The Real Estate Roundtable

October 5, 2020

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

The Honorable Michael J. Desmond
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Guidance Regarding Code Section 1061 [REG-107213-18]

Dear Assistant Secretary Kautter and Chief Counsel Desmond:

On behalf of The Real Estate Roundtable, I am pleased to provide comments regarding Proposed Regulations[1] under Section 1061,[2] a new provision added to the Code by the Tax Cuts and Jobs Act of 2017 ("TCJA"). Section 1061 provides for a greater than three-year holding period in the case of certain net long-term capital gain with respect to any applicable partnership interest held by the taxpayer.

A large share of the real estate investment and development that takes place across the country uses the partnership as its entity of choice. Nearly two million real estate partnerships in the United States with more than eight million partners own over $7 trillion in assets.[3] We believe most partnerships, in all businesses, aim to reward the general partner with a share of the ultimate capital gain that reflects the risks they have taken—equity capital, assumption of business risk, and good, old-fashioned sweat equity. Congress had specific concerns in mind when it drafted section 1061 and narrowly tailored the provision to apply in those situations.

The Roundtable commends Treasury and the IRS for thoughtfully addressing a number of issues that should help avoid unintended consequences and increase the likelihood that the 3-year holding period that applies under Section 1061 is implemented consistent with Congressional intent. Specifically:

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[1] REG-107213-18 (the proposed regulations published therein are hereinafter referred to as the "Proposed Regulations" or "Prop. Reg. §"; any references to "Explanation of Provisions at _" are to the preamble to the Proposed Regulations).

[2] All references to "Section" or "§" are to the Internal Revenue Code of 1986, as amended (the "Code") or to the Treasury Regulations (the "Regulations" or "Reg. §") promulgated thereunder.

[3] Internal Revenue Service, *SOI Tax Stats – Partnership Statistics by Sector or Industry* (last updated Sept. 10, 2020).

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- The Proposed Regulations appropriately limit the application of Section 1061 to assets that produce capital gain that is treated as long-term capital gain under Section 1222 and exclude gain from property used in a trade or business (Section 1231 gains and losses). In addition to aligning with the clear language of the statute,[4] this result appears consistent with the drafters' intent.[5]

- The Proposed Regulations provide an important "look-through" rule that allows real estate investment trusts ("REIT(s)") to distinguish when making distributions that are traceable to gain subject to recharacterization under Section 1061 and distributions that are properly subject to long-term capital gain treatment because the gain is Section 1231 gain or is derived from assets held for more than 3 years. The look-through rule is necessary to ensure that the REIT dividends paid to shareholders are not unfairly deprived of the same preferential long-term gain treatment that would apply to assets owned individually or in partnership form.

- The Proposed Regulations provide rules that allow an exclusion from recharacterization of capital gains and losses with respect to a partner's capital interest in a partnership.

Nonetheless, certain provisions of the Proposed Regulations warrant further consideration and additional, clarifying guidance, particularly in situations where they may tend unintentionally to discourage real estate investment, entrepreneurial risk-taking, and job creation. Recommended clarifications and proposed changes to the final regulations are discussed below. The recommendations were developed by The Roundtable's Tax Policy Advisory Committee, and specifically its Section 1061 Working Group, which includes leaders of the nation's top real ownership, development, lending, and management firms, representatives of the major national real estate industry associations, and outside advisors.

Executive Summary of Real Estate Roundtable Recommendations

1. **Definition of an "Applicable Trade or Business."** The Proposed Regulations have applied the definition of an Applicable Trade or Business[6] too broadly by including even a stand-alone real estate joint venture, as well as other common real estate arrangements that Congress did not intend to cover. Consistent with the statute, the regulations should require that an applicable trade or business be engaged in "raising or returning capital" on a regular, continuous, and

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[4] Gain from property used in a trade or business is treated as long term based on the operation of section 1231 and not by reference to section 1222.

[5] The drafters of section 1061 sought to distinguish between "money managers" and those who actively work to improve an asset. Speaking about the provision the day it was introduced and adopted in committee, House Ways and Means Chairman Kevin Brady (R-TX), its author, said it would "make[] sure you don't have the giant hedge funds spinning in and out" of investments and would reward "those who put in skin in the game and then work to make the skin in the game better." Chairman Brady specifically referenced "traditional real estate partnerships," such as those that "build the strip centers or the industrial parks," as the types of partnerships that would continue to qualify for long-term capital gains treatment. *Top House Tax Writer Kevin Brady Says He's Effectively Closing the Loophole for Hedge Funds* (CNBC Nov. 6, 2017).

[6] Unless otherwise defined herein, all capitalized terms used herein are defined in the Proposed Regulations.

substantial basis. We believe the "raising or returning capital" should be defined more narrowly to fit only those partnerships engaged in the business of raising or returning capital.

2. **Borrowed Funds Contributed by a Partner.** The Capital Interest Exception allows partners to exclude their own capital interests in the partnership from potential recharacterization. The Proposed Regulations provide an exception to the Capital Interest Exception by ignoring certain borrowed funds contributed by any partner to a partnership with at least one API holder and an unrelated non-service partner. We believe this exception is overly broad and does not properly target the intended abuse. Moreover, the exception would eliminate a significant source of capital available for productive, job-creating commercial real estate investment. Accordingly, we believe the exception should be limited to only the perceived abuse.

3. **Transfers Described Under Section 1061(d).** Section 1061(d)(1) provides a special rule for transfers of applicable partnership interests to certain specified related persons. The Proposed Regulations would override the nonrecognition provisions of the Code by requiring an inclusion of gross income as a result of such transfers. We believe overriding the Code's nonrecognition provisions is inconsistent with the statutory text and the underlying legislative intent and can lead to inappropriate results. Moreover, Section 1061(d) should not recharacterize Section 1231 gains.

Detailed Analysis

I. Definition of Applicable Trade or Business

We request that the Proposed Regulations be clarified to make it clear that: (i) businesses that do not both raise or return capital and engage in either investment or development activities do not satisfy the ATB Activities Test, (ii) the mere raising of capital *for* a business or investment activity (as opposed to raising and returning capital as part of a business) is not treated as "raising or returning capital" as defined in the statute and (iii) engaging in isolated transactions does not satisfy the regular, continuous, and substantial standard for the ATB Activities Test.

Clarification That Both Prongs of the ATB Activities Test Must be Satisfied

The Proposed Regulations provide that the ATB Activities 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."[7] Specified Actions "means Raising or Returning Capital Actions and Investing or Developing Actions."[8]

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[7] Prop. Reg. § 1061-2(b)(1).

[8] Prop. Reg. § 1061-2(b)(1)(i)(A).

Although we believe it was intended that term "Specified Actions" mean that both Raising or Returning Capital Actions and Investing or Developing Actions be performed,[9] this is not clear. It is possible that one might interpret that term in a manner to say that Raising or Returning Capital Actions (or, alternatively, Investing or Developing Actions) are each a Specified Action. In that case, one might conclude that the ATB Activities Test can be satisfied if there are only activities Raising or Returning Capital Actions (or, alternatively, Investing or Developing Actions).

In order to prevent, a misinterpretation of the rules, we recommend clarifying that the ATB Activities Test is not satisfied unless both Raising or Returning Capital Actions "and" Investing or Developing Actions are conducted.[10]

Guidance Regarding the Meaning of Raising or Returning Capital

In addition, the Proposed Regulations cast too wide a net in their interpretation of what activities constitute Raising or Returning Capital Actions. By failing to give greater meaning and significance to this prong of the ATB Activities Test, the proposed rules would capture common and everyday partnerships of all sizes, small and large, that lack the core traits of the asset management/investment fund structures targeted in the statute and its legislative history. The plain reading of the statute, longstanding principles of statutory construction, and clear statements of legislative intent by the drafters of Section 1061 strongly suggest that the raising or returning capital language was included in the statute to narrow the operation of Section 1061 to asset management/investment fund businesses.

Section 1061 defines an applicable trade or business as "any activity conducted on a regular, continuous, and substantial basis which . . . consists, in whole or in part, of—(A) raising or returning capital, and (B) either—(i) investing in (or disposing of) specified assets (or identifying specified assets for such investing or disposition), or (ii) developing specified assets."[11] Raising or Returning Capital Actions are simply defined in the Proposed Regulations as "actions involving raising or returning capital but does not include Investing or Developing Actions."[12] Although there is not more specific guidance on the meaning of the term, the Proposed Regulations contain an example of a hardware store that "raises capital," implying that the capital raising activities of the hardware store might be the type of capital raising activities that could help satisfy the ATB Activities Test.

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[9] The examples in the Proposed Regulations appear to apply the term Specified Actions in a manner that interpret the term in a way that both requirements are satisfied and the statute seems to be clearly drafted in a manner that both prongs needs to be present to have an applicable trade or business. See §1061(c)(2) ("The term 'applicable trade or business' means any activity conducted on a regular, continuous, and substantial basis which, regardless of whether the activity is conducted in one or more entities, consists, in whole or in part, of (A) raising or returning capital, and (B) either (i) investing in (or disposing of) specified assets (or identifying specified assets for such investing or disposition), or (ii) developing specified assets.").

[10] We are not necessarily suggesting that an activity be conducted each year of the partnership's existence for the ATB Activities Test to be satisfied.

[11] § 1061(c)(2).

[12] Prop. Reg. § 1.1061-1(a).

In our interpretation of what was meant by "raising or returning capital", it does not seem appropriate to interpret the term so broadly as to include any activity to raise money as such an interpretation would include virtually every business, which would make the "raising or returning capital" prong meaningless. It is an important facet of statutory construction that a provision should not be interpreted in a manner that renders a provision meaningless. The Supreme Court has weighed in on this several times including language in their opinion such as:

> "A statute should be construed so that effect is given to all its provisions, so that no part will be inoperative or superfluous, void or insignificant."[13]

> "The Government's reading is thus at odds with the basic interpretive canon that " '[a] statute should be construed [to give effect] to all its provisions, so that no part will be inoperative or superfluous, void or insignificant.'"[14]

> "We assume that Congress used two terms because it intended each term to have a particular, nonsuperfluous meaning."[15]

> "But of course we construe statutes, where possible, so as to avoid rendering superfluous any parts thereof."[16]

Accordingly, we believe the term "raising or returning capital" needs to be narrowed in some manner so that it does not cover virtually all partnerships, since all partnerships that invest or develop raise or return capital to their partners. There is strong evidence suggesting that the "raising or returning capital" prong was meant to limit the scope of the statute to a business that raises capital in a manner similar to an asset management business that raises capital *as part of* their business on a regular, continuous, and substantial basis.

In the clearest statement of the drafters' legislative intent regarding Section 1061, the Ways and Means Committee stated in its report accompanying the Tax Cuts and Jobs Act that, "The Committee is concerned about Federal tax issues arising from the use of carried interests in asset management businesses."[17]

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[13] *Hibbs v, Winn*, 542 U.S. 88, 101 (2004) (citing to Singer, Statutes and Statutory Construction §46.06, pp. 181–186 (rev. 6th ed. 2000) to support its position regarding "[t]he rule against superfluities.")

[14] *Corley v. U.S.*, 556 U.S. 303, 314 (2009) (citing to *Hibbs, supra).*

[15] *Bailey v. U.S.,* 516 U.S. 137, 146 (1995).

[16] *Astoria Federal Savings & Loan Ass'n v. Solimino*, 501 U.S. 104, 112 (1991).

[17] H. Rpt. 115-409 (2017) at 277. The Ways and Means Committee further stated, "In these arrangements, the investment fund typically is a partnership. The investors are limited partners that contribute capital to acquire fund assets, and the fund manager is the general partner of the investment fund partnership." *See also* footnote 5, which includes statements made by then-Ways and Means Committee Chairman Kevin Brady (R-TX) when the 3-year holding period was added to the legislation in which Chairman Brady indicated his intention to distinguish between partnerships that are in the business of managing financial assets and real estate partnerships that develop and improve properties.

The Joint Committee of Taxation's 2007 analysis of carried interests ("JCT Analysis") further supports this conclusion.[18] The JCT Analysis is replete with references to the "asset management" business as the target of the carried interest proposals and notes that those are the focus of its analysis.

For example, Part One of the JCT Analysis stresses the focus on carried interests in particular businesses, each of which raise capital from investors as part of their business. The JCT Analysis states:

> Part One provides background information about carried interests and going-public transactions of partnerships involved in private equity, hedge fund, venture capital fund, and similar alternative asset management and financial advisory business activities.[19]

The JCT Analysis recognized that carried interest existed in other contexts but noted that the focus was on the "asset management business":

> The use of carried interests is not limited to asset management businesses, but can extend to any business in which investors desire to align the interests of managers with those of investors by using positive investment yield as the measure of managers' income. However, *this discussion is focused on carried interests used in asset management businesses,* a feature of which is that investment yield may include income taxed at lower rates.[20]

The JCT Analysis further notes that raising capital is an aspect of these businesses noting, for example, that private equity funds "typically operate by collecting capital commitments from investors. These are promises to make funds available for investment. These commitments may then be called upon to make investments when opportunities arise."[21] We believe that this type of capital raising, which is commonly ***part of*** an asset management business, is what was referenced in the statute, and was not meant to cover any capital raising ***for a*** business such as a partnership that operates a hardware business. Stated differently, the concept of "raising or returning capital" should be limited to those that, as the JCT Analysis referenced it, "typically operate by collecting capital commitments." To be covered by the carried interest rules, the raising or returning of capital should be part of the business "operations" and not raising of capital conducted by a business to finance other operations.

In the example of the hardware store, the hardware store may raise capital from others which may be in the form of equity or debt. However, that fund raising is not part of its business operations. It is simply a method of financing its business operations. When the hardware store raises money, it does not earn profits from the funds that are raised and needs to deploy those funds wisely to earn income.

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[18] Joint Committee on Taxation, "Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests," (JCX-41-07), July 10, 2007 (a description of present law and analysis of Federal tax issues relating to partnership carried interests) (hereinafter cited as "JCT at p._").

[19] JCT at p. 1 (emphasis added).

[20] JCT at pp. 45-46 (emphasis added).

[21] JCT at p. 34.

Contrast the hardware store with the asset management businesses described in the JCT Analysis. In the asset management business, funds earn revenues based on the capital that they raise. As the JCT Analysis noted, based on a recent study, over 60% of the revenues of fund managers come from management fees.[22] The referenced study describes those fees as follows:

> Most funds use one of four methods for the assessment of management fees. Historically, the most common method was to assess fees as a constant percentage of committed capital. For example, if a fund charges 2% annual management fees on committed capital for ten years, then the lifetime fees of the ten-year fund would be 20% of committed capital…. In recent years, many funds have adopted a decreasing fee schedule, with the percentage falling after the investment period. For example, a fund might have a 2% fee during a five-year investment period, with this annual fee falling by 25 basis points per year for the next five years.
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> The third type of fee schedule uses a constant rate but changes the basis for this rate from committed capital (first five years) to net invested capital (last five years). Finally, the fourth type of fee schedule uses both a decreasing percentage and a change from committed capital to net invested capital after the investment period.[23]

The common denominator in all of those methods is that, in each case, the management fee is based on the capital committed and/or invested. In other words, in asset management businesses raising capital is part of the business itself and directly leads to revenues for the business. Therefore, it seems the definition of "raising or returning" capital should be refined so that it only includes "raising or returning" capital activities in which the business earns compensation based on either (i) capital committed, (ii) capital contributed, or (iii) capital invested. We believe that this was intended to also include fees that might be adjusted for the value of the capital invested by that investor. Compensation should be defined broadly enough to include not only actual cash compensation but any compensation that is adjusted based on those metrics. This would distinguish asset managers that "raise or return" capital as part of their business from businesses like the hardware store that merely raise and return capital to invest in their business.

Consider, for example, a publicly traded REIT ("Pub REIT") that is in the business of owning and operating real estate. It raises capital to finance its business. The fund-raising may be in the form of an equity-raise in the public markets and/or the issuance of debt. Pub REIT owns all of its assets through an operating partnership that Pub REIT controls. In order to incentivize and compensate certain service providers, Pub REIT and the operating partnership agree that certain individuals will be granted interests in the operating partnership that may constitute a profits interest. Neither Pub REIT nor the operating partnership earns compensation based on the capital that was raised, which contrasts with an asset management business which raises and returns capital as part of its business. Therefore, Pub REIT and the operating partnership, and the individuals receiving the interests should not be treated as satisfying the raising or returning capital prong of the ATB Activities Test.

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[22] JCT at p. 37.

[23] Metrick and Yasuda, "The Economics of Private Equity Funds." *The Review of Financial Studies*, v. 23 n 6 2010 pp.2309-2310.

Guidance on the Regular, Continuous, and Substantial Standard and Applying It to Each Prong Independently

Guidance is needed in the Proposed Regulations making it clear that the regular, continuous, and substantial standard applies independently to each prong of the ATB Activities Test. We recognize that there is a concern that one of the activities of the two prongs (say, raising or returning capital actions) may not be occurring regularly or continuously in the trade or business and therefore the proposed regulations, as observed above, provide that it is not necessary for both actions of the prong to occur in a single year for the ATB Activities Test to be met. We appreciate that a profits interest in a partnership may be transferred for services to a person at various times over the life of the partnership including when, say, the raising or returning capital activities have long ceased for that partnership.

While we recognize this concern, we believe that the aggregation of activities of one or more entities and related parties is adequate to address the concern without implying that raising or returning capital activities of a trade or business may not occur with a degree of regularity, continuity, and substantiality. The aggregation of activities would include a raising or returning capital trade or business that is conducted for or on behalf of one or more partnerships (funds) whose durations may overlap. For example, private equity fund sponsors tend to have a series or complex of funds of varying vintages (each a partnership with a carried interest or other incentive transferred to a general partner or manager affiliated with the sponsor). An affiliate of the sponsor is responsible for raising capital or returning capital for each of its fund partnerships (whether through its broker-dealer affiliate and/or the use of placement agents), which activities for the sponsor's complex of funds occurs nearly each year of the existence of the funds. Typically, a sponsor is engaged in raising capital for the next fund in a series of funds once the prior fund's capital raise has closed.

As previously mentioned, the proposed regulations aggregate activities of one or more entities and related parties. Prop. Reg. §1.1061-2(b)(1)(i)(C)(1) specifies that if a Related Person(s) (within the meaning of Prop. Reg. §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 Activities Test is satisfied. Moreover, 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 Activities Test is satisfied with respect to the principal. Applying these aggregation rules of the ATB Activities Test to the above example, even though in one year raising or returning capital actions of the sponsor may not be regular, continuous, and substantial in relation to a particular partnership and an API in such partnership, the sponsor's activities vis-à-vis its affiliates conducting raising or returning capital activities for the other funds would cause the sponsor to satisfy the raising or returning capital prong with respect to any of the sponsored funds.

Accordingly, because aggregation rules are included in the ATB Activities Test, we suggest omitting the second sentence of Prop. Reg. §1.1061-2(b)(1)(i)(A) ("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.") and Prop. Reg.

§1.1061-2(b)(1)(i)(B), which is an acknowledgement that Raising or Returning Capital Actions and Investing or Developing Actions are not both required to be taken in each taxable year.[24] Because the proposed regulations expressly provide that an API is always an API, an API would not lose its qualification as such merely because, say, a fund sponsor has decided to wind down or dispose of its business.[25]

Section 1061(b) Exemption

If Treasury does not consider it appropriate to restrict Section 1061(a) by defining the "raising or returning capital" prong of the ATB Activities Test (so as to exclude raising or returning of capital conducted by a business to finance other operations), we believe Treasury should not reserve on its authority under Section 1061(b), as was expressed in the Proposed Regulations.[26] 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. As discussed further above, according to the JCT Analysis, carried interests as used in asset management businesses were the particular focus of legislators as they contemplated carried interest proposals.[27] We believe that in crafting the Section 1061(b) exemption for income or gain attributable to any asset not held for portfolio investment on behalf of third party investors, that Congress meant to exclude from Section 1061(a) carried interests that are not used by asset management businesses, since the term "portfolio investment" is synonymous with an investment made on behalf of third party investors by a portfolio manager as part of the asset management business.[28] Accordingly, we believe the Section 1061(b) exemption should be clarified by Treasury in regulations to apply to a business that may raise or return capital to finance its operations or a business that does not include asset management.

II. Borrowed Funds Contributed by a Partner

Economic Impact

The proposed regulations would introduce a substantial impediment to raising capital for commercial real estate investment. The proposal's Loaned Capital Exception (defined below)

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[24] We believe our analysis of the raising or returning capital actions and suggested changes to the proposed regulations applies equally to the investing or developing actions.

[25] Prop. Reg. §1.1061-2(a)(1)(i) ("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 Prop. Reg. §1.1061-3, are satisfied.").

[26] Explanation of Provisions at §II.D.

[27] See text at n. 17-23.

[28] A portfolio manager is a professional responsible for making investment decisions and carrying out investment activities on behalf of vested individuals or institutions. The investors invest their money into the portfolio manager's investment policy for future fund growth such as a retirement fund, endowment fund, education fund, or for other purposes. Portfolio managers work with a team of analysts and researchers, and are responsible for establishing an investment strategy, selecting appropriate investments, and allocating each investment properly towards an investment fund or asset management vehicle. https://en.wikipedia.org/wiki/Portfolio_manager.

discourages the use of borrowed funds for co-investment by general partners, whether the funds are obtained through legitimate arrangements or perceived abusive sources This could have the result of disincentivizing sponsors from encouraging the alignment of interests of their employees and other professionals with their limited partners by providing liquidity alternatives for such individuals to make significant capital contributions to their funds, or may otherwise make the cost of such contributions prohibitive due to the need for such professionals to seek alternative arrangements that would not run afoul of the broad scope of the proposed Loaned Capital Exception. In turn, this would create conflicts with potential limited partners who require such alignment, and impact fundraising from third parties.

It is quite common with respect to real estate investment – and as Section 1061 contemplates – for investors to require a general partner to make a co-investment in the same manner and on the same terms as the capital that they employ into the investment. The general partner's co-investment is often fulfilled by participation from all levels of employees of the general partner sponsoring the investment, and in many cases the general partner will lend the employees the funds (or commonly provide credit support to third party lending made available to such employees) to enable their participation in the investment. Generally, the reason for such lending is to provide liquidity to such employees because the timing for funding of capital commitments may be uncertain as investments are made over the life of the fund. Accordingly, the Loaned Capital Exception creates a real disincentive for general partners to finance or support the financing of the participation of its employees in its commercial real estate investments, even if such financing is otherwise recourse to the employee and such credit support is being provided as an incentive for third parties to provide better terms on such financing. These borrowed funds represent a significant source of capital available for real estate investment, and an important business point for attracting third party capital for real estate investment sponsors.

API Gains and Losses: Capital Interest Exception

By way of background, the proposed regulations generally apply to long-term capital gains and losses recognized with respect to an API (i.e., API Gains and Losses). API Gains and Losses do not include gains and losses with respect to an API Holder's capital investment in the partnership (Capital Interest Allocations and the "Capital Interest Exception").[29]

[29] Section 1061(c)(4)(B) generally provides in relevant part that an API does not include a capital interest in the partnership that provides a right to share in partnership capital commensurate with the amount of capital contributed (determined at the time of receipt of such partnership interest). The legislative history for the Capital Interest Exception states that "[a]n applicable partnership interest does not include any capital interest in a partnership giving the taxpayer a right to share in partnership capital commensurate with the amount of capital contributed (as of the time the partnership interest was received), or commensurate with the value of the partnership interest that is taxed under section 83 on receipt or vesting of the partnership interest. For example, in the case of a partner who holds a capital interest in the partnership with respect to capital he or she contributed to the partnership, if the partnership agreement provides that the partner's share of partnership capital is commensurate with the amount of capital he or she contributed (as of the time the partnership interest was received) compared to total partnership capital, the partnership interest is not an applicable partnership interest to that extent." .H.R. Conf. Rep. No. 115-466 at 420-21.

Capital Interest Allocations are allocations that are "made in the same manner" to all partners.[30] For this purpose, allocations are 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 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 with respect to both API Holders and Unrelated Non-Service Provider Partners. The proposed regulations provide that a partner's capital account is the partner's invested capital in a partnership that maintains capital accounts under Reg. §1.704-1(b)(2)(iv) (i.e., in compliance with the existing partnership allocation rules under Section 704(b)).[31] Lastly, a qualifying Capital Interest Allocation may be made only by a partnership that has both API Holders and Unrelated Non-Service Partners.[32] To illustrate the application of the Capital Interest Exception, the proposed regulations provide the following example (the "Example").[33]

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 Reg. §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.

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 x 20%). Additionally, GP receives a 2% Investment Allocation from PRS, or $160 of net capital gain ($8,000 ($10,000-$2,000) x 2%). In total, PRS allocates $2,160 of net capital gain to GP for the

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[30] Prop. Reg. §1.1061-3(c)(3)(i).

[31] Prop. Reg. §1.1061-3(c)(3)(ii)(A). To qualify to be treated as a capital account for this purpose, each partner's account must be increased by the money and the net fair market value of property contributed to the partnership and income and gain allocated to the partner. Explanation of Provisions at § II.C.1.b.

[32] Including indirectly through tiers of partnerships. 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. Explanation of Provisions at § II.C.1.c.

[33] Prop. Reg. §1.1061-3(c)(7)(i), Example 1.

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.

Under a 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 and is therefore excepted from recharacterization under the proposed regulations. GP's API allocation of $2,000 of net capital gain is not a Capital Interest Allocation and therefore is not excepted from recharacterization 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.

Loaned Capital Exception

As illustrated above, a fundamental aspect of the Capital Interest Exception is the capital account balance of the API Holder. Under the existing Section 704(b) capital account definition and rules relating to the maintenance of capital accounts, the capital account balance of a partner must be increased by the amount of money contributed by such partner. The Proposed Regulations -- by providing an exception to the Capital Interest Exception for certain debt-funded capital of the API Holder, modify this settled concept. 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) (a "Prescribed Loan" and the "Loaned Capital Exception").[34] However, repayments of the Prescribed Loan are included in capital accounts as those amounts are paid unless the repayments are funded with a similar Prescribed Loan.[35] Notably, for a loan to meet the definition of a Prescribed Loan, the person making the Prescribed Loan is not required to be "related" to the partner who borrowed the funds. In other words, Prescribed Loans may be between unrelated parties for general tax purposes.

[34] Explanation of Provisions at §II.C.1.b.; Prop. Reg. §1.1061-3(c)(3)(ii)(C) ("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).").

[35] Prop. Reg. §1.1061-3(c)(3)(ii)(C) (second sentence).

The Loaned Capital Exception appears to take aim at the perceived abuse of limited partners loaning the general partner of the partnership an amount of capital that entitles the general partner to 20% of the partnership's profits (i.e., 20% of partnership capital) in order to avoid the application of Section 1061 and fit within the Capital Interest Exception.[36] The interest on the loan equals the hurdle rate otherwise applicable to the general partner's 20% share of profits. The general partner repays the loan with the distributions of capital and profits by the partnership.

For example, a $1 billion fund yields an 8% internal rate of return (IRR) and then shares profits 80-20 with the general partner. The economics of the returns are that the limited partners receive $1 billion of return of capital distributions plus distributions equal to an 8% IRR on their capital, and then cash distributions are split 80-20 between the limited partners and the general partner, respectively. Assume instead the limited partners invest $800 million and make a nonrecourse loan of $200 million to the general partner bearing an interest rate of 8%. The general partner invests the $200 million of loan proceeds in the partnership and is entitled to the same return of capital and hurdle rate described above. All cash flow distributions allocable to the general partner go first to pay off the loan. The result is the limited partners receive $1 billion ($800 million return of capital and $200 million principal on loan) plus 8% IRR (the 8% return on $800 million plus 8% interest on the $200 million loan), and then cash is split 80-20 (because the general partner has fully repaid the loan and receives further distributions from the partnership free and clear thereafter). Because the general partner's 20% interest in the partnership was purchased by the general partner and is comparable to the limited partners' allocations from the partnership, the general partner's allocations would otherwise qualify for the Capital Interest Exception (ignoring the Loaned Capital Exception.

However, the Loaned Capital Exception, which does not discriminate between the potentially abusive situations and legitimate borrowing arrangements, would apply to a general partner who undertakes to borrow from any one or more of the limited partners on an arm's length basis – even from a partner who could be in the business of lending money. In the Example,[37] if the general partner borrowed $150 of the $300 capital contribution from one of the limited partners on a recourse basis,

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[36] House Ways and Means Committee Chairman Dave Camp's 2014 tax-reform discussion draft contained a similar Loaned Capital Exception, under which the Camp Bill would not have taken into account as invested capital amounts borrowed from the partnership or any partner related to the holder of the applicable partnership interest. See Camp Bill Discussion Draft Feb. 21, 2014.§3621 (Code §1061(c)(2)(E)(iii) (Any amount borrowed directly or indirectly from the partnership or any other partner of the partnership or any person related to such other partner or such partnership shall not be taken into account under this subparagraph. For purposes of the preceding sentence, a person shall be treated as related to another person if the relationship between such persons would be described in section 267(b) or 707(b) if such sections and section 267(f) were applied by substituting '10 percent' for '50 percent' each place it appears)). Similarly, Rep. Sander Levin's Carried Interest Fairness Act of 2015 (the "Levin Bill"), would have not taken into account amounts contributed as a qualified capital interest to the extent such amounts were acquired with proceeds of a loan or other advance or guaranteed by another partner or the partnership (or any personal related to any such other partner or the partnership. Levin Bill §3 (§710(d)(8)(A) (an investment services partnership interest shall not be treated as a qualified capital interest to the extent that such interest is acquired in connection with the proceeds of 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))). H.R. 2889. June 25, 2015. 114th Cong. 1st Session.

[37] See text at n. 33.

for purposes of the Capital Interest Exception, the general partner's capital account would be credited with only $150 thereby disqualifying[38] the general partner's pro rata allocations that are otherwise allocated in the same manner as those of the limited partners.

As described above, for purposes of the Capital Interest Exception, repayments of the Prescribed Loan are included in the capital account as those amounts are paid by the partner, provided that the loan is not refinanced with another Prescribed Loan. If the partner who obtained the Prescribed Loan could obtain the borrowed funds from a non-partner lending institution under equivalent terms, what is the tax policy objective behind favoring the loan from a non-partner lending institution over the same loan from another partner? The existing Code and Regulations already have transfer-pricing rules that ensure "related party" transactions are on terms that are comparable to third-party transactions (albeit, the Prescribed Loan in fact may be from an unrelated party).

We believe the Loaned Capital Exception should not be written as a broad-based liability rule that does not target an indicated abuse, given the strong inference that Congress did not intend to include the Loaned Capital Exception in Section 1031.[39] Moreover, the legislative history of the Capital Interest Exception indicates that the Capital Interest Exception should apply 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.[40] As there is no limitation[41] on the use of debt by an Unrelated Non-Service Partner to fund its capital in the partnership, the Loaned Capital Exception creates an unwarranted distinction. Accordingly, we believe the Loan Capital Exception should apply only to the perceived abuses or provide a safe-harbor excepting loans that are obtained on arm's length terms. The perceived abuse should not encompass (1) recourse loans, (2) adequately secured

[38] The effect of the disqualification is that any long-term capital gains or losses allocated to the general partner with respect to its otherwise qualifying Capital Interest are recharacterized as short-term capital gains or losses unless the holding period of such property is greater than 3 years.

[39] As previously noted, both the Camp Bill and the Levin Bill contained "loaned capital" exceptions in the proposed statutory language, and such exceptions were explicit in such draft legislation. Given the authors of the Tax Cuts and Jobs Act of 2017 were clearly familiar with the prior proposals, yet chose not to include a loaned capital exception in Section 1061 (or make any mention of it in the legislative history), is an indication that the choice not to include the rule was intentional. See Camp Bill and Levin Bill loaned capital exceptions at supra n. 36. Cf. §1061(f) (the Secretary shall issue such regulations or other guidance as is necessary or appropriate to carry out the purposes of Section 1061). The legislative history indicates that such guidance is to address the prevention of abuse of the purposes of the provision. See H.R. Conf. Rep. No. 115-466 at 422 (2017); see also Joint Committee on Taxation, General Explanation of Public Law 115-97, JCS-1-18, at 203 (2017).

[40] Conf. Rep. at 420-21.

[41] Cf. Rev. Rul. 80-235 (partner's nonrecourse obligation to pay partnership nonrecourse liabilities and only out of distributions of cash by the partnership does not result in an increase in the partner's basis in the partnership) and Rev. Rul. 72-135 (general partner's nonrecourse loan to the limited partners or to the partnership where the loan to the limited partners is for their subscriptions in the partnership was treated as contribution to the partnership by the general partner).

nonrecourse loans,[42] or (3) back-stop guarantees where the borrower is primarily liable on a debt described in (1) or (2).

Transfers Described Under Section 1061(d)

Background

Section 1061(d)(1) provides:

> If a taxpayer transfers any applicable partnership interest, directly or indirectly, to a person related to the taxpayer, the taxpayer shall include in gross income (as short term capital gain) the excess (if any) of—
>
> (A) so much of the taxpayer's long-term capital gains with respect to such interest for such taxable year attributable to the sale or exchange of any asset held for not more than 3 years as is allocable to such interest, over
>
> (B) any amount treated as short term capital gain under subsection (a) with respect to the transfer of such interest.[43]

For purposes of this provision, Section 1061(d)(2) defines a related person as (1) a family member within the meaning of Section 318(a)(1), or (2) a person who performed a service within the current calendar year or the preceding three calendar years in any applicable trade or business in which or for which the taxpayer performed a service.[44] The legislative history describes a person specified in the second category as a "colleague."[45]

The Proposed Regulations state that Section 1061(d) will require inclusion of the relevant amount in gross income "regardless of whether gain is otherwise recognized on the transfer under the Internal Revenue Code"[46] and define relevant transfers to include "contributions, distributions, sales and exchanges, and gifts."[47]

Section 1061(d) Does Not Override Nonrecognition Treatment

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[42] Adequately secured nonrecourse loans should include loans where the borrower's interest in the partnership serves as the collateral for the loan and the value of such collateral represents adequate security for a lender under arm's length terms.

[43] (emphasis added).

[44] The Proposed Regulations expand the related-person definition to include Passthrough Entities to the extent owned, directly or indirectly, by the referenced family members or service providers. Prop. Reg. § 1.1061-5(e)(1)(iii).

[45] H.R. Conf. Rep. 115-466 (2017).

[46] Prop. Reg. § 1.1061-5(a).

[47] Prop. Reg. § 1.1061-5(b). The Proposed Regulations do, however, exempt contributions under Section 721 from the application of Section 1061(d). Prop. Reg. § 1.1061-5(e)(2).

While we recognize that the statute under Section 1061(d) is ambiguous in certain ways, we do not think it is ambiguous with regard to whether it can apply in the absence of a gain recognition transaction. We believe that application of Section 1061(d) to transactions where gain is not otherwise recognized is unambiguously inconsistent with the statutory language of Section 1061(d) and leads to inappropriate results from a policy perspective.

a. The Statutory Language Does not Support Overriding Nonrecognition Treatment

The operative language in Section 1061(d) that modifies the general application of Section 1061(a) describes the gain that is subject to recharacterization as follows: "so much of the *taxpayer's long-term capital gains with respect to such interest* for such taxable year *attributable to the sale or exchange of any asset* held for not more than 3 years as is allocable to such interest."

The terms used in the highlighted language makes clear that the statute can apply only in a situation where gain is otherwise recognized. Specifically, the long-term capital gain that is subject to recharacterization must be "attributable to the sale or exchange of any asset." The statute references an actual sale or exchange of one or more assets, and the referenced assets are those held by the partnership (presumably directly or indirectly).

The statute also describes the gain attributable to such sales or exchanges as "the taxpayer's long-term capital gain with respect to such interest." Under Section 1222(3), "[t]he term 'long-term capital gain' means gain from the sale or exchange of a capital asset held for more than 1 year, *if and to the extent such gain is taken into account in computing gross income*."[48] Thus, use of the defined term "long-term capital gain" necessarily requires that gain must be recognized in order for Section 1061(d) to apply.[49]

The reference to an actual "sale or exchange of any asset" by the partnership raises questions with respect to the appropriateness of the look-through approach implemented by the Proposed Regulations with respect to related-party sales of an API. The statutory language of Section 1061(d) more clearly provides a rule that, if a partner transfers an API, the partner should recognize short-term capital gain

[48] (emphasis added).

[49] Note also that Section 1061(a) applies by reference to nearly identical language. That is, Section 1061(a) recharacterizes as short-term capital gain "the excess (if any) of *the taxpayer's net long-term capital gain with respect to such interests for such taxable year*," over such gain applying Section 1222(3) and (4) and substituting three years for one year. The only difference between the referenced language in Section 1061(a) and Section 1061(d) is the use of "net long-term capital gain" and plural "interests" in Section 1061(a) as opposed to "long-term capital gains" and singular "interest" in Section 1061(d). While Section 1061(a) makes no explicit reference to the stated "net long-term capital gain" being recognized, it is clear that Section 1061(a) has no application unless such gain is recognized. Similar to Section 1061(d), the requirement that gain must be recognized to invoke Section 1061(a) derives from the use of the term "net long-term capital gain". "Net long-term capital gain" is defined as "the excess of long-term capital gains for the taxable year over the long-term capital losses for such year." § 1222(7). As described above, "long-term capital gain" (and "long-term capital loss") can only exist "if and to the extent such gain is taken into account in computing gross income." It necessarily follows that net long-term capital gain can only exist under the same circumstances.

with respect to the interest that is no less than the amount that the taxpayer would have recognized if the taxpayer had continued to hold the interest for the remainder of the taxable year.

Note that the statute references the "taxpayer's long-term capital gains with respect to such interest *for such taxable year*." The statute appears to extend the relevant period for evaluating long-term capital gains with respect to the API beyond the transfer date and until the end of the taxable year. Under this interpretation, Section 1061(d) would prevent the holder of an API from avoiding allocated short-term capital gain by transferring the API to a related person in advance of a sale of capital assets held for three years or less by the partnership. Under this interpretation, the transfer could be a gain recognition or nonrecognition transaction, but the only gain that would be recharacterized would be long-term capital gain recognized by the partnership with respect to assets with less than a three year holding period that is allocated to the transferred API and that is in excess of the amount of gain recharacterized under Section 1061(a) (e.g., upon a transfer of the API in a gain recognition transaction).

In developing the look-through approach implemented in the Proposed Regulations, presumably Treasury and the IRS have read the "taxable year" reference to address situations where a partner transfers APIs in multiple taxable years with the taxable year reference isolating the transfers considered for purposes of Section 1061(d) to those that occur in the current taxable year. Also, presumably the transfer of the API is viewed as an indirect transfer of the underlying partnership assets held for not more than three years. Even if this indirect transfer approach is considered defensible, an indirect "transfer" does not create an indirect "sale or exchange" that generates "long-term capital gain." If defensible at all, the look through approach could be defensible only in a transaction where long-term capital gain is recognized in connection with the transfer of the API to the related person.

As these points illustrate, under either interpretation, the unambiguous statutory language leads to the clear conclusion that Section 1061(d) should apply only to the transfer of an API between related persons where gain is otherwise recognized, either by the partnership under the better interpretation or the partner under the alternate interpretation.

b. Comparison with Prior Camp Bill Provision Highlights Different Application

We recognize that the model for Section 1061(d) may have been borrowed from a provision contained in The Tax Reform Act of 2014 (H.R. 1) (the "Camp Bill"). That provision would have applied by reference to the same related parties, and the operative rule reads as follow:

> If a taxpayer transfers any applicable partnership interest, directly or indirectly, to a person related to the taxpayer, the taxpayer shall include in gross income (as ordinary income) so much of the *taxpayer's recharacterization account balance for such taxable year* as is allocable to such interest (determined in such manner as the Secretary may provide and reduced by any amount treated as ordinary income under subsection (a) with respect to the transfer of such interest).[50]

[50] Camp Bill § 1061(e)(1) (emphasis added).

Importantly, the Camp Bill provision taxing APIs would have operated very differently from Section 1061, as enacted by the TCJA, and the related-party provision quoted above was integrally tied to that different approach.

At a high level, the basic Camp Bill provision determined the percentage capital that corresponded the API holder's percentage carried interest and calculated an interest-like return on the capital amount. The cumulative interest-like return defined the "recharacterization account balance."[51] Net capital gain allocated with respect to an API was subject to characterization as ordinary income until such allocated gain exceeded the recharacterization account balance.[52]

In effect, the Camp Bill provision would have determined the compensatory amount with respect to an API as if the API holder had received an interest-free loan to fund the acquisition of his or her API. The cumulative interest amount, as reflected by the recharacterization account balance, represented the presumed compensatory amount attributable to the API-holders service-related activities, and the timing for inclusion of this compensatory amount was determined by the allocation of partnership income.[53]

To understand the purpose of the related-party provision under the Camp Bill, it is important to note that the Camp Bill carried interest provision had a separate rule that overrode nonrecognition treatment on all API transfers, regardless of whether such transfers were to related parties.[54] Thus, the related-party provision was not aimed at triggering gain. Instead, the related-party provision apparently was aimed at avoiding assignment of the compensatory amount, reflected as the recharacterization account balance, to a related taxpayer.

Section 1061, as enacted by the TCJA, operates in a completely different manner from the Camp Bill provision. The amount that is intended for recharacterization under Section 1061 does not steadily accrue over time and is not readily determinable at any given time. Instead, the amount treated as short-term capital gain is simply a product of the holding period of property at the time sold. At the time that a partner transfers his or her API to a related person, the gain on capital assets owned by the partnership with a holding period of three years or less almost certainly bears no relationship to the capital gain that ultimately would be recharacterized under Section 1061(a) if the API holder remained a partner. Instead, as such assets continue to be held by the partnership without being sold, the holding period would eclipse three years and would cease to be subject to recharacterization under Section 1061.

Viewed from this perspective, Section 1061(d), as enacted by the TCJA, should not be considered an assignment of income provision that overrides nonrecognition treatment since the proper amount of

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[51] Camp Bill § 1061(c).

[52] Camp Bill § 1061(a).

[53] *Compare* S. 1639, 116th Cong. (2019) (the Ending Carried Interest Unfairness Act introduced by Senator Ron Wyden (D-OR) would provide for current inclusion of a similar interest-like return as ordinary income).

[54] Camp Bill § 1061(b)(3).

compensatory income associated with the API is not determinable at the time of the transfer.[55] Consistent with the statutory language of Section 1061(d), which is materially different from the Camp Bill provision,[56] the transfer of an API between related persons should simply alter the recharacterization analysis of long-term capital gain recognized by the API holder such that the partner's holding period with respect to the API is not the only factor to be considered.

c. Application to Nonrecognition Transactions Produces Irrational Results

Recognizing that the better reading of Section 1061(d) requires a gain recognition transaction to invoke the provision, it also is important to recognize the inappropriate results that follow if Section 1061(d) applies to a number of common nonrecognition transactions.

Take, for example, a partner who holds an API in the general partner entity but ceases to work for the sponsor organization and thus is required to forfeit the general partner interest. Technically, that individual, who provided services in the ATB Activity, is transferring the general partner interest (an API) to the general partner entity, which also provides services in the ATB Activity. Under the Proposed Regulations, this transaction would appear to require the forfeiting partner to include in gross income an amount equal to the built-in gain in capital assets held for three years or less. Obviously, it makes no sense for an individual who involuntarily transfers his or her partnership interest for no consideration in a forfeiture transaction to recognize gain in connection with that transfer.

As another example, consider a scenario where the majority of general-partner interests in multiple real estate funds are held by a holding partnership. In an effort to simplify the structure and reduce administrative costs, the parties determine to liquidate the holding partnership and distribute each partner's pro rata share of the general partner interests. Following the transaction, the partners who formerly held their interests in the general partner entities indirectly through the holdings partnership would simply hold such general partner interests directly. There is nothing about such a transaction that rationally justifies requiring the recognition of gain.

Similarly, the contribution by an API holder of his or her API to a wholly owned S corporation implicates no shifting in the ultimate receipt of gain that could be subject to Section 1061.

We recognize that the Proposed Regulations except Section 721 transactions due to the ability to track the underlying gain to the transferor of the API.[57] It may be possible to exempt other transfers

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[55] In following the proposed interpretation of Section 1061(d) whereby the transferor is treated as recognizing short-term capital gain at least equal to the amount that would have been recharacterized and allocated to the transferred API during the remainder of the taxable year, the recharacterized amount does represent a reasonable proxy for the amount that Section 1061(a) would treat like a compensatory amount and that is assigned to a related taxpayer.

[56] The Camp Bill reference to "recharacterization account balance" is simply a specified amount that could be included in gross income upon any transfer while the reference in Section 1061(d), as enacted by TCJA, to "long-term capital gain" is a defined term that requires a recognition event to be included in gross income.

[57] Prop. Reg. § 1.1061-5(e)(2).

that implicate no shifting of gain or otherwise represent sympathetic cases,[58] if all such transfers can be properly identified.

If final regulations adopt the proposed approach whereby Section 1061(d) recharacterizes long-term capital gain recognized by the partnership in the taxable year after a related-party transfer of an API, coordination would be necessary to the extent that gain following the nonrecognition transaction would be allocated to the same Owner Taxpayer as before the transaction.

Contributions of APIs under Section 721, pro rata distributions of APIs under Section 731, and contributions of APIs to wholly owned S corporations all represent examples of this scenario.[59]

If the final regulations implement the existing look-through model implemented in the Proposed Regulations, interpreting the statutory language to require recognition of long-term capital gain to invoke Section 1061(d) would eliminate the need to distinguish nonrecognition transactions that are subject to the rule from those that are not. The statute and legislative history provide no guidance for distinguishing such transactions which should be read as an indication that such transactions should not be subject to Section 1061(d) in the first place.[60]

Section 1061(d) Should Not Recharacterize Section 1231 Gain

The Proposed Regulations define "net long-term capital gain with respect to a transferred API" as:

> 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

[58] In other contexts, transfers by reason of death have been excluded for purposes of determining inclusion events. *See*, *e.g.*, Reg. § 1.1400Z2(b)-1(c)(4)(1).

[59] Presumably, a rule could be written to simply turn off Section 1061(d) to the extent that the same gain would be recharacterized and allocated to an Owner Taxpayer in the absence of Section 1061(d). Such a rule could address transactions that are not pro rata but that would, without such a rule, result in duplication of recharacterized gain for an Owner Taxpayer.

[60] We also note that, as enacted, Section 1061(d) appears to be an assignment of income provision that is intended to prevent taxpayers from transferring an API to a related party in whose hands the interest would not be an API and thereby avoiding the impact of Section 1061. Significantly, the Proposed Regulations include a rule providing that "[o]nce 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 . . . are satisfied." Prop. Reg. § 1.1061-2(a)(1)(i). This rule is not contained in the statute, and one can surmise that Section 1061(d) may not have been viewed as necessary if such a rule existed. In this regard, we note that, while the Levin Bill (i.e., the Carried Interest Fairness Act of 2015) specifically provided that a partnership interest would "be treated as an investment services partnership interest if acquired from a related person in whose hands such interest was an investment services partnership interest" (*see* Carried Interest Fairness Act of 2015, §710(c)(1)(C)), the Camp Bill contained no such provision. Section 1061(d) of the Camp Bill appears to have been aimed at addressing such transfers where the API taint would not carry over to the transferee. If the "once an API, always an API" rule is retained in the final regulations, we believe that the significance of Section 1061(d) is greatly diminished, which provide further justification for limiting the scope of Section 1061(d) to only those transactions that are clearly covered by the statute.

> 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.[61]

By referencing "net long-term capital gain from assets held for three years or less", it appears that Section 1061(d), as interpreted by the Proposed Regulations, would apply to Section 1231 assets held for three years or less as well as capital assets with the same holding period. While we recognize that the statutory language in Section 1061(d) provides arguable authority for this approach,[62] it seems hard to justify this approach from a policy perspective. Section 1061(d) is apparently aimed at preventing the holder of an API from circumventing Section 1061(a), and it is hard to defend imposing on taxpayers a result through Section 1061(d) that is worse than if Section 1061(a) applied to assets sold by the partnership. As indicated above, Section 1061(a) recharacterizes "the taxpayer's net long-term capital gain with respect to such interests for such taxable year" while Section 1061(d) applies by reference to "the taxpayer's long-term capital gains with respect to such interest for such taxable year." We believe that the relevant "long-term capital gain[s]" should be interpreted consistently for purposes of Section 1061(a) and 1061(d). As is the case with Section 1061(a),[63] long-term capital gain recognized with respect to Section 1231 assets should not be recharacterized under Section 1061(d).

* * *

In real estate, success is measured largely by the capital appreciation of the property. Traditionally, this capital appreciation has been treated as long-term capital gain for all partners. General partners receive fees for routine services like leasing and property management. Those fees are taxed at ordinary tax rates. The carried interest is granted for the value the general partner adds to the venture

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[61] Prop. Reg. § 1.1061-5(c)(1)(A). 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. *Id.* 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. *Id.*

[62] Section 1061(d)(1)(A) references a "taxpayer's long-term capital gains 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." (emphasis added.) We note that the Proposed Regulations define a relevant "taxpayer" that can invoke application of Section 1061 as an Owner Taxpayer and a Passthrough Taxpayer. It is significant that determination as to whether Section 1231 gain may be taxed at capital gain rates may be made only at the Owner Taxpayer level. That is, if Section 1231 losses exceed Section 1231 gains with respect to a person paying tax, such losses are ordinary. § 1231(a)(2). Similarly, Section 1231 gains in a taxable year may be recaptured as ordinary income by the person subject to tax to the extent of Section 1231 losses treated as ordinary losses during the preceding five-year period. § 1231(c)(2). By defining related persons who may be subject to transfers subject to Section 1061(d) by reference to Section 7701(a)(1), a transfer by a Passthrough Taxpayer may be subject to Section 1061(d). The fact that the treatment of gain from a Section 1231 asset as capital gain cannot be determined at the Passthrough Taxpayer level argues for interpreting "any asset" under the statute to exclude Section 1231 assets. *Cf.* T.D. 9889, 2019 I.R.B. Lexis 471 (preamble discussing complexity created by the potential dual nature of Section 1231 gains and losses for purposes of the rules applicable to qualified opportunity zones).

[63] Prop. Reg. § 1.1061-5(b)(6)(i).

beyond routine services, such as business acumen, experience, and relationships. It is also recognition of the risks the general partner takes with respect to the general partnerships' liabilities. These risks can include funding predevelopment costs, guaranteeing construction budgets and financing, and exposure to potential litigation over countless possibilities. Congress understood that long-term capital gain treatment was appropriate for general partners' profit interests in common real estate investment and development arrangements and therefore narrowly drafted section 1061 to apply to specific situations. Our comments our aimed at preserving the drafters' intent while avoiding unnecessary disruption to common, everyday real estate partnerships—small and large—throughout the country.

The Real Estate Roundtable appreciates the opportunity to share our comments as you finalize the Section 1061 Proposed Regulations. Please do not hesitate to contact me or Ryan McCormick, Real Estate Roundtable Senior Vice President and Counsel, at (202) 639-8400 with any questions or requests for additional information.

Sincerely,

Jeffrey D. DeBoer
President and Chief Executive Officer