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Highlights from the Proposed Carry Regulations

On July 31, Treasury published proposed regulations on the "three-year carry rule," which was enacted in 2017 pursuant to Section 1061 of the Code.[1] Generally, the proposed regulations follow Section 1061 by recharacterizing long-term capital gains as short-term capital gains ("1061 Recharacterization") if the asset generating the gains has a holding period of three years or less and is recognized on or with respect to an "applicable partnership interest" ("API").

An API generally includes any partnership interest transferred or held in connection with the performance of specified investment management services (an "applicable trade or business" or "ATB"), subject to narrow exceptions for capital interests, interests purchased by unrelated third parties and interests held by corporations. 1061 Recharacterization applies to (i) gains allocated in respect of API through tiers of partnerships and other pass-through type entities, (ii) gains on dispositions of API or interests in pass-through type entities that directly or indirectly hold an API and (iii) gains from assets received as distributions in respect of an API.

These new rules are proposed to become effective when published as final regulations, except as noted below in the case of preserving API treatment of an API held through either an S corporation or passive foreign investment company ("PFIC") with a "qualified electing fund" election ("Pedigreed QEF").

Key Takeaways and Questions

Broad Scope. The scope of partnership interests potentially included within the definition of API is very broad, and might include partnership interests in partnerships that do not receive carry or pay carry but are engaged in or connected with an ATB (e.g., a co-invest or self-managed fund or even an investment advisor that also owns investments), subject to the exceptions.

Once an API, Always an API. Once a partnership interest is treated as an API with respect to a holder or taxpayer, it remains treated as an API, even if services in respect of the API cease to be performed or the ATB terminates.

Narrow Exception for Capital Interests. Gains and losses recognized in respect of a "capital interest" are not subject to 1061 Recharacterization. However, as implemented by the proposed regulations, this exception is narrower than how private funds and other investment partnerships commonly handle the investment of insiders' capital, rendering it unavailable in many typical and non-abusive arrangements.

For direct API holders, the capital interest exception generally applies only to (i) allocations made in accordance with capital accounts, provided that the allocation is also made in the same manner as it is for unrelated non-service providers and (ii) gains from the disposition of an interest entitled to such allocations, subject to adjustments determined by reference to the amount of allocations that would be eligible for the exception if the underlying assets were sold. In the case of tiered partnerships (e.g., a fund GP and a fund), for the upper-tier partnership allocations to qualify for the exception, they must be made in accordance with each upper-tier partner's (e.g., GP member's) share of the underlying capital account (or in some cases may be made in accordance with the upper-tier capital accounts).

- The narrowness of this exception thus potentially excludes from its scope any interest in a partnership whose partners participate differently in partnership assets, such as a partnership with excuse rights or side-pockets or a GP partnership whose members have differing interests in GP capital and carry.

- GP investments in many closed-end funds will also fail to qualify for the capital interest exemption simply by reason of the GP being allocated and not distributed carry, since such allocations would preclude gains from the GP's

[1] Section references are to the Internal Revenue Code of 1986, as amended (the "Code")

invested capital from being allocated pro rata to capital accounts, assuming it is instead allocated pro rata to invested capital, which is typically the case.

- It is also unclear whether the narrowness of the exception is intended to require a GP to pay carry on its own capital interest when investment returns on outside capital are subject to carry. While the proposed regulations specifically permit a capital interest to be not reduced by the "cost of services," whether this relief refers only to management fees or also to carry is unclear. The examples in the proposed regulations that illustrate the capital interest exception contemplate that the GP's capital interest bears carry and conclude such self-paid carry is subject to 1061 Recharacterization.

- Because the above limitations on the capital interest exception could likely be avoided by segregating differing asset participation into separate partnerships, it seems unlikely that the final regulations will exclude these types of interests from the exception.

- Notably, the capital interest exception does not apply to a service partner's invested capital funded with loans from or guaranteed by another partner or the partnership (or a related person), such as loans commonly made by fund sponsors to employees to fund their capital commitments, notwithstanding risk of loss borne by the borrower.

- The capital interest exception is generally unavailable where there are no significant (5%+) unrelated non-service provider partners. Though the more reasonable interpretation of the regulations supports concluding that GP co-invest partnerships without outside capital should not be subject to 1061 Recharacterization (subject to the satisfaction of the other requirements for the capital interest exception, such as allocations being made in accordance with capital accounts), this conclusion is far from clear.

- While also unclear, the capital interest exception seems to be available for allocations on crystalized carry that are made in the same manner as on outside capital, though of course not on the allocation supporting the crystalized carry itself.

    - For example, a hedge fund GP is allocated $100 of crystalized but unrecognized carry and leaves such amounts invested in the fund to earn profit or loss commensurate with other fund investors. The $100 of gains ultimately recognized in respect of such carry is subject to 1061 Recharacterization when it is recognized (including in a later years), whereas subsequent allocations of gains on such $100 credited to the GP's capital account appear to be protected under the capital interest exception, provided that such allocations are made in the same manner as those on outside capital.

Distributions in Kind. An asset distributed in-kind with respect to an API retains the API taint until the asset meets the three-year holding period.

- In-kind distributions may still be desirable in order to defer gains until the three-year holding period is met.

- However, if the distributed asset is sold during the three-year holding period, 1061 Recharacterization would apply to gains recognized on appreciation attributable to post-distribution periods.

- Though unclear, it appears that post-distribution appreciation can be protected from 1061 Recharacterization if the distributed asset is contributed to another partnership (provided that allocations of such appreciation, when recognized, are made in accordance with capital accounts).

Three-Year Period Tested at Level of Gains Recognition. Generally, the three-year holding period is tested at the level of the gains recognition event. More specifically, an asset sale is always tested by reference to the holding period in

that asset, whereas a sale of an API or pass-through type entity holding directly or indirectly an API is generally tested by reference to the holding period in that entity.

- This encourages transactions to be structured in a manner that preserves underlying holding periods and thereby allows new carry recipients to obtain long-term capital gains treatment in a subsequent asset sale of assets held for longer than three years.

- However, a lookthrough rule applies to sales of interests in a pass-through type entity if either (i) the holding period in a lower-tier API or pass-through type entity holding an API is three years or less or (ii) 80% of the assets at the asset level are held for three years or less. In addition, special recognition rules apply to direct and indirect transfers of API to specified related persons, as noted below.

Certain Income Items not Affected. The three-year carry rule does not apply to certain amounts treated as long-term capital gains, including Section 1231 gains (e.g., gains from real estate used in trade or business), qualified dividend income ("QDI"), Section 1256 gains (e.g., gains on traded futures), and certain mixed straddles.

- This encourages liquidity events in private equity transaction to be structured to produce QDI.

- For real estate funds, this seems to encourage asset-level sales of real estate used in a trade or business that would produce Section 1231 gains.

Carry Waivers. Many funds permit waivers of carry, including carry otherwise subject to 1061 Recharacterization, and provide for such waived carry to be recovered from subsequent gains, and sometimes only gains not subject to 1061 Recharacterization. The proposed regulations do not specifically attack these "carry waiver" provisions. However, the preamble identifies potential challenges based on existing anti-abuse rules.

Corporate "Passthrough" Entities. The proposed regulations reiterate Treasury's view that 1061 Recharacterization cannot be avoided by holding an API through an S corporation and expand this view to cover an API held through a Pedigreed QEF.

- For S corporations, this rule is retroactive to 2018 (consistent with prior guidance). For Pedigreed QEFs, the rule is effective for years beginning after the date of the proposed regulations.

- Capital gains dividends from real estate investment trusts ("REITs") and regulated investment companies ("RICs") are treated in the same manner as imputed long-term capital gains from S corporations and Pedigreed PFICs and thereby subject to 1061 Recharacterization to the extent attributable to gains on assets held for three years or less. However, REITs and RICs are apparently not treated as pass-through entities for purposes of applying 1061 Recharacterization to an API held by a REIT or RIC. Unless final regulations change this result, it may be possible for sponsors of real estate funds to hold their GP interest indirectly through a REIT and thus not be subject to 1061 Recharacterization.

Transfers to Colleagues and Family Members. Upon a transfer of an API (or asset received in respect of an API distribution) to a family member or to a colleague (i.e., a person who performed services in the current or preceding three years to the relevant ATB), gains are accelerated and recognized in respect of built-in appreciation on the one-to-three-year assets. This applies to otherwise non-taxable transactions, and in an otherwise taxable transaction, subjects the recognized gains to 1061 Recharacterization to the extent of any built-in API gains on underlying one-to-three year assets.

- This presents traps and likely unintended results. For example, could gain be realized/accelerated on a forfeiture by a departing GP partner (which would not reflect economic income)?

- Note that if a taxable sale of an API is not subject to this rule, 1061 Recharacterization is determined by reference to the holding period in the API, subject only to specific lookthrough rules. However, if a taxable sale is subject to this rule by reason of the purchaser's status, 1061 Recharacterization is always determined by reference to holding periods at the asset level.

- This rule does not apply on contributions to partnerships; instead, the built-in gains, when recognized, will be allocated to the contributor under Section 704(c) principles.

Netting of Loss. While 1061 Recharacterization applies to net capital gains that would otherwise be long-term capital gains in a year, there is no corresponding recharacterization of net capital loss on assets with a one-to-three-year holding period.

- This leads to an arguably unfair result if a service provider is allocated loss from assets held for one to three years during a year, and is allocated gains from assets held for one to three years in a subsequent year. Because the first year's loss would remain long-term and not be recharacterized as short-term, it would net against other long-term gains instead of the later year's gains treated as short-term by reason of 1061 Recharacterization.

Unrelated Purchaser. If an unrelated purchaser who is not performing services (and did not perform, and does not anticipate performing services) buys an interest in an API, it ceases to be an API with respect to the purchaser. The preamble states that this exception applies only on a purchase of an API, but not on a contribution to capital of the partnership in exchange for an interest in the API.

- In the context of seed or other third-party investments in fund managers, it would thus matter whether the investor purchases an interest from the GP members, or contributes to capital of the fund manager. This may be in tension with a goal by the existing GP members to avoid gains recognition on the investment.

Basis shifting. If a partner sells a partial interest in a partnership and the selling partner holds both an API and a capital interest in such partnership, the basis in the partial interest sold is determined by apportioning the partner's basis in its entire aggregate partnership interest among the sold and retained portions, based on their current fair market values.

- This results in basis shifting between the API and the capital interest, which may be either favorable or unfavorable to the taxpayer depending on the relevant facts, though the capital interest exception contains lookthrough rules intended to limit taxpayer favorable results.

Summary of Proposed Regulations

What is an API?

Generally. Very generally an API is a partnership interest directly or indirectly held by or transferred to the taxpayer, or a "Passthrough Entity" held directly or indirectly by the taxpayer, in connection with the performance of services, by any such persons or a related person, in an ATB. An "API Holder" is a person directly or indirectly holding an API. A Passthrough Entity is a partnership, S corporation or Pedigreed QEF (but notably, not a REIT or RIC). For this purpose, a partnership interest includes non-equity financial instruments or contracts whose value is determined in whole or in part by reference to the partnership.

Once an API, always an API. An API retains its character through multiple tiered Passthrough Entities, including (i) even if the relevant services are not longer being performed or the relevant ATB ceases and (ii) even if transferred via a contribution or exchange, unless and until the requirements of one of the exceptions below is satisfied (such as a purchase by an unrelated investor). Thus, "once an API, always an API." See below for further discussion regarding treatment of APIs after a transfer.

ATB. An ATB is activity conducted on a regular, continuous, and substantial basis (by reference to the rules under Section 162) that consists of (i) raising or returning capital, and (ii) investing in, disposing of or developing "specified assets" (including securities, real estate held for rent or investment, cash options, and derivatives, but not including operating pass-through businesses). For this purpose, activities of multiple related entities are taken into account, and may span multiple years. Once an interest is an API, it remains an API, even if the ATB activity ceases. The proposed regulations are explicit that a management company's ATB activities will taint the GP's interest both where the management company is a related person to the GP, and where the management company performs under a delegation of the GP's obligations to the fund.

Calculating the 1061 Recharacterization

Generally. The 1061 Recharacterization is made at the ultimate taxpayer level across all of the taxpayer's direct and indirect APIs. The amount of 1061 Recharacterization is (i) the taxpayer's aggregate taxable allocations of net long-term capital gains from all API Passthrough Entities for the taxable year in which the taxpayer holds an interest, without regard to 1061 Recharacterization, minus (ii) the same amount, calculated substituting a three-year holding period for the normal one-year holding period used when calculating long-term capital gains, with the resulting amount being recharacterized as short-term capital gains. This computation excludes certain types of income altogether that are not subject to 1061 Recharacterization (described below).

Net losses. 1061 Recharacterization does not apply to net losses in a year. As noted above, this means that taxpayers cannot use losses in a year to offset gains in a different year, each of the type subject to 1061 Recharacterization, since the loss year would not have been recharacterized so would retain its character as long-term capital loss.

Excepted income. Certain income and gains taxed at long-term capital gains rates are excepted from 1061 Recharacterization, including Section 1231 gains, QDI, Section 1256 gains and certain mixed straddles, as well as any other capital gains and losses that are characterized as long-term or short-term without regard to the holding period rules in Section 1222.

Installment sale gains. Gains from installment sales are included in the computation of the 1061 Recharacterization (and may be recharacterized) when they are otherwise included in income, but the relevant holding period is determined at the time of the sale. Notably, gains from installment sales may be recharacterized when recognized beginning in 2018 even if the installment sale took place prior to the enactment or effective date of Section 1061.

RIC and REIT capital gains dividends. RIC and REIT capital gains dividends recognized by an API Holder are subject to 1061 Recharacterization by reference to RIC or REIT's holding period in the asset. This requires obtaining from the RIC or REIT certain reporting, and if sufficient reporting is not provided, then the entire amount is subject to 1061 Recharacterization. Under a special rule, if an API Holder holds a RIC or REIT for six months or less, and the RIC or REIT reports gains with a three-year holding period, and then the API Holder sells its shares in the RIC or REIT at a loss, that loss is treated as also having a three-year holding period to the extent of the reported three-year gains.

PFIC gains: Long-term capital gains realized in respect of a Pedigreed QEF are subject to 1061 Recharacterization by reference to the PFIC's holding period in the asset.

Transition rule. Under a "transition rule," a partnership may elect to treat all of its gains and losses on assets held with a three-year holding period as of January 1, 2018, as "transition amounts" and excepted from 1061 Recharacterization. The utility of this rule is unclear.

Transfers, Distributions and Revaluations

Transfers of APIs. A direct or indirect transfer of an API (i.e., a partnership interest that is an API), including a taxable sale or tax-free contribution or distribution, does not remove the taint, and the API continues to be subject to 1061 Recharacterization after the transfer, unless and until any exception to 1061 Recharacterization applies, such as a taxable sale to an unrelated purchaser or a transfer to a corporation other than an S corporation or Pedigreed QEF.

Distributions in respect of APIs. If property is distributed-in-kind with respect to an API (i.e., property which is not itself an API, such as corporate stock or other assets, "Distributed API Property"), the distribution does not accelerate the recognition of gains or application of 1061 Recharacterization (assuming the distribution is not otherwise taxable). Instead, when the Distributed API Property is disposed of in a taxable disposition, then 1061 Recharacterization applies if the holding period is three years or less (inclusive of the Passthrough Entity's holding period). Gains attributable to appreciation after the distribution-in-kind is subject to 1061 Recharacterization, though the rationale for this result is unclear.

Revaluations. Assets in respect of API must be revalued and the built-in API gains ("Unrealized API Gain") must be subsequently tracked to the original API Holder under principles of Section 704(c). This revaluation and tracking is required (i) upon contributing an API, or a Distributed API Property, to a Passthrough Entity, (ii) if the partnership issuing the API is otherwise doing a 704(b) revaluation (i.e., a capital account book-up) and (iii) if any partnership in the tiered partnership structure is otherwise doing a 704(b) revaluation. While this revaluation rule ensures, as confirmed in the preamable, that API Gain is not shifted among taxpayers or otherwise excepted from 1061 Recharacterization, it also appears to provide a mechanism for capping the amount of API Gain under the capital interest exception discussed below.

This rule appears to require tracking allocations within corporate Passthrough Entities under 704(c) principles. It is unclear, however, how S corporations could make allocations in any manner other than pro rata to its outstanding shares, or how shareholder inclusions in respect of a Pedigreed QEF can be other than consistent with their capital interest in the PFIC.

Taxable Dispositions of APIs

Generally, 1061 Recharacterization is determined by reference to the holding period of the property sold. In other words, if the applicable partnership issuing the API sells assets, then satisfaction of the three-year holding period for allocations of resulting gains or losses are determined at the asset level, but if interests in an Passthrough Entity holding directly or indirectly API, then satisfaction of the three-year holding period is determined with respect to the Passthrough Entity interest being sold, subject to a lookthrough rule.

However, if there is a disposition of the Passthrough Entity holding directly or indirectly an API, then the following "Lookthrough Rule" applies:

- *Lookthrough on direct API sales*. In the sale of a directly held interest in API that satisfies the three-year holding period, 1061 Recharacterization might nevertheless apply to a portion of such gains if 80% of the underlying assets, by fair market value, are assets that would be subject to 1061 Recharacterization if sold directly (the "Substantially All Test"). For purposes of this calculation (i) cash, cash equivalents, and assets that would be recharacterized as ordinary income items under Section 751 are ignored and (ii) assets of lower-tier partnerships are counted as if held directly.

- *Tiered-entity lookthrough*. In a sale of an interest in a Passthrough Entity that directly or indirectly holds API and that satisfies the three-year holding period, 1061 Recharacterization may nevertheless apply if either (i) the interest in any lower-tier Passthrough Entity directly or indirectly holding the API fails to satisfy the three-year holding period or (ii) the directly held API satisfies the three-year holding period and the assets underlying the API meet the Substantially All Test.

- *Measure of 1061 Recharacterization*. If lookthrough applies by reason of an interest in a lower-tier Passthrough Entity failing the three-year holding period, then all of the gains are subject to 1061 Recharacterization. If lookthrough otherwise applies, the 1061 Recharacterization is based on the portion of the gains that would have been subject to 1061 Recharacterization in a hypothetical asset sale.

Special additional lookthrough rules apply to gains on API sales to specified related parties, as discussed below.

Capital Interest Exception

Generally. Under the Code, API does not include a capital interest that "provides the taxpayer with a right to share in partnership capital commensurate with (i) the amount of capital contributed … or (ii) the value of such interest subject to tax under Section 83." The proposed regulations implement this relief from 1061 Recharacterization by providing that "Capital Interest Gains and Losses" are not subject to such recharacterization. Capital Interest Gains and Losses include "Capital Interest Allocations," "Passthrough Interest Capital Allocations" and "Capital Interest Disposition Amounts."

- A Capital Interest Allocation generally refers to an allocation to an API Holder if the allocation is (i) made in accordance with capital accounts of those partners receiving the allocation, (ii) made to unrelated non-service provider partners under the same terms as to the API Holder, provided the non-service provider partners have "significant" capital account balances aggregating at least 5% of total partner capital account balances ("Qualified Outside Capital") and (iii) clearly identified under the partnership agreement and on the partnership's books and records as separate from allocations made with respect to the API. This includes, for example, allocations to the fund GP in respect of its co-invest in the fund (provided these three restrictions are satisfied).

- A Passthrough Interest Capital Allocation generally refers to an allocation by a Passthrough Entity that is a direct or indirect API Holder (e.g., a fund GP that is a partnership, or a partnership partner of such fund GP) if the allocation is (i) an allocation of Capital Interest Allocations to the Passthrough Entity that is made by the Passthrough Entity according to either each of its owners' share of the Passthrough Entity's capital account in the entity making the Capital Interest Allocation or the capital accounts of all those owners (and in the case of a corporate Passthrough Entity, in each case accounts maintained using similar principles) or (ii) an allocation from an asset other than API directly held by the Passthrough Entity and made by the Passthrough Entity according to either capital accounts or capital accounts as reduced by the portion of their balances not attributable to such assets (and in the case of a corporate Passthrough Entity, accounts maintained using similar principles).[2] This includes, for example, allocations both from the fund GP in respect of its co-invest and in respect of a fund GP's other direct investments that are not API (provided in each case the allocations requirements are satisfied).

- Capital Interest Disposition Amount generally refers to gains or losses from the disposition of a interest in a Passthrough Entity entitled to Capital Interest Gains and Losses, provided that such amount is limited (and any excess gains or losses are subject to 1061 Recharacterization) by reference to the amount of Capital Interest Gains or Losses that would be allocated in respect of such interest if the underlying assets were sold.

Permitted deviations. Despite the general rule requiring that a capital interest be allocated in accordance with capital accounts, a Passthrough Entity is permitted to deviate so as to not burden the capital interest with the "cost of services," although whether this relief is limited to only management fees or also to carry is unclear, as noted above. Additionally, a capital interest may be subordinate to allocations made to unrelated non-service provider partners.

Effect of revaluations. An important unanswered question is whether allocations made on the portion of capital accounts attributable to unrealized or realized gains from API can qualify for the capital interest exception.

- It is clear that, under Section 704(c) principles, Unrealized API Gain in respect of API contributed to another partnership is allocated to the contributor when recognized and subject to 1061 Recharacterization. It is also clear that all other gains or losses allocated to an upper-tier partnership receiving such API in respect of the contributed API is API Gain or Loss in the hands of the upper-tier partnership and its partners.

[2] It is unclear how this type of allocation is classified and therefore treated when allocated to another Passthrough Entity, even if made pro rata to capital accounts at that level, since it would appear to be in respect of an API and cannot be a Capital Interest Allocation given that it is not made in respect of Qualified Outside Capital at any level.

- Instead of API being contributed to another partnership, suppose that there is a revaluation of partnership assets underlying the API and that Unrealized API Gain is allocated to the capital account of the API Holder and that thereafter all allocations are made pro rata to capital accounts, including in respect of Qualified Outside Capital and the API. While the Unrealized API Gain, when recognized and allocated to the API Holder under Section 704(c) principles, is clearly treated as API Gain, the amount of Unrealized API Gain would seem to be capped at the revaluation amount. This is because the allocations made according to capital accounts after such revaluation would all seem all to qualify as Capital Interest Allocations.

- Similarly, suppose that Distributed API Property is contributed to a partnership, triggering a revaluation of such property, and after such contribution all partnership allocations are made pro rata to capital accounts, including in respect of Qualified Outside Capital and the interest received for the contributed property. Again, while the Unrealized API Gain attributable to contributed property would be allocated under Section 704(c) principles back to the contributor when recognized, allocations on such contributed capital after the contribution would seem to qualify as Capital Interest Allocations.

- We do not believe that these results are inconsistent with the statement in the preamble that the revaluation rule is intended to prevent Unrealized API Gain from subsequently qualifying, e.g., through a recapitalization or division of the partnership, for the capital interest exception before the taxable income is recognized. However, because these results are inconsistent with applying 1061 Recharacterization to gains on Distributed API Property attributable to appreciation during the post-distribution period, it is very unclear whether they are intended by the proposed regulations.

Loans and guarantees. Finally, a special rule requires the Passthrough Entity to discount any capital account to the extent contributions were made that are attributable to loans made or guaranteed by another partner or the Passthrough Entity, or their related persons. This would apply, for example, in the context of loans made by a fund manager to its employees to help them meet their capital commitment obligations. The rationale for applying this rule without regard to a partner's risk of loss with respect to the loans is unclear.

Corporate Passthrough Entities. S corporations and Pedigreed QEFs are permitted to apply these rules by maintaining and determining accounts similar to partnership capital accounts. As noted above, it is unclear how S corporations could make allocations in any manner other than pro rata to its outstanding shares, or how shareholder inclusions in respect of a Pedigreed QEF can be other than consistent with their capital interest in the PFIC. In circumstances when these Passthrough Entities are required but unable to allocate income on the basis of these accounts, it is unclear how amounts recognized from interests in the Passthrough Entities can qualify for the capital interest exception.

Other Exceptions

Corporate exception. An interest held through a corporation is not subject to 1061 Recharacterization. However, the proposed regulations do not apply this exception to an API held through an S corporation or through a Pedigreed QEF, in each case because shareholders otherwise recognize the share of long-term capital gains. For S corporations, this rule is retroactive to 2018 (consistent with prior guidance). For Pedigreed QEFs, the rule is effective for tax years beginning after the date of the proposed regulations.

Notably, RICs and REITs are not removed from the exception for interests held through corporations. Apparently, a GP interest in carry could be held by the carry recipients through a REIT (in a real estate fund), thus avoiding 1061 Recharacterization.

Non-ATB employee. An interest transferred to a person in connection with performance of services to another entity that is not conducting an ATB, is not an API, assuming the person provides services only to that other entity. This may be applicable where employees of a target portfolio company are granted interests in a partnership holding entity above the portfolio company, and could prevent those interests from being subject to 1061 Recharacterization.

Purchase by unrelated investor. The taxable purchase of an API for fair market value will cleanse the API status in the hands of the purchasing taxpayer, provided that (1) the purchasing taxpayer is not a "related person" to any person providing services in the relevant ATB, to the target partnership, or to any directly or indirectly held lower-tier partnership of the target partnership; (2) the "related party transfer" rule (discussed below) does not apply; and (3) the purchaser has never been, and does not anticipate becoming, a service provider for the target partnership or any directly or indirectly held lower-tier partnership thereof. Importantly, contributions of capital to a partnership in exchange for a partnership interest in the API do not qualify for this exception – the API must be purchased.

Transfers to Colleagues and Family Members

A special "1061(d) Rule" applies when an API is transferred to any of (i) a family member, (ii) another person who provided services to the relevant ATB in the current or preceding three years (i.e., a current or former colleague), or (iii) a Passthrough Entity in which a person in the preceding clauses owns an direct or indirect interest, in each case whether transferred by the taxpayer or by a Passthrough Entity that holds the API. This 1061(d) Rule applies to transfers including contributions, distributions, sales and exchanges, and gifts, and applies whether or not the transfer is otherwise a taxable event.

Upon such a transfer, the built-in API Gain that would have been subject to 1061 Recharacterization when realized is accelerated and recognized, calculated generally on the basis of a hypothetical asset sale (and looking down through tiers of Passthrough Entities). If the transfer is otherwise taxable, it is possible that the amount subject to 1061 Recharacterization would be more than the total gains realized on the transfer—if so, all the gains realized are subject to 1061 Recharacterization, but not any excess. Note that the 1061(d) Rule always operates by reference to the holding period and gains and the asset level, unlike the rules for taxable entity dispositions generally which apply at the entity level unless a Lookthrough Rule applies.

Notably, a contribution to a partnership is not subject to the 1061(d) Rule because the Unrealized API Gain will be tracked to the contributor, as above.

Reporting Rules

The proposed regulations contemplate that Passthrough Entities as well as REITs and RICs will report certain information for taxpayers to make the determinations and calculations required by these rules, including information necessary to determine whether gains have a holding period less than three years, whether gains are of a type excluded from 1061 Recharacterization (e.g., Section 1231 gains, Section 1256 gains, and QDI, as above), and information required to determine application of the Lookthrough Rule, under future guidance and forms. Additionally, if an entity requires information from its subsidiaries for this purpose, it may request such information and such subsidiaries are required to provide it, with certain timing rules. If the entities do not provide sufficient information, and the taxpayer is unable to determine the facts, then 1061 Recharacterization generally applies.

Applicability

The proposed regulations generally apply to taxpayers for taxable years beginning on or after the date final regulations are published. Except with respect to the transition rules, taxpayers may rely upon the proposed regulations until publication of final regulations so long as they are applied consistently and in their entirety. The transition rules may be relied upon for tax years beginning in 2020 and subsequent tax years until publication of final regulations. The rule providing that the term "corporation" does not include S corporation is applicable for taxable years beginning after December 31, 2017. The rule providing that the term "corporation" does not include a Pedigreed QEF is applicable for taxable years beginning after the date proposed regulations are published.