October 5, 2020

BY ELECTRONIC TRANSMISSION

Internal Revenue Service, Room 5203
U.S. Department of the Treasury
P.O. Box 7604, Ben Franklin Station
Washington, D.C. 20044

RE: Proposed Regulations Regarding the Recharacterization of Certain Gains with respect to Applicable Partnership Interests Under Section 1061 - CC:PA:LPD:PR (REG-107213-18)

On behalf of its membership, the Small Business Investor Alliance ("SBIA") is pleased to submit the following comments in response to the above-referenced notice of proposed rulemaking by the Internal Revenue Service ("IRS") regarding guidance under section 1061 of the Internal Revenue Code ("Code") on the tax treatment of certain partnership interests (i.e., "carried interest") held in connection with the performance of services ("Proposed Rulemaking").[1]

The SBIA is the national organization that represents small business funds and their investors in domestic small businesses. Throughout the recent pandemic, small business investment funds have continued to invest in domestic small businesses - keeping businesses alive, workers employed, and providing the capital needed to create new jobs. These private equity funds pursue many strategies (e.g., growth, mezzanine, turnaround, buyout) to reinvigorate established businesses and launch new ones.

Small business investors provide capital to our best job creators.

Comments on Proposed IRS Regulations

The Proposed Rulemaking conforms generally to congressional intent under the TCJA, but with several notable exceptions. The American Investment Council ("AIC") has submitted a comment letter that details many of those exceptions. SBIA affirms the AIC letter and offers additional comments and recommendations regarding allocation arrangements that appropriately could be treated as Capital Interest Gains and Losses under the regulations.[2]

Section 1061 recharacterizes as short-term capital gains certain net long-term capital gains of a partner that holds one or more applicable partnership interests. In particular, a taxpayer's net long-term capital gain calculation with respect to an Applicable Partnership Interest ("API") is determined as if a three-year holding period applied rather than a one-year period.[3] An API is generally any interest in a partnership that, directly or indirectly, is transferred to (or held by) the taxpayer in connection with performance of

[1] Congress enacted Sec. 1061 under the Tax Cuts and Jobs Act of 2017 (Pub. L. 115-97) ("TCJA").

[2] IRS Notice of Proposed Rulemaking, REG-107213-18 (July 31, 2020) ("NOPR") at 38 ("The Treasury Department and the IRS request comments on other allocation arrangements that appropriately could be treated as Capital Interest Gains and Losses under the regulations without inappropriately expanding the capital interest exception, taking into account the statutory requirement that the API Holder's right with respect to its capital interest be commensurate with other partners' rights with respect to their contributed capital.")

[3] 26 U.S.C. 1061 (a)

substantial services in any applicable trade or business (ATB), which consists of raising or returning capital and investing in or developing certain specified assets (e.g., securities, real estate, commodities).

Sec. 1061 also includes specific exceptions to the three-year holding period as an API. A proposed exemption governs capital gains and losses (i.e., "Capital Interest Gains and Losses"), with respect to a capital interest. It includes proposed rules for determining if capital gains and losses allocated to an API holder are treated as allocations with respect to its capital investment and, therefore, excluded from the application of section 1061.

1. *Loans by Partners to Partnership or Other Partners*

The Proposed Rulemaking provides that the capital interest exception does not apply to an API attributable to any loan or other advance made or guaranteed, directly or indirectly, by any other partner, the partnership or any of their related persons. Partners may not receive credit for capital contributions made with recourse loans or non-recourse loans with adequate security from an employer or related person. However, an API will be eligible for the capital interest exception in respect of amounts repaid on the loan. This concept was not included in Code Section 1061 and presents a problem for many typical fund manager arrangements.

This exclusion from the proposed exception would serve as an unintended barrier to entry for otherwise qualified fund managers, especially those who are less represented based on age, gender, or race, and who do not have ready access to capital necessary to buy into a service partnership. This exclusion, moreover, does not align with statutory intent. As explained fully in the AIC comment letter, the legislative history for the TCJA contains no evidence of congressional intent for contributions made with loans to be ineligible for the capital interest exception.

If regulators determine that limitations must be imposed, then SBIA urges narrow tailoring to avoid unintended consequences or specific situational risks (e.g., loans that are non-recourse or lack substantial security may be excluded from the capital interest exception). There are numerous real-world scenarios whereby loans or advances to a service partner should not trigger exclusion from the capital interest exception:

- Borrowing funds at market rates and terms from otherwise unrelated partners and applying those funds as contributed capital. For example, a senior founder of the fund might loan capital to the more junior members of the team to allow them to make required capital contributions. Such loan would be typically set up at the market rate and subject to repayment. Junior members of the fund management team often do not have sufficient capital to make required capital contributions and borrowing from a senior founder provides with ready access to capital at reasonable rates that might not otherwise be available to them.

- Collective action by service partners to borrow from a third-party at the management company or level guaranteed by the partnership. Another commonly used approach is for service partners to cause the management company of which they are members to borrow from an unrelated third party, with the partnership guaranteeing the loan. This arrangement also assists more junior members of the team to have access to capital at reasonable rates that might not otherwise be available to them individually. The loan between the management company and an unrelated third party (i.e., a bank) would be at the market rates, subject to market terms on repayments.

- Other commonly used arrangements: the broad language of the Proposed Rulemaking's restriction on the use of loans can affect such arrangements as borrowing by the general partner entity from the bank, and borrowing by the partners directly from the bank; in each case, guaranteed by the partnership. This restriction effectively forces the service providers, including junior service providers who are just starting their careers, to rely on their own creditworthiness and ability to

borrow to fund their required capital contributions to the fund. This restriction creates an unintended barrier to entry for otherwise qualified fund managers.

2. *Capital Interests – "In the Same Manner"*

The focus on the uniform manner in which capital interest in a partnership is treated by the Proposed Rulemaking may also create unintended consequences that limit the capital interest exclusion for certain common fund arrangements.[4]

In practice, the capital interests of general partners and limited partners, which are negotiated and defined in partnership agreements, are not always allocated in the same manner. Liquidity rights and other economic terms may differ in some respects. Limited partners often negotiate different terms with side letters that govern the management fee rate, carried interest rate, excuse provisions and other economics. In addition, general partners do not typically owe management fees or carried interest with respect to their own commitment. If, for instance, a general partner funds two percent of total capital and earns twenty percent (20%) carry on all limited partners, but not on its contribution, then the Proposed Regulation could be read to apply the capital interest exception only to 80 percent of the return on the general partner's two-percent capital interest. Moreover, certain special allocations of fees and expenses not borne by the fund manager or other common commercial situations, for example, when partners participate in deals in varying percentages to account for other commercial concerns, appear to preclude the application of the capital interest exception. This ambiguity seeds the possibility that capital interest allocations to service providers in many funds may not qualify for the capital interest exception under the Proposed Rulemaking.

The Proposed Rulemaking would result in most commercial arrangements between the general partners and the limited partners disqualifying the interest of the general partner from the capital interest exception because the Proposed Rulemaking requires that allocations must be made in the same manner to *all* partners. SBIA urges federal regulators to narrow the scope or, alternatively, provide additional flexibility and clarity to this language in the Proposed Rulemaking to limit its potential negative impact on existing partnership agreements.

Carried Interest Helps Grow Domestic Small Businesses

Private equity is a long-term strategy that pays out, if at all, years after the initial investment is made. Under the "carried interest" model, the general partner is paid profits only if the fund's portfolio companies are profitable and successful. This way, the general partner's economic interests are aligned with those of the capital investors. This alignment of interests is particularly important and strong for smaller funds investing in smaller businesses.

Many private equity funds that invest in lower middle market sector depend on the carried interest model to attract the best fund managers and talented business executives that excel at turning around companies. Successful deals result in many years of working with the management of the companies, leading to revenue growth and operational efficiencies. Without an incentive to drive smart executives to smaller private equity funds, there will be reduced value for the portfolio companies. Investment professionals at small business

[4] NOPR at 116. The Proposed Regulation at 26 CFR Sec. 1.1061-3(c)(3)(i) states that allocations must be made "*in the same manner* to all partners" and that "allocations will be considered to be made in the same manner if, under the partnership agreement, the allocations are based on the relative capital accounts of the partners … 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." (*emphasis added*). Alternatively, the only exceptions are that allocations to an API holder may be subordinated to allocations to unrelated non-service partners and that an allocation to an API holder need not be reduced by the cost of services provided by the API holder or a related person to the partnership.

investment funds become trusted partners who are involved in the growth of their portfolio companies, making them the more akin to business owners than pure investors.

Scale matters in private equity investing. The smaller the fund, the more likely it is to invest in domestic small businesses. The smaller the fund, the smaller the management fees are to run the fund and the greater the importance of the carried interest.

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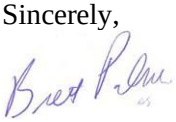
As always, SBIA appreciates the opportunity to discuss these issues and looks forward to the opportunity to work together to update applicable regulations to ensure America's small businesses have access to the capital they need.

Sincerely,



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