1061-1, in PRS. 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 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 23, 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) * * * Paragraph (b)(5), (f)(9), and (f)(10) of this section apply to taxable years beginning on or after the date the Treasury decision adopting these regulations as final regulations is published in the **Federal Register**.

Sunita Lough,

Deputy Commissioner for Services and Enforcement.