

MEMO# 12684

November 17, 2000

IRS RELEASES FINAL REGULATIONS ON CAPITAL GAIN FROM THE SALE OF INTERESTS IN PASS-THRU ENTITIES

[12684] November 17, 2000 TO: TAX MEMBERS No. 28-00 ACCOUNTING/TREASURERS COMMITTEE No. 37-00 RE: IRS RELEASES FINAL REGULATIONS ON CAPITAL GAIN FROM THE SALE OF INTERESTS IN PASS-THRU ENTITIES The Internal Revenue Service has issued final regulations relating to sales or exchanges of interests in partnerships, S corporations, and trusts. The regulations interpret the look-through rule provisions of the capital gain taxation rules in section 1(h) of the Internal Revenue Code (the "Code")¹ and provide guidance relating to the determination under Code section 1223 of a partner's holding period(s) in a partnership interest. The rules are effective for sales of partnership interests on or after September 21, 2000. The final regulations under section 1223 (the "1223 regulations") provide rules governing the allocation of gain recognized on the sale of a partnership interest in which a partner has a divided holding period² and generally require that gain be allocated proportionately between long-term and short-term capital gain or loss. Under a special rule, the regulations permit use of the actual holding period of the portion of the interest that is sold if the interest is a unit in a publicly traded partnership (a "PTP"). The final regulations under section 1(h) (the "1(h) regulations") provide that taxpayers, including regulated investment companies, that recognize long-term capital gain on the sale of a partnership interest must treat the gain as 28 percent-rate gain to the extent it is attributable to collectibles held by the partnership. Final Regulations Under Section 1223 The 1223 regulations require the allocation of a divided holding period with respect to an interest in a partnership. Generally, the holding period of a partnership interest will be divided if a partner acquires portions of an interest at different times or if an interest is acquired in a single transaction that gives rise to different holding periods under section 1223. ¹ These look-through provisions were added to Code section 1(h) by section 311 of the Taxpayer Relief Act of 1997 and amended by sections 5001 and 6005(d) of the Internal Revenue Service Restructuring and Reform Act of 1998. ² A holding period may be a "divided holding period" if the partnership interest is either acquired over time or in a single transaction that gives rise to different holding periods under section 1223. ² Under the 1223 regulations, the holding period of a portion of a partnership interest is generally determined based on a fraction that is equal to the fair market value of the portion of the partnership to which the holding period relates (determined immediately after the acquisition) over the fair market value of the entire partnership interest. The 1223 regulations provide that a partner generally cannot specifically identify the actual holding period for a partial partnership interest that is sold or exchanged. Rather, the holding period of the transferred interest must be proportionately allocated between long-term and short-term based on the partner's divided holding period in his or her entire interest in the

partnership. The 1223 regulations do provide for specific identification of divided partnership interests in the case of a PTP. A selling partner may use the actual holding period of the portion of a partnership interest sold if the partnership is a PTP as defined under section 7704(b), the partnership interest is divided into identifiable units with ascertainable holding periods, and the selling partner can identify the portion of the interest transferred. Final Regulations Under Section 1(h) Section 1(h) of the Code provides maximum statutory tax rates for long-term capital gains of individuals in general and provides regulatory authority to apply the rules to sales and exchanges of interests in pass-thru entities and to sales and exchanges by pass-thru entities. Section 1(h) provides three categories of long-term gains: 20 percent for net capital gain from the sale or exchange of capital assets held for more than one year; 25 percent for unrecaptured section 1250 gain (arising from the disposition of certain depreciable realty); and 28 percent for capital gains or losses from the sale or exchange of collectibles (which include precious metals) held for more than one year. While capital gain attributable to the sale or exchange of an interest in a pass-thru entity held for more than one year generally falls into the 20 percent-rate gain category, the 1(h) regulations provide for special rate treatment similar to treatment under Code section 751(a) on the sale of shares in a pass-thru entity that holds collectibles. In order to prevent the conversion of 28 percent-rate gain to 20 percent-rate gain by virtue of holding collectibles through a pass-thru structure, the 1(h) regulations treat the gain as 28 percent-rate gain to the extent it is attributable to collectibles held by the partnership. The 1(h) regulations provide that a pass-thru entity's holding period in the collectibles is not relevant in determining whether long-term capital gain recognized on the sale of an interest in the entity is collectibles gain (taxable at a 28 percent rate). Naomi Gendler Camper Assistant Counsel Attachment (in .pdf format) Note: Not all recipients receive the attachment. To obtain a copy of the attachment to which this memo refers, please call the ICI Library at (202) 326-8304 and request the attachment for memo 12684. ICI Members may retrieve this memo and its attachment from ICINet (<http://members.ici.org>).