



Advanced Planning for Section 1061's Three-Year Capital Gains Holding Period of Carried Interests

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Revisiting Holding the Carried Interest Through an S Corporation

Eighteen months ago, we published an article addressing advanced planning ideas for dealing with [Section 1061's three-year holding period requirement](#) for long-term capital gains treatment for income derived from carried interests held by hedge funds, private equity groups (PEGs) and like holders.

For many of our clients, the extension of the required holding period for capital gains treatment from one to three years hasn't been a problem, as their typical holding period for an investment exceeds three years. But for hedge funds and some PEGs, the three-year holding period requirement is a problem. In our original article, we discussed several advanced Section 1061 planning ideas. We mentioned the possible use of an S corporation to hold carried interests, based on the fact that Section 1061(c)(4) provides that the three-year holding period requirement doesn't apply to a "corporation." If a carried interest is held in an S corporation, direct or indirect gains on the sale of partnership interests and assets would pass through to the S corporation shareholder(s). Section 1061 doesn't define "corporation" or explicitly restrict the exclusion of corporation from the scope of "corporations" to C corporations. S corporations are typically understood to be "corporations" under the Internal Revenue Code.

Now, for the rest of the story. . .

The IRS quickly issued Notice 2018-18 to close what it perceived to be a "loophole" in Section 1061's language

The IRS immediately recognized that holding carried interests in S corporations would exploit a loophole in the language of Section 1061 that taxpayers could drive the proverbial truck thru. In response, the IRS issued Notice 2018-18^[1] in an attempt to put a freeze on Section 1061 planning using S corporations. The Notice put taxpayers on notice of the IRS's position that the term "corporation" in Section 1061 doesn't include an S corporation. The Notice also announced the IRS's intention to issue Section 1061 regulations that would be retroactive to tax years beginning after December 31, 2017.

After issuance of Notice 2018-18, many tax practitioner's position on the use of S corporations fall in the vicinity of those esteemed authors who concluded that "[h]owever questionable the legal authority for Notice 2018-18 and the intended regulations, they do reach a sensible result and we doubt that many taxpayers will feel comfortable taking a position contrary to the predicted regulations."^[2]

But now it is more than 18 months after the issuance of Notice 2018-18 and the IRS hasn't issued proposed or final Section 1061 regulations. In the 2019-2020 Priority Guidance Plan issued on October 8, 2019, the Treasury Department and the IRS listed the issuance of Section 1061 regulations as only the 41st priority on their list of regulations intended to implement the 2017 Tax Act. It could be another year or longer before proposed Section 1061 regulations are published. There is no way to estimate when final Section 1061 regulations will be issued. Maybe there will never be final Section 1061 regulations. It seems like a good time to revisit the question of whether there is sufficient statutory support for the IRS's position that Section 1061's reference to "corporation" excludes an S corporation and whether taxpayers should be taking a closer look at using S corporations for Section 1061 planning purposes.

Should the IRS be permitted to "fix" to Section 1061's language by issuing regulations?

It is clear that for Section 1061 to function effectively, taxpayers should not be able to exploit an S corporation loophole. This is the

reason that Ginsburg and Levin felt that Notice 2018-18 reached a “sensible result.” But at the same time, it the drafters of Section 1061 should have known enough tax law to distinguish between S and C corporations. Is it really reasonable to assume that the drafters of Section 1061 were so hurried that they inadvertently created such a gaping loophole? Perhaps instead the undefined and unqualified reference to “corporation” in Section 1061 creates an intentional “loophole”? Could the language of Section 1061 reflect the drafters’ deliberate desire to give the impression that they wanted to attack the carried interest “problem” without actually effectively addressing the problem? Even assuming for the purpose of argument that the reference to “corporation” was a drafting error, does the IRS have the authority to co-opt the role of Congress and “fix” Section 1061 by rewriting the meaning of “corporation”?

Examining the IRS’s authority to issue Treasury Regulations to fix Section 1061’s definition of “corporation”

The IRS generally has broad authority to promulgate Treasury Regulations. The US Supreme Court ordinarily gives a degree of deference to the IRS when reviewing the validity of regulations.^[3] But there are limits to deference. Regulations cannot contradict the unambiguous language of the statute that it is interpreting.^[4] The issue before the Tax Court in CWT Farms was similar to the issue that would face a court asked to consider Section 1061 regulations. In CWT Farms, the IRS had issued a regulation which attempted to modify the commonly accepted definition of “fair market value” by referencing how that definition was modified under Section 83. The Tax Court held that the regulations were invalid, pointing out that Section 83 unequivocally modified the concept of fair market value, while in Section 56 (the provision applying the regulation’s definition), the modifying language was omitted. The Tax Court concluded that the use of term “fair market value” in Section 56 was not ambiguous and therefore not a candidate for the IRS defining the term in a manner falling outside of its common definition and usage. The IRS’s attempt to modify the definition through regulation

was invalid. The IRS did not have the authority to issue regulations inconsistent with the statute they purported to interpret.

If the analysis and reasoning of CWT Farms is applied to the anticipated Section 1061, it seems reasonable to suggest that a court would look at the way the term “corporation” was used in the statute and conclude that there is nothing on the face of the Section 1061 suggesting that the term “corporation” does not include an S corporation. A court looking outside of Section 1061 would note that there are numerous Internal Revenue Code provisions support the argument that references to “corporation” includes both S corporations and C corporations. Section 1361(a)(1) defines an S corporation as a small business corporation for which the S election has been made. Section 1371(a) provides that unless it is inconsistent with the S corporation rules or unless otherwise expressly provided in the S corporation rules, subchapter C applies to S corporations. For these reasons, when the term “corporation” is used in the context of Section 368 tax-free reorganizations, the statute is interpreted by the IRS and taxpayers to refer to both S and C corporations. Several S corporation statutes do explicitly treat S corporations as pass-thru entities taxed as individuals for certain tax purposes, but when called upon to interpret tax statutes favorable to individuals outside of the core S corporation statutes, courts have concluded that S corporations should be treated in a manner consistent with corporations rather than individuals. In the absence of any hint in the wording of Section 1061 supporting a contrary interpretation, there is strong support for assuming that courts would interpret the use of the term “corporation” in a manner consistent with the general use of that term in the Internal Revenue Code.

In Notice 2018-18, the IRS both informs taxpayers that it intends to issue regulations supporting its position, and presumably puts taxpayers on notice that the government will fight with taxpayers taking contrary positions. But other than a general inclination to defer to the IRS’s position, there doesn’t appear to be a logical reason grounded in the language of Section 1061 for a court to hold that the threatened regulations would be a valid exercise of the IRS’s authority under Section 7805. An argument by the IRS that its position must be vindicated because a contrary result would result

in a windfall (i.e., avoidance of the impact of the three-year holding period requirement) isn't persuasive because courts have blessed taxpayer windfalls in the past. In Gitlitz v. Commissioner, the US Supreme Court concluded that when Congress passes a statute whose plain text gives the taxpayer the benefit of a "double windfall," the statute should nevertheless be given effect, in spite of the IRS's arguments to the contrary.^[5] Perhaps the definition of "corporation" in Section 1061 is a good candidate for a technical corrections fix, but that in itself is no reason for a court to accept IRS regulations lacking statutory support. Also, fixing the statute itself is not likely to have a retroactive effect.

If and when it benefits the IRS, the agency will vigorously argue that S corporations are "corporations" for income tax purposes. In a recent decision involving the issue of whether nonprofit corporations are "corporations" for purposes of Section 6621, the taxpayer argued that Notice 2018-18 (yes, the Section 1061 notice) was "formal administrative guidance" supporting the position that the term "corporation" used in the Internal Revenue Code does not have a broad meaning. The IRS opposed this interpretation. In response to the taxpayer's position, the Federal Circuit noted that "[w]hile we question whether the regulations described in the Notice [2018-18], if codified, would be proper in view of the government's position in this case that the Code incorporates the broad, common law meaning of 'corporation,' we leave that issue for another day. Indeed, the Notice is just that—a Notice regarding regulations that do not yet, and may never, exist. The Claims Court declined 'to express any views on whether the approach of some as-yet-to-be issued regulations is inconsistent with the government's arguments in this case.' We do the same here."^[6] Obviously, the Federal Circuit's discussion of Notice 2018-18 expresses judicial skepticism about the IRS's habit of taking self-interested positions regarding what "corporation" means under the Internal Revenue Code. The court's comments certainly don't appear to bode well for the IRS's position if it elects to litigate the definition of "corporation" for Section 1061 purposes.

Considering the issue of retroactivity mentioned in Notice 2018-18

The IRS certainly has a track record of threatening taxpayers with regulations and then failing to follow through on a reasonable timetable. It's quite possible that another 18 months will pass without the IRS issuing Section 1061 proposed or temporary regulations. Notice 2018-18 states that Section 1061 regulations will be retroactive back to December 31, 2017. But, Section 7805(b)(2) generally provides that for regulations to be retroactive, they must be issued within 18 months after the date of enactment of the applicable statute, unless the IRS makes a case that a longer retroactive period is necessary to prevent abuse. In several instances where the IRS has argued for a longer retroactive period based on perceived abuse, the courts have rejected the IRS's position on the grounds that the underlying statute did not support the IRS's regulatory position or clearly highlight the claimed abuse. [\[7\]](#) Taxpayers should also note that proposed but not finalized Section 1061 regulations would carry no more weight with the courts than a position advanced on brief by the IRS.[\[8\]](#)

Notice 2018-18 was issued on March 1, 2018. Under Section 7805(b)(1)(C), Section 1061 regulations can generally be retroactive the date of an IRS notice. In a 2019 Policy Statement, the IRS announced that it will not assert a position adverse to a taxpayer based in whole or in part on a notice if it fails to issue proposed regulations within 18 months after the date a notice is published.[\[9\]](#) It now appears that the IRS will fail to meet the 18-month deadline for issuing regulations retroactive back to March 1, 2018. A court could hold the IRS to its word in the Policy Statement and refuse to exclude retroactively S corporations from the scope of "corporations" under Section 1061.

Advanced Section 1061 planning considerations

- **Advanced Section 1061 planning opportunities apply to both newly issued carried interest and previously issued carried interests.** Potential advanced Section 1061 planning includes not only structuring the holding of future issuances

of carried interests through S corporations but also planning for transferring existing holdings of carried interests into S corporations. Section 1061 does not appear to prohibit or restrict the contribution of carried interests to S corporations, opening the door for Section 1061 planning opportunities.^[10] In light of the current uncertain status of Notice 2018-18 and the threatened regulations, PEGs and hedge fund sponsors, among others, may be considering the consequences of transferring carried interests into S corporations owned by one or more of their professions.

- **Seek qualified tax advice.** Businesspersons considering advanced Section 1061 planning should obtain the advice and help of qualified and experienced tax advisors. Taxpayers should seek advice from a respected tax advisor regarding the tax authority for taking a return position regarding the definition of “corporation” under Section 1061, the consequences associated with contesting a tax position with the IRS, the disclosure of tax positions and the proper structuring for holding carried interests through S corporations.
- **Only taxpayers willing to undertake challenging the IRS should consider using S corporations.** Even where the taxpayer has the better end of a fight with the IRS, the cost and effort of winning should be considered. Taxpayers interested in pursuing advanced Section 1061 planning must be prepared for the burden and expense associated with challenging the IRS’s Notice 2018-18 position during the audit and tax litigation process.
- **Consider other planning options.** There are a number of other planning options that have been discussed both in our articles and beyond to help mitigate the impact of Section 1061. Given the fact that some of those planning ideas haven’t come under IRS’s scrutiny to the same degree as S corporations, they should be considered before use of S corporations.
- **Disclosure of Section 1061 planning on Form 8275 can mitigate against taxpayer and return preparer penalties.**

Any taxpayer considering taking a return position involving the holding of a carried interest through an S corporation should seek advice from qualified tax advisors regarding the return position disclosure rules. While taxpayers are not obligated to disclose uncertainty regarding positions on their returns, the proper disclosure of uncertain positions can mitigate against the imposition of penalties.^[11] In addition to disclosure of a return position, taxpayers must assure themselves that they have a reasonable basis for their proposed return position, which means that the position must be based on one of the authorities set forth in Treasury Regulation § 1.6662-4(d)(3)(iii).^[12] Until final Section 1061 regulations are issued, disclosure of the return position would be made on Form 8275.

- **“Substantial authority” tax opinions might be tool to consider in connection with advanced Section 1061 planning.** Disclosure on Form 8275 is not required for penalty mitigation if a taxpayer has “substantial authority” for a return position. As mentioned above, taxpayers are exposing themselves to the potential for a substantial expenditure of time and expense if they take a contested return position. For most taxpayers, it makes sense to fight the good battle with the IRS only in situations where there is meaningful chance of prevailing – i.e., a position supported by substantial authority. Under the Internal Revenue Code, there is “substantial authority” for a tax position only if the weight of tax authorities in favor of a tax position outweigh those taking a contrary position. The weight of tax authorities is determined in light of the pertinent facts and circumstances. The “tax authorities” that can be used in the determination are those listed in Treasury Regulation § 1.6662-4(d)(2) (e.g., the statute, legislative history, rulings, tax cases). Taxpayers who intend to rely on the existence of substantial authority for a return position should seek the advice of a “non-disqualified professional tax advisor”^[13] to obtain a well-reasoned written opinion. Ideally, a written tax opinion should be obtained during the Section 1061 planning process, not years later if an audit occurs.

- **Finally, beware of placing too much reliance on Revenue Procedures 93-27 and 2001-43 in connection with your carried interest tax planning.** The point where taxpayers are considering engaging in advanced Section 1061 planning is also a good time to consider the potential impact of Revenue Procedures 93-27 and 2001-43 on the tax treatment of their carried interests. Taxpayers rely on these Revenue Procedures as authority for not filing a Section 83(b) election when a carried interest is subject to risk of forfeiture for Section 83 purposes and to support their general position that the receipt of the carried interest isn't taxable. But Revenue Procedure 93-27 provides that its safe harbor isn't available if the interest is transferred within two years after issuance. This result can cause problems where the taxpayer doesn't file a Section 83(b) election, as it opens the door for the IRS to argue that upon a sale or transfer within two years, all of the taxpayer's proceeds are taxable compensation not eligible for long-term capital gains treatment. These potential issues should be avoidable by paying some amount for the carried interest, thereby bringing the carried interest within the scope of Section 83 and outside of the scope of the Revenue Procedures.^[14] Under Section 83, a vested carried interest would be valued on a liquidation basis at \$100 on the date of issuance, so there wouldn't be additional compensation income payable by the holder, and the holder would file a Section 83(b) election if the carried interest is subject to vesting requirements.

^[1] Notice 2018-18, 2018-12 IRB 443.

^[2] Ginsburg, Levin, and Rocap, Mergers, Acquisitions, and Buyouts ¶1505.2 (May 2019 Edition).

^[3] See for example, Mayo Foundation for Medical Ed. and Research v. United States, 584 U.S. 44 (2011); Commissioner v. Portland Cement Co. of Utah, 450 U.S. 156 (1981) and National Muffler Dealers Association, Inc. v. United States, 440 U.S. 472 (1979).

^[4] CWT Farms, Inc. v. Commissioner, 79 T.C. 1054 (1982), aff'd. 752 F.2d 518 (10th Cir. 1985).

[5] Gitlitz v. Commissioner, 531 U.S. 206 (2001).

[6] Charleston Area Medical Center Inc. v. U.S., 124 AFTR 2d 2019-XXXX (CA Fed Cir.) (10/17/2019).

[7] Stobie Creek Investments LLC v. United States, 608 F.3d 1366 (Fed Cir. 2010); Klamath Strategic Investment Fund LLC ex rel St. Croix Ventures LLC v. United States, 440 F. Supp. 2d 608 (E.D. Tex. 2006).

[8] F.W. Woolworth Co. v. Commissioner, 54 T.C. 1233 (1070)

[9] Department of the Treasury Policy Statement on the Tax Regulatory Process dated March 5, 2019.

[10] Section 1061(d) addresses the transfer of carried interests to related family members but not to S corporations. But see the discussion of Revenue Procedures 93-27 and 2001-43 below.

[11] Penalties include Section 6662's 20% substantial understatement penalty and Section 6694's preparer penalties.

[12] A tax advisor can advise taxpayers and return preparers whether or not there is a reasonable basis for a return position.

[13] A disqualified professional tax advisor is defined in Section 6664(d)(4)(B)(ii).

[14] If \$100 is paid for a carried interest, the holder would receive \$100 back if the assets of the LLC (or partnership) were sold on the day of issuance, technically turning the interest into a capital interest not subject to the Revenue Procedures.

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