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January 19, 2010

Hon. Douglas Shulman  
Commissioner  
Internal Revenue Service  
1111 Constitution Avenue, N.W.  
Washington, DC 20224

Re: Comments Concerning Partnership Allocations Permitted Under Section 514(c)(9)(E)

Dear Commissioner Shulman:

Enclosed are comments concerning partnership allocations permitted under section 514(c)(9)(E). These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association, and should not be construed as representing the policy of the American Bar Association.

Sincerely,

Stuart M. Lewis  
Chair, Section of Taxation

Enclosure

cc: Michael Mundaca, Acting Assistant Secretary (Tax Policy), Department of the Treasury  
William Wilkins, Chief Counsel, Internal Revenue Service  
Joshua Odintz, Acting Tax Legislative Counsel, Department of the Treasury  
Curt G. Wilson, Associate Chief Counsel, Office of Associate Chief Counsel (Passthroughs & Special Industries), Internal Revenue Service  
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**AMERICAN BAR ASSOCIATION  
SECTION OF TAXATION**

**REQUEST FOR GUIDANCE ON PARTNERSHIP ALLOCATIONS  
PERMITTED UNDER SECTION 514(c)(9)(E)**

The following comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation (“Section”) and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Wayne Pressgrove, Joshua Wanderer, and Joshua Weinberger of the Real Estate Committee of the Section of Taxation. Substantive contributions were made by Roger Baneman, Samuel Levy, Stan Ramsey, Steve Schneider, Jeanne Sullivan, Laura Kalick, and David Shevlin. These Comments were reviewed by James Sowell, Committee Chair. The Comments were further reviewed by James Lowy of the Section’s Committee on Government Submissions and by William Caudill, Council Director for the Real Estate Committee.

Although the members of the Section of Taxation who participated in preparing these Comments have clients who might be affected by the federal income tax principles addressed by these Comments, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: January 19, 2010

## EXECUTIVE SUMMARY

These Comments address certain issues that have arisen in applying the “fractions rule” described in section 514(c)(9)(E) and Regulation section 1.514(c)-2.<sup>1</sup>

Under section 514, all or a portion of a tax-exempt organization’s income with respect to “debt-financed property” generally will be treated as unrelated business taxable income (“UBTI”), subject to federal income tax, based on the ratio of the average acquisition indebtedness with respect to the property over the average adjusted basis of the property for the relevant taxable year. Section 514(c)(9), however, provides an exception in the case of real property held by certain tax-exempt organizations (“Qualified Organizations”) if several requirements are met. When a partnership in which the tax-exempt organization is a partner holds the real property, generally the exception will be available only if the partnership’s allocations have substantial economic effect under section 704(b) and also satisfy the so-called “fractions rule” contained in section 514(c)(9)(E).

Under the fractions rule, a partnership’s allocation of items to a partner that is a Qualified Organization cannot result in that partner having an overall share of partnership income for any partnership taxable year greater than such partner’s percentage share of overall loss for the partnership taxable year in which the partner’s percentage share of overall loss will be the smallest.<sup>2</sup>

The fractions rule often thwarts legitimate business arrangements. Although we believe that the general approach taken by the fractions rule is not well suited to address the perceived abuse at which the rule is aimed, these Comments do not address the general approach embodied by the fractions rule. Past commentators have stated the case against application of the fractions rule generally.<sup>3</sup>

Instead, these Comments address certain very specific issues that arise under the fractions rule in transactions regularly undertaken by real estate funds with Qualified Organizations as partners. The hope is that, the Internal Revenue Service (the “Service”) and the Department of the Treasury (“Treasury”) will make targeted changes to the

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<sup>1</sup> References to a “section” are to a section of the Internal Revenue Code of 1986, as amended (the “Code”), unless otherwise indicated.

<sup>2</sup> Reg. § 1.514(c)-2(b)(1)(i), -2(c)(2).

<sup>3</sup> See, e.g., *ABA Tax Section Asks for Changes in Guidance Regarding Effect of Notice 90-41 on Acquisition Indebtedness*, 91 Tax Notes Today 13-11 (Jan. 16, 1991) (hereafter referred to as the “ABA 90-41 Comments”); *N.Y. State Bar Says UBTI Rules Carry Too Big a Stick*, 91 Tax Notes Today 70-30 (Mar. 29, 1991) (hereafter referred to as the “NYSBA 90-41 Comments”); *California Bar Suggests Elimination of Qualified Allocation Rules*, 92 Tax Notes Today 117-46 (June 5, 1992); *AICPA Criticizes Proposed Regs as Unnecessarily Complex*, 93 Tax Notes Today 87-21 (Apr. 21, 1993); *NYSBA Submits Report on Debt-Financed Income Regs*, 93 Tax Notes Today 94-21 (Apr. 30, 1993) (hereafter referred to as the “NYSBA Prop. Reg. Comments”); *NYSBA Submits Report on Taxation of Pension Funds*, 97 Tax Notes Today 34-39 (Feb. 20, 1997).

Regulations under the fractions rule (or issue other guidance interpreting certain provisions in the Regulations), to eliminate certain significant problems under the fractions rule that arise in commercially common transactions.

**Comments Relating to Disregarded Allocations.** Regulation section 1.514(c)-2 describes certain allocations that will be ignored in determining whether partnership allocations will satisfy the fractions rule. In the first part of these Comments, we recommend:

First, with respect to the exception for “reasonable” preferred returns,<sup>4</sup> the rule providing that the preferred return must be currently distributed<sup>5</sup> should be eliminated.

Second, the rule contained in Regulation section 1.514(c)-2(f), providing that the allocation of certain partner-specific items will be ignored, should be liberalized.

Third, the standard for determining “unlikely” losses under Regulation section 1.514(c)-2(g) should be a “more-likely-than-not” standard.

Fourth, the chargeback exception contained in Regulation section 1.514(c)-2(e) should be clarified to address how that provision operates with respect to overall partnership income or loss when certain items have been ignored under Regulation section 1.514(c)-2(f) or (g).

**Comments Relating to Changes in Interests.** The Regulations provide a rule relating to variations in allocations that result from actual economic adjustments to the partners’ interests (*e.g.*, sales of interests, redemptions, or contributions).<sup>6</sup> This rule is relevant for many real estate funds that do not receive all investor commitments at one time, but instead admit investors in stages over some limited period of time. These “staged” closings also may raise other issues that implicate the fractions rule. We generally recommend that the Regulations be amended to permit real estate funds to undertake staged closings in circumstances that will not compromise the purposes of the fractions rule.

Economic adjustments to partners’ interests also may occur as a result of capital call defaults and reductions in capital commitments. These issues are arising frequently as a result of the current economic downturn. The circumstances that create these economic adjustments generally are beyond the control of the parties, and the adjustments do not pose a threat to the purposes of the fractions rule. We recommend certain changes to, or clarifications of, the Regulations to accommodate these situations.

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<sup>4</sup> Reg. § 1.514(c)-2(d)(2).

<sup>5</sup> Reg. § 1.514(c)-2(d)(6)(i).

<sup>6</sup> Reg. § 1.514(c)-2(k)(1).

**Comments Relating to Tiered Partnerships.** Under the current Regulations, in a tiered partnership setting, there is concern that violation of the fractions rule with respect to a lower-tier partnership may cause an upper-tier real estate fund to be treated as violating the fractions rule with respect to all of its investments. We recommend that the Service and Treasury amend the Regulations (or issue other guidance) to confirm that such a result will not follow when the tiered arrangement is not structured with an intent to violate the purposes of the fractions rule.

## DISCUSSION

### I. Background

Section 511(a) imposes tax on the UBTI of certain tax-exempt organizations. Under section 512(c)(1), when a tax-exempt organization is a partner in a partnership that conducts a trade or business unrelated to the purpose justifying the tax-exempt status of the organization, the tax-exempt organization must include in calculating its UBTI its share of the gross income of the partnership from the unrelated trade or business and its share of partnership deductions directly connected with such gross income.

Certain types of income, such as interest, dividends, rents from real property, and gains from the sale or exchange of property that is not “dealer” property, generally are excluded from UBTI.<sup>7</sup> Income that is otherwise excepted from UBTI, however, may still be classified as UBTI under section 514 if the property generating the income is “debt-financed.” Section 514(b)(1) generally defines “debt-financed property” as property that is held to produce income and with respect to which there is “acquisition indebtedness” at any time during the taxable year (or, if the property was disposed of during the taxable year, with respect to which there was an “acquisition indebtedness” at any time during the 12-month period ending with the date of such disposition).

Although section 514 provides that a tax-exempt organization generally will earn UBTI with respect to “debt-financed property,” section 514(c)(9) provides that real property subject to “acquisition indebtedness” will not be subject to these rules in certain circumstances. This favorable rule for real property applies only with respect to tax-exempt entities that are Qualified Organizations. Section 514(c)(9)(C) defines a “Qualified Organization” as: (1) a charitable organization described in section 170(b)(1)(A)(ii) and affiliated support organizations; (2) a pension trust described in section 401; (3) a title-holding company under section 501(c)(25); and (4) a retirement income account under section 403(b)(9).

In order to qualify for the real property exception contained in section 514(c)(9), several requirements must be met. In addition, when the real property is held by a partnership in which the Qualified Organization owns an interest, (1) all partners must be Qualified Organizations; (2) each allocation to a Qualified Organization must be a qualified allocation under section 168(h)(6) (*i.e.*, “straight-up” pro rata allocations); or (3) all partnership allocations must have substantial economic effect and satisfy the fractions rule.<sup>8</sup> In practice, for most real estate partnerships in which Qualified Organizations participate, it is necessary to satisfy this last alternative to take advantage of the exception contained in section 514(c)(9).

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<sup>7</sup> I.R.C. § 512(b).

<sup>8</sup> I.R.C. § 514(c)(9)(E).

Under the fractions rule, the allocation of items to a Qualified Organization cannot result in that partner having an overall share of partnership income for any year greater than such partner's percentage share of overall loss for the year in which the partner's percentage share of overall loss will be the smallest.<sup>9</sup> A partnership is required to satisfy the fractions rule on both a prospective and actual basis for each taxable year of the partnership, beginning with the first taxable year in which the partnership holds debt-financed property and has a partner that is a Qualified Organization.<sup>10</sup>

An anti-abuse rule contained in Regulation section 1.514(c)-2(k)(4) describes the purpose of the fractions rule as follows:

The purpose of the fractions rule is to prevent tax avoidance by limiting the permanent or temporary transfer of tax benefits from tax-exempt partners to taxable partners, whether by directing income or gain to tax-exempt partners, by directing losses, deductions, or credits to taxable partners, or by some other similar manner.<sup>11</sup>

The Regulations permit certain allocations to be ignored in applying the fractions rule.<sup>12</sup> The Regulations also provide rules relating to variations in allocations that result from actual economic adjustments to the partners' interests (*e.g.*, sales of interests, redemptions, or contributions).<sup>13</sup> Further, the Regulations contain rules relating to the application of the fractions rule in the context of tiered partnerships.<sup>14</sup>

The recommendations set forth below relate, in part, to limitations imposed with respect to certain of the exceptions relating to permissible allocations. The

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<sup>9</sup> Reg. § 1.514(c)-2(b)(1)(i), -2(c)(2).

<sup>10</sup> Reg. § 1.514(c)-2(b)(2).

<sup>11</sup> Reg. § 1.514(c)-2(k)(4). A simple example illustrates the "abuse" that the fractions rule is intended to prevent. Consider the following: A taxable person ("TP") and a Qualified Organization ("QO") each contribute \$100 to a partnership ("PRS"). PRS borrows \$800 and acquires for \$1000 commercial property subject to a ten-year lease with a credit-worthy tenant. The partners intend to share equally in the income and loss of PRS over the six-year period during which they intend to invest. However, because QO would derive no benefit from tax losses that will be generated through depreciation and interest during the early years of the investment, the partners agree to allocate the first \$100 of losses to TP. Subsequent profits will first offset losses allocated to TP and then will be divided equally between the partners. All cash will be distributed 50-50, except that liquidating distributions will be made in accordance with positive capital accounts. Under these facts, PRS would violate the fractions rule because QO's lowest possible share of losses for any taxable year is zero percent (*i.e.*, QO's share of losses in a year when TP might be allocated all losses), and QO's highest possible share of income 50%. Under these facts, the fractions rule operates to prevent QO from taking advantage of section 514(c)(9) to avoid UBTI because PRS's allocations have the effect of directing losses to TP, a taxable partner. The fractions rule operates without regard to an abusive intent among the partners. In many circumstances, the arrangement described in the example could be undertaken for legitimate business purposes. For instance, the arrangement could have involved a taxable partner/developer who agrees to absorb the first losses with respect to a speculative property to entice investors (Qualified Organizations or other investors) to contribute funds to the venture.

<sup>12</sup> Reg. § 1.514(c)-2(d) - (j).

<sup>13</sup> Reg. § 1.514(c)-2(c).

<sup>14</sup> Reg. § 1.514(c)-2(m).

recommendations also address the application of the fractions rule in the context of “staged closings” (*i.e.*, the admission of investors to a single fund over a limited time period), an arrangement that is common in the investment fund context generally and that may raise certain issues in complying with the fractions rule. The recommendations further address the effect of economic adjustments arising from capital call defaults and reductions in capital commitments. Finally, the recommendations address the application of the fractions rule in the context of tiered partnerships, specifically when a real estate fund has invested in a lower-tier partnership that itself is not fractions rule compliant.

## **II. Reasonable Preferred Returns**

### **A. Background**

The Regulations provide that the allocation of income and gain with respect to a reasonable preferred return for capital will be disregarded in determining overall partnership income or loss for purposes of the fractions rule.<sup>15</sup> Such allocations, however, will only be disregarded to the extent that the income or gain does not exceed the cash that has been distributed to the partner as a reasonable preferred return for the taxable year of the allocation and all prior years, as of the due date, without extensions, for filing the partnership’s tax return for the taxable year of the allocation.<sup>16</sup> This timing rule has been a part of the reasonable preferred return rule since the fractions rule was first outlined in Notice 90-41,<sup>17</sup> the notice that preceded the Proposed and Final Regulations relating to the fractions rule. The timing rule appears to have been adopted because of a perceived concern by Treasury and the Service that Qualified Organizations and their taxable partners might seek to take advantage of the reasonable preferred return exception to avoid the fractions rule in an unintended manner.<sup>18</sup> For example, the parties might intentionally allocate income disproportionately to the Qualified Organization well in advance of the corresponding distribution, thereby creating a timing advantage for the taxable partner.

### **B. Analysis**

As has been suggested in prior comment letters,<sup>19</sup> we believe that, not only was this timing rule promulgated to address a problem that does not exist (as described below), but that it creates a disadvantage for Qualified Organizations relative to non-fractions rule sensitive investors in real estate joint ventures and is a departure from common business practice. The vast majority of real estate joint ventures with preferred returns paid to

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<sup>15</sup> Reg. § 1.514(c)-2(d)(2). The Regulations also provide that the income a Qualified Organization receives in connection with a reasonable guaranteed payment for services or capital will be ignored in computing its allocable share of overall partnership income or loss. Reg. § 1.514(c)-2(d)(3).

<sup>16</sup> Reg. § 1.514(c)-2(d)(6)(i).

<sup>17</sup> 1990-1 C.B. 350.

<sup>18</sup> Although this concern was not explicitly described in Notice 90-41, it was expressed in the preamble to the Proposed Regulations in 1994. PS-56-90, 57 F.R. 62266. See the text accompanying note 23, *infra*.

<sup>19</sup> See *ABA 90-41 Comments*, *supra* note 3; *NYSBA 90-41 Comments*, *supra* note 3; *NYSBA Prop. Reg. Comments*, *supra* note 3.

money partners contain allocations that match the preferred return as it accrues, without regard to whether cash has been distributed with respect to the preferred return. Forcing a Qualified Organization to be allocated income to match a preferred return only to the extent cash has been paid out has the potential to change the economics of the preferred return the parties have agreed to in a manner that does not affect taxable money partners.<sup>20</sup>

Consider the following example: Assume a Qualified Organization and a taxable general partner form a partnership to own real estate financed in part with acquisition indebtedness. Assume further that the Qualified Organization contributed \$900 of capital to acquire the real estate, and the general partner contributed \$100. Operating cash flow is distributed first to the Qualified Organization only until it has received a ten-percent preferred return, and any remaining cash flow is distributed 70% to the Qualified Organization and 30% to the taxable general partner. Losses of the partnership will be allocated, first 70% to the Qualified Organization and 30% to the general partner to reverse prior 70/30 profits, and then 90/10 (in proportion to contributed capital).

Assume that in year one the partnership has \$10 of net income and \$30 of cash flow, but decides to retain the cash to make capital improvements to the real estate. Normally, in the absence of fractions rule concerns, the \$10 of net income would be allocated to the Qualified Organization to match the \$10 accrual of preferred return. However, because no distributions of the preferred return were made, the Qualified Organization cannot be allocated profits to match the preferred return without violating the fractions rule.<sup>21</sup> Thus, the \$10 of net income in year one must be allocated to match the residual 70/30 sharing of profits, or \$7 to the Qualified Organization and \$3 to the general partner.

Assume that in year two the partnership sells the property for an amount equal to its adjusted basis and otherwise breaks even. The partnership will distribute the net proceeds in liquidation in accordance with the partners' capital account balances. Thus, the Qualified Organization will receive \$907 and the general partner will receive \$103. The Qualified Organization has received \$3 less than it would have received had the partners

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<sup>20</sup> The need to satisfy the reasonable preferred return rule typically only arises in the case of a "true" preferred return, when the partner in question is receiving a share of income as a preferred return that exceeds its pro rata share of contributed capital. In some situations, partners share in a layer of profit that is designated a preferred return, but the preferred return is paid out in proportion to contributed capital. In these cases, this tier does not need to be excluded in calculating a Qualified Organization's highest share of overall income because its share of the preferred return is the same as its fractions rule percentage. Nonetheless, non-pro rata preferred returns occur with sufficient frequency that practitioners believe these issues related to the reasonable preferred return rule need to be resolved.

<sup>21</sup> If the preferred return profit tier is not ignored, the Qualified Organization's highest share of overall net income in any year will be 100%, and its lowest share of losses will be 90% (ignoring the 70/30 tier of losses, which should be ignored under the chargeback rule described in Section V below).

been able to allocate net income to match the accruing preferred return, which was their intended economic arrangement.<sup>22</sup>

When the fractions rule Regulations were finalized in 1994, Treasury and the Service acknowledged comments questioning the need for the timing rule. However, Treasury and the Service decided to retain the timing rule, based on the view that allowing the allocation of profits to match the accrual, rather than the payment, of a preferred return would be a departure from normal commercial practice followed by partnerships with taxable money partners.<sup>23</sup> Treasury reasoned that taxable money partners would not be willing to be allocated taxable income to match an accruing preferred return in advance of the actual receipt of the cash by many years because of the risk that they would have a tax liability with no cash to pay it.

Our experience has found the exact opposite to be true. As stated above, in the absence of fractions rule concerns, the vast majority of partnerships with preferred returns allocate profits to match the preferred return as it accrues, regardless of whether the money partner is taxable or is tax-exempt. Taxable partners typically address the “phantom income” concern by negotiating for tax distributions, pursuant to which the partnership will “advance” money to its taxable partners if the distributions they receive in a given year are less than their tax liability for such year. In our experience, taxable partners are not willing to risk giving up a portion of their preferred return because of phantom income concerns. Thus, this timing rule continues to place Qualified Organizations at a competitive disadvantage relative to their taxable investor counterparts.

Furthermore, as has been suggested in prior comments, if a preferred return allocation is allowed to match an accruing preferred return, and that preferred return is a compounding return (which is typically the case), there will be no motivation for taxable partners to use this exception to avoid the fractions rule by manipulating allocations because the compounding feature will cause more preferred return to accrue. A taxable partner generally would not seek to allocate “phantom” income to a Qualified Organization when the preferred return is growing and compounding as a result of not being distributed. Finally, the substantiality rules<sup>24</sup> in the section 704(b) Regulations adequately prevent the partners from creating timing advantages by allocating income to a Qualified Organization that will later be reversed.

### **C. Recommendation**

In summary, the timing rule addresses a problem that we believe does not exist, interferes with normal market practice, and creates unnecessary complexity, and in some cases, economic distortion, for joint ventures with Qualified Organizations as partners.

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<sup>22</sup> A similar example was used in the *NYSBA 90-41 Comments*, *supra* note 3, to describe this problem as it related to the timing rule set out in the Notice.

<sup>23</sup> See T.D. 8539 (preamble), 1994-1 C.B. 157.

<sup>24</sup> Reg. § 1.704-1(b)(2)(iii).

Accordingly, we recommend eliminating the timing rule for reasonable preferred returns under Regulation section 1.514(c)-2(d)(6)(i).

Alternatively, rather than eliminating the timing rule altogether, Treasury and the Service might adopt a rule that would permit allocations to match a reasonable preferred return as it accrues even if it exceeds the preferred return cash distributions, so long as the partnership agreement requires that distributions always be made first to match any accrued but unpaid preferred return.<sup>25</sup> Such a rule would eliminate the economic distortion concern in most cases and would also minimize the lapse of time between preferred return allocations and preferred return distributions.

### **III. Partner Specific Items**

#### **A. Background**

The Regulations provide that allocations of certain partner-specific expenditures will be disregarded in determining overall partnership income or loss if the expenditures are allocated to the partners to whom the expenditures are attributable.<sup>26</sup> The Regulations list the following expenditures that will be disregarded:

- (1) Expenditures for additional record-keeping and accounting incurred in connection with a transfer of a partnership interest, including expenditures incurred in computing section 743(b) basis adjustments;
- (2) Administrative costs resulting from having a foreign partner;
- (3) State and local taxes and expenditures related to those taxes; and
- (4) Any other expenditures designated by the Service by revenue ruling, revenue procedure or private letter ruling.<sup>27</sup>

#### **B. Analysis**

We recommend that the list of partner-specific items that will be disregarded in applying the fractions rule be expanded to include certain other partner-specific items commonly incurred by real estate investment funds. Most importantly, allocations of management fees paid to a manager of a real estate investment fund should be disregarded.<sup>28</sup> It is commercially common that large investors in such funds negotiate

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<sup>25</sup> Distributions would not be required to match preferred return profit allocations that are subsequently reversed with losses.

<sup>26</sup> Reg. § 1.514(c)-2(f).

<sup>27</sup> *Id.*

<sup>28</sup> Other expenses similar to management fees also should be ignored. For example, the partnership might pay a separate fee to the management company or an affiliate in connection with the acquisition or disposition of an investment or the refinancing of an investment. Negotiations with respect to sharing in these fees generally are consistent with negotiations relating to the management fees.

lower management fees than the other partners. Absent fractions rule concerns, the simplest way to reduce the burden of management fees on large investors is to specially allocate the management fee expense among the partners based on the economic arrangement they have negotiated.

If the non-pro rata allocations of management fee deductions are not ignored, the allocations will be taken into account in determining partners' shares of overall income and loss and may cause a fractions rule violation. For example, if a Qualified Organization negotiates a share of management fees that is lower than its share of contributed capital, such allocation will cause its lowest share of overall partnership loss (taking into account the manner in which management fees are allocated) to be less than its share of contributed capital. Thus, any share of income allocated in proportion to contributed capital will be higher than the Qualified Organization's lowest share of overall partnership loss and will violate the fractions rule.<sup>29</sup>

### **C. Recommendation**

In order to permit non-abusive commercially common allocations to be made, we recommend that Treasury and the Service amend the rule ignoring partner-specific items by replacing the exclusive list of types of permitted items with a general rule ignoring all reasonable partner-specific items that relate to a specific partner or that reflect a *bona fide* agreement among partners to share a specific expense in specified proportions, when the agreement is not *motivated* by tax avoidance. In the absence of such an amendment, we recommend that the Service issue a revenue ruling or revenue procedure specifically permitting the special allocation of management (and similar) fees among partners to reflect the manner in which the partners have agreed to bear the expense.<sup>30</sup>

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<sup>29</sup> For example, assume that two partners, A (a Qualified Organization) and B, generally share income and losses on a 50-50 basis. With respect to management fees, however, A is in a superior bargaining position and hence negotiates to bear 40% of the expense while B bears 60% of such expense. In year one, the partnership breaks even (*i.e.*, has no net income or loss) except that it incurs a management fee of \$100. The management fee, which is equal to the overall partnership loss for the year, is allocated \$40 to A and \$60 to B. Accordingly, for the year, A's share of overall partnership loss is 40% and B's share is 60%. In year two, the partnership earns \$1,000 of net income not taking into account the management fee. The management fee in year two is \$100, which is again split \$40 to A and \$60 to B. For year two, A's share of overall partnership income is \$460 (\$500 - \$40) and B's share is \$440 (\$500 - \$60). A's share of overall partnership income in year two is 51.1% (\$460/\$900). Although the share of income in year two does not necessarily represent A's highest possible share of overall partnership income under the partnership agreement, the fact that A's share of overall partnership income in year two is higher than A's share of overall partnership loss in year one would violate the fractions rule.

<sup>30</sup> Such guidance would be significant beyond simply permitting the special allocation of deduction items attributable to management fees. Under the current Regulations, the exception for chargebacks (described in Section V.A of these Comments below) is not available when items, such as management fees, that are not included in the list set forth in Regulation section 1.514(c)-2(f) are specially allocated under the partnership agreement in a year in which those allocations may subsequently be subject to chargeback. This result follows due to the requirement in Regulation section 1.514(c)-2(e)(2)(ii) that the chargeback exception will apply only if the original allocation of overall income or loss being charged back "consists of a pro rata

#### IV. Unlikely Losses

##### A. Background

The Regulations provide that unlikely losses or deductions that may be specially allocated to partners are disregarded in determining overall partnership income or loss, so long as a principal purpose of the allocation is not tax avoidance.<sup>31</sup> To be excluded, the loss or deduction must have a “low likelihood of occurring, taking into account all relevant facts, circumstances, and information available to the partners (including bona fide financial projections).”<sup>32</sup> The Regulations provide the following examples of types of events that may give rise to unlikely losses or deductions:

- (1) tort and other third-party litigation that gives rise to unforeseen liabilities in excess of reasonable insurance coverage;
- (2) unanticipated labor strikes;
- (3) unusual delays in securing required permits or licenses;
- (4) abnormal weather conditions (considering the season and the job site);
- (5) significant delays in leasing property due to unanticipated severe economic downturn in the geographic area;
- (6) unanticipated cost overruns; and
- (7) the discovery of environmental conditions that require remediation.<sup>33</sup>

When the unlikely loss rule was first outlined in Notice 90-41, the rule contained a “more likely than not” standard in determining whether a loss was unlikely.<sup>34</sup> Specifically, the Notice provided that an allocation would be considered unlikely only if all of the information available to the partners at the time the allocation becomes part of the agreement “reasonably indicates that it is more likely than not that the allocation will not be made.”<sup>35</sup> This standard was eliminated without explanation when the fractions rule Regulations were proposed.

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portion of each item of partnership income, gain, loss, and deduction . . . that is included in computing overall partnership income or loss.” This problem would seem to be solved if management fees (as well as any other permissible partner-specific special allocation) were excluded from overall partnership income or loss under Regulation section 1.514(c)-2(f), as the “pro rata portion” rule applies only with respect to items that are taken into account in calculating overall partnership income or loss.

<sup>31</sup> Reg. § 1.514(c)-2(g).

<sup>32</sup> *Id.*

<sup>33</sup> *Id.*

<sup>34</sup> Notice 90-41, 1990-1 C.B. 350, section IV.

<sup>35</sup> *Id.*

## **B. Analysis**

The standard for an unlikely loss is vague and thus gives little comfort to Qualified Organizations and their taxable partners when attempting to draft allocations to reflect legitimate business arrangements. For example, it is common for general partners to be responsible for funding cost overruns in development partnerships. Because of the uncertainty as to how “unlikely” a cost overrun needs to be before it may safely be ignored for fractions rule purposes, many advisers are concerned that the fractions rule will be violated if the general partner is obligated to contribute the necessary funds and is entitled to be allocated the corresponding tax loss attributable to the overrun.

In addition, many practitioners interpret in a restrictive manner the examples provided in the Regulations to illustrate situations that may give rise to unlikely losses. First, the examples give the impression that there must be an unlikely “event” that causes the loss. The implication is that the exception would not apply to a loss that the parties would not have predicted given reasonable assumptions in originally analyzing the investment but that cannot be traced to a specific and identifiable event.<sup>36</sup> Second, the examples used (*e.g.*, torts, labor strikes, abnormal weather conditions, leasing delays due to “severe” economic downturn, discovery of environmental conditions) generally would be highly unlikely.<sup>37</sup>

If the Regulations were amended to add clarity to the standard of what it means to be “unlikely” for these purposes, we suggest that many of the problems surrounding this issue would be eliminated.

## **C. Recommendation**

Although no standard is perfect, a “more likely than not” standard such as the standard outlined in Notice 90-41 is appropriate for situations such as the funding of cost overruns. These situations are not likely to occur, but they nevertheless are common enough that the parties need to assign responsibility for bearing the related costs. Such a

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<sup>36</sup> For example, when one partner in a partnership owning retail property is responsible for securing an anchor tenant for the property, that partner might be allocated disproportionate losses if the property operates without an anchor tenant for some period of time (*e.g.*, two consecutive years). A number of circumstances could create difficulty in securing an anchor tenant for the property. Taking into account all facts and circumstances, if such failure truly is an “unlikely” event, a loss allocation that would become effective only upon the occurrence of such an event should not create a fractions rule violation.

<sup>37</sup> For example, a loss allocation that governs the allocation of losses attributable to the bottom ten percent of the equity of a partnership, and that only applies when the first 90% of the capital of a well capitalized partnership has been wiped out, could easily meet the definition of an “unlikely loss” if the parties would reasonably not have anticipated incurring such significant losses at the beginning of the investment. These losses could be attributable simply to a general decline of the business of the partnership rather than to a specific event. Many practitioners would worry that these types of losses are not ignored under the current rule given the restrictive nature of the examples. Regulation section 1.514(c)-2(g) (last sentence) does, however, at least provide that no inference is to be drawn as to the likelihood of a loss or deduction based on the fact that the partnership agreement includes a provision for allocating the loss or deduction.

change to the Regulations would permit Qualified Organizations to participate in legitimate business arrangements that have nothing to do with tax avoidance and would make the fractions rule easier to apply in practice.

## **V. Interaction of Chargebacks with Partner Specific Items and Unlikely Losses**

### **A. Background**

Under the current Regulations, two special rules are provided for chargebacks (*i.e.*, allocations of income that are made to reverse prior allocations of losses or vice-versa). Allocations of what would otherwise be overall partnership income that are made to reverse a prior “disproportionately large” allocation of loss are ignored for purposes of computing a Qualified Organization’s share of overall partnership income, and allocations of what would otherwise be overall partnership loss that are made to reverse a prior “disproportionately small” allocation of overall partnership income are ignored for purposes of computing a Qualified Organization’s share of overall partnership loss.<sup>38</sup> An allocation of loss is disproportionately large if it exceeds the Qualified Organization’s “fractions rule percentage,” and an allocation of income is disproportionately small if it is less than the Qualified Organization’s “fractions rule percentage.”<sup>39</sup> A Qualified Organization’s “fractions rule percentage” is defined as its percentage share of overall partnership loss for the year in which its share of overall partnership loss will be the smallest.<sup>40</sup> In the typical case, a Qualified Organization’s fractions rule percentage will equal its share of contributed capital.

The following example illustrates how the chargeback rule operates. Assume a Qualified Organization and a taxable general partner form a partnership to own real estate financed in part with acquisition indebtedness. Assume further that the Qualified Organization contributed \$900 of capital to acquire the real estate, and the general partner contributed \$100. Operating cash flow is distributed 90% to the Qualified Organization and ten percent to the general partner until each has received a ten-percent preferred return, and any remaining cash flow is distributed 70% to the Qualified Organization and 30% to the taxable general partner. Net income is allocated 90% to the Qualified Organization and ten percent to the general partner to match the accruing preferred return, and then 70/30. Losses are allocated, first 70% to the Qualified Organization and 30% to the general partner, to chargeback prior 70/30 profits, and then 90/10 (in proportion to contributed capital).

If the 70% share of losses to the Qualified Organization cannot be ignored under the chargeback rule, then its lowest share of losses would be 70%, and since the Qualified Organization’s highest share of overall income is 90%, this partnership would have a fractions rule violation. However, the Qualified Organization’s “fractions rule percentage”

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<sup>38</sup> Reg. § 1.514(c)-2(e)(1)(i).

<sup>39</sup> Reg. § 1.514(c)-2(e)(2)(i).

<sup>40</sup> Reg. § 1.514(c)-2(c)(2).

should be 90%, which is equal to its share of contributed capital. The Qualified Organization's 70% residual share of income should thus be considered "disproportionately small" because it is lower than its fractions rule percentage. Therefore, the Qualified Organization's 70% share of losses should be ignored under the chargeback rule, because it is being made to reverse a disproportionately small share of overall income. There is thus no fractions rule violation, because the only share of losses not ignored is 90%, which is not lower than the Qualified Organization's highest share of income.

The current chargeback rules described above do not allow for chargebacks of partner-specific items or items attributable to unlikely losses that are specially allocated to one or more partners. As a result, a problem arises if a partner contributes capital to pay specific expenditures with the intent that it will receive a special allocation of income, thereby entitling the contributor to a return of such contribution. For example, in a real estate fund, certain partners may agree to contribute capital to fund unanticipated third-party litigation costs relating to a property. Such partners (which may be Qualified Organizations) would be specially allocated the deductions attributable to the litigation costs, which is consistent with their agreement to bear the economic costs of these expenditures. The understanding of the parties, however, may be that the contributors will bear such costs only to the extent that the partnership does not earn sufficient profits to offset the costs. To properly reflect this economic arrangement, the partnership agreement generally will provide that the contributing partners will be specially allocated future overall partnership income (in excess of previously allocated overall partnership losses) to offset the special allocation of the deductions.

If a Qualified Organization in this situation bears a share of litigation costs (or any other excluded partner-specific item or item of unlikely loss) that is higher than its fractions rule percentage (which will usually be its share of contributed capital excluding the portion attributable to specific expenditures), it will need to be allocated a disproportionately high share of income to properly charge that deduction back. If that chargeback is not ignored, the allocation will cause a fractions rule violation.<sup>41</sup>

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<sup>41</sup> This result follows because the allocation of overall partnership income charging back the specially allocated deduction will cause the Qualified Organization's highest share of overall partnership income to be higher than its lowest share of overall partnership loss. To illustrate the fractions rule violation, consider the following example. Assume that, in the situation described above, the Qualified Organization agrees to fund \$1,000 of third-party litigation costs under the condition that the expenses relating to such costs will be reversed with the income to the extent that the partnership is profitable on an overall basis. Accordingly, in a year following the litigation when the aggregate profit of the partnership exceeds the aggregate losses over the life of the partnership, the profit allocated to the Qualified Organization would exceed 90% due to the income allocation that is intended to reverse the prior deductions attributable to the litigation costs. The allocation of income in excess of 90% would exceed the Qualified Organization's fractions rule percentage of 90%.

## **B. Analysis**

The chargeback rule under the current Regulations only applies to chargebacks of prior allocations of *overall* partnership income or loss.<sup>42</sup> In the case of the third-party litigation expenses described in the example contained in the immediately preceding section, the economic arrangement involves a chargeback to offset a particular expense and not overall partnership income and loss. Thus, an income allocation that offsets the expense will not qualify as an allocation that is ignored under the chargeback rule. This situation is an example of a technical violation of the fractions rule that stems from a common and reasonable market arrangement that we believe does not violate the policy behind the fractions rule and is not abusive.

## **C. Recommendation**

We recommend that the Regulations be amended to permit a chargeback of overall income to offset a partner-specific item or an item of unlikely loss.<sup>43</sup>

# **VI. Staged Closings and Compliance with the Fractions Rule**

## **A. Background**

One common concern regarding the application of the fractions rule is the effect of the admission of additional partners after the initial formation of the partnership, or, at least, in connection with the admission of partners to a partnership at a time when a Qualified Organization is already a partner (*i.e.*, at a time during which the fractions rule applies). When additional partners enter or exit the partnership, a Qualified Organization's share of income and loss will in all likelihood increase or decrease, with the result that there would be, on its face, a literal or technical violation of the fractions rule. The Regulations provide a solution to this problem by stating that, generally, the fractions rule will be tested as of the year of the change of the interests in the partnership and in subsequent years (*i.e.*, on a prospective, but not retroactive, basis).<sup>44</sup> The Regulations add, however, that changes in partnership allocations that result from a shift or transfer in partnership interests will be closely scrutinized to determine whether the transfer or shift stems from a prior agreement, understanding, or plan.<sup>45</sup>

This exception is essential for any partnership that anticipates that, in the natural course of events or by explicit design, it will admit additional partners at a later point after its initial formation. By definition, upon a subsequent closing and admission of new

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<sup>42</sup> See Reg. § 1.514(c)-2(e)(1)(i).

<sup>43</sup> If the partnership subsequently incurs a loss, so that the overall partnership income that charges back the partner-specific allocation of deductions or loss is reversed with an allocation of overall partnership loss, that allocation of overall partnership loss (which effectively recreates the effect of the original partner-specific allocation of deductions or loss) should be ignored just as the original partner-specific allocation was ignored.

<sup>44</sup> Reg. § 1.514(c)-2(k)(1).

<sup>45</sup> *Id.*

partners, the interests of the existing partners will be adjusted. If not for this rule, such a transaction would be a clear violation of the fractions rule.<sup>46</sup> Indeed, in PLR 200351032,<sup>47</sup> the Service ruled privately that a subsequent closing contemplated in the partnership's original agreement from the outset would fall within this exception and there would be no violation of the fractions rule.<sup>48</sup>

## **1. Common Structures in Real Estate Funds**

Many leveraged real estate funds in which Qualified Organizations participate admit new partners in a number of rounds of closings. There are several common commercial arrangements to address the fact that partners are providing capital at different times. In some arrangements, later-admitted partners contribute capital (plus an interest factor on the capital), which is distributed to earlier partners. Alternatively, later-admitted partners might contribute both capital and an interest factor, but only the interest factor is distributed to the earlier-admitted partners. In yet another arrangement, capital is committed in stages (and partners are admitted at different points in time upon their making a capital commitment), but the initial operations of the partnership are entirely debt financed, with all of the committed capital being contributed by all partners at a later date. There are other variations on the foregoing structures, but the common thread often is that all of the partners are economically treated as entering at the same point in time in terms of sharing in profits and losses of the partnership (*e.g.*, as of the date of the formation of the fund), and the earlier-entering partners are then generally reimbursed for the time value of money.

The various structures can result in different tax treatment. When new capital (plus interest) is distributed to the original partners, the transaction could be treated as a disguised sale of partnership interests, governed by section 707(b). The payment of interest or an interest-type factor – either together with the capital or alone – could be treated as a payment of interest or, more likely, if such payment is required under the partnership agreement, a guaranteed payment governed by section 707(c).<sup>49</sup> When some partners are admitted on the basis of capital commitments, even if such partners do not contribute their capital until such time as later partners are admitted, these original partners would presumably need to be allocated income or loss to account for the partnership's operations during the period of time prior to the later partners being admitted. The later-admitted

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<sup>46</sup> A simple example will illustrate the concern. A partnership is initially formed with two partners, one Qualified Organization and one taxable partner, with each partner holding a 50% interest in the partnership. When a subsequent partner is admitted, say for a one-third interest, the Qualified Organization's interest in the partnership by definition will be reduced from 50% to 33 ⅓%. This smaller interest in partnership losses (*i.e.*, 33 ⅓%) as compared to the original interest in partnership profits (*i.e.*, 50%) would be a technical violation of the fractions rule, if not for the exception provided for in the Regulations.

<sup>47</sup> (Dec. 19, 2003).

<sup>48</sup> See PLR 200351032 (Dec. 19, 2003).

<sup>49</sup> For a fuller discussion and analysis of the disguised sale and guaranteed payment issues, see J. Lokey and D. Rocap, *Selected Tax Issues in Structuring Private Equity Funds*, 841 Tax Planning for Domestic & Foreign Partnerships, LLCs, Joint Ventures & Other Strategic Alliances (PLI) 741 (2008).

partners may need special allocations to bring their capital accounts into conformity with those partners who were previously admitted.

## **2. Fractions Rule Issues**

With respect to each of these approaches or any other structure used in a staged closing arrangement, there are two levels of analysis for determining if the fractions rule will be implicated (and possibly violated). First, as noted above, the simple shifting of partnership interests (and therefore, shifting allocation of income and loss going forward) as a function of the admission of new partners requires a threshold level of analysis that the shifting of interests will not be viewed as violative of the fractions rule by the Service upon “close scrutiny” as provided for in the Regulations.

Second, it is necessary to address the question of whether the tax treatment of the specific construct employed (*e.g.*, a disguised sale, payment of interest) creates any issues under the fractions rule. With respect to the constructs mentioned above, for example, a disguised sale should not implicate the fractions rule, because amounts transferred as part of a sale would not enter into the distributive share of each partner and therefore, would not affect the allocation of partnership income or loss.<sup>50</sup> Amounts treated as guaranteed payments, however, could create fractions rule issues.<sup>51</sup> Moreover, when later-admitted partners need to be allocated a disproportionate amount of income or loss to account for the distributive share of partnership items already allocated to previously admitted partners, the fractions rule could come into play. Presumably, these partners will need to be allocated in the first year or perhaps the second taxable year of the partnership an amount of income or loss so that their respective capital accounts are in the proper proportion with all of the other partners.<sup>52</sup>

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<sup>50</sup> This conclusion assumes that the simple shifting of interests does not create a fractions rule issue under Regulation section 1.514(c)-2(k)(1), as discussed above.

<sup>51</sup> The following example illustrates the problem. A partner that is a Qualified Organization contributes \$100 of capital in year one of a fund, and is entitled to a ten percent interest factor on that capital, until subsequent partners are admitted in year two and contribute their pro rata share of the partnership’s capital. Assuming the interest factor does not meet the requirements for a reasonable guaranteed payment under Regulation section 1.514(c)-2(d)(3), the income accrued to the Qualified Organization (presumably \$10 for year one and a pro rata portion of the interest factor for year two until the subsequent partners are admitted) with respect to the guaranteed payment would be treated as an allocable share of partnership income for purposes of the fractions rule. Reg. § 1.514(c)-2(c)(1)(ii)(B). That additional allocation of income would be in excess of the partner’s more general share in partnership’s profits and losses and would likely violate the fractions rule.

<sup>52</sup> Here, too, an example can illustrate the concern. In year one, A and B enter into subscription agreements with respect to Fund, with each partner holding a 50% interest. Neither partner is called upon to contribute capital but the Fund purchases a property with debt financing. (The debt financing is secured by the capital commitments of A and B.) The operations of the property yield \$6 of net income for the year, and \$3 of income is allocated to each of A and B. The capital account of both A and B is \$3. In year two, C enters into the partnership for a one-third interest. At that time, A, B, and C each contribute \$100 to the partnership. If the capital accounts were left unadjusted, A and B would have capital accounts of \$103, while C would have a capital account of \$100 – even though from an economic standpoint, A, B and C are intended to be treated on an economically equivalent basis. That is, the capital account of each party would ideally equal \$102. To

## **B. Lack of Guidance for Acceptable Shifts in Interests**

Many Qualified Organizations are reluctant to participate in staged closing arrangements because of the lack of guidance addressing the circumstances in which a shifting of interests will not cause a fraction rule violation. The Regulations provide no examples, and there are no published rulings or other forms of guidance from the Service other than a single private letter ruling<sup>53</sup> in which the Service permitted a shifting of interests upon the admission of a subsequent partner in a relatively straightforward factual setting and without addressing the common fractions rule concerns created by staged closings.<sup>54</sup> In addition, staged closings are almost always specifically provided for in the partnership agreement, so there is concern that shifts in connection with staged closings will be “closely scrutinized,” given that they do arguably stem from “a prior agreement, understanding, or plan or could otherwise be expected given the structure of the transaction.”<sup>55</sup> Because staged closings are commonplace features of real estate investment partnerships, and the subsequent admission of additional partners is not designed to subvert or circumvent the policy of the fractions rule, both taxpayers and the Service would benefit from the issuance of guidance to address the parameters of acceptable shifting of interests resulting from the admission of new partners.

## **C. Problematic Allocations Resulting from Staged Closings**

The second level of fractions rule analysis discussed above is of even greater concern. With respect to disproportionate allocations, there is no authority in the Code, Regulations, or other Service guidance relating to allocations in a staged closing arrangement (whether such allocations are a result of operating income or loss, are a function of a paid or unpaid interest factor, or relate to guaranteed payments) when a second group of partners enter into the partnership at a later time and often in a later taxable year. Liquidating distributions in a fractions rule agreement will be in accordance with positive capital accounts and allocations made under the agreement must be consistent with both with the fractions rule and the substantial economic effect rules of section 704(b). In order to reflect the economic deal of the parties, the capital accounts of the partners often

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achieve parity among the capital accounts, any loss in year two would be disproportionately allocated to A and B or any income would be disproportionately allocated C to bring the parties’ capital accounts into equilibrium. Without any other applicable exception, these allocations in year two could violate the fractions rule if any of A, B, or C was a Qualified Organization.

<sup>53</sup> PLR 200351032 (Dec. 19, 2003).

<sup>54</sup> The facts in the private letter ruling stated that the partnership would solicit subscriptions from investors; once the partnership received sufficient subscriptions to raise the necessary capital, the partnership would admit those investors as partners into the partnership at the initial closing. If, however, less than a target amount of capital was raised from the initial closing, the partnership would seek additional capital commitments from investors, both from existing partners and other new investors. At the earlier of a fixed date in the following year or at the point at which the partnership had raised the targeted amount of capital, the investors making the new capital commitments would be admitted as partners. This set of facts assumes a relatively tight time frame and other specific parameters for the subsequent closing, thus creating a limited set of circumstances under which the ruling was issued.

<sup>55</sup> Reg. § 1.514(c)-2(k)(1).

will have to be adjusted by way of disproportionate allocations in the taxable year when the new partners enter the partnership. Such disproportionate allocations, however, may create a current violation of the fractions rule, as described above.

#### **D. Recommendation**

To address these common and we believe non-abusive scenarios in the typical structure of real estate funds (as well as other investment funds), while furthering the congressional intent to allow Qualified Organizations to make investments on a tax-exempt basis in leveraged real estate, we recommend that guidance be issued to provide certain safe harbors and exceptions to the fractions rule with respect to staged closings and the subsequent admission of investors, as described in the following paragraphs.

##### **1. 24 Month Safe Harbor for Shifting Interests**

First, we recommend that a safe harbor be created to permit shifting of interests in connection with staged closings under circumstances that would not invoke “close scrutiny” under Regulation section 1.514(c)-2(k)(1).<sup>56</sup> We suggest that the safe harbor cover shifts occurring as a natural consequence of the admission of additional partners (or increases in the relative interests of certain partners vis-à-vis other existing partners) within 24 months of the initial formation of a partnership pursuant to a provision in the partnership agreement addressing staged closings. We also suggest that the safe harbor sanction staged closing provisions contained in the partnership agreement that are designed to admit partners on identical economic terms, making adjustments for time-value-of-money factors relating to the time period of investment. We believe the 24-month period is a reasonable and realistic time frame that should cover most commercially common staged closing arrangements. This safe harbor is intended to be relatively easy for taxpayers to apply and for the Service to administer.

##### **2. Permissible Disproportionate Allocations (and Safe Harbor) for Staged Closings**

We also recommend that guidance be issued to permit, within certain pre-defined standards, allocations of otherwise disproportionate amounts of income or loss (or items thereof) to the partners on account of a staged closing. We recommend that the following standards be applied to determine when such disproportionate allocations would be permitted: (i) the later entering partners are admitted within a reasonable period after the formation of the partnership; (ii) such allocations are necessary to ensure that the partners’ capital accounts are in the proper proportions upon the admission of the later partners (or

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<sup>56</sup> Such a safe harbor would not be violative or inconsistent with the underlying policy of the fractions rule. The fractions rule is intended to prevent tax advantaged shifting of income and losses among taxable and tax-exempt partners. *See supra* text accompanying note 11. Because changes in interests pursuant to staged closings represent actual economic shifts in ownership and are not accomplished with any view towards benefiting taxable partners, we believe these transactions should not be viewed as compromising the purpose of the fractions rule.

are brought into such proportions within a reasonable time thereafter), consistent with the terms of the partnership agreement; and (iii) there is no tax avoidance motive with respect to the allocations.<sup>57</sup>

In addition to this general rule, we also believe that a safe harbor would be appropriate to provide greater certainty for taxpayers. We propose a safe harbor similar to the model adopted by the Regulations with respect to reasonable preferred returns and guaranteed payments. Specifically, we suggest that the guidance provide a safe harbor when the later entering partners are admitted no later than 24 months after the formation of the partnership and the additional requirements set forth below are met:

(i) To the extent that an allocation is to account for an interest factor being paid to the earlier entering partners, the interest rate for the deemed interest factor is not be greater than a rate which would qualify under the current Regulations for a reasonable preferred return;<sup>58</sup>

(ii) The partnership's documents from the outset anticipated the subsequent admission of partners during the staged closing period, and such documents set forth the time frame in which such partners would be admitted, and how much additional capital is intended to be raised;<sup>59</sup> and

(iii) The partnership agreement and any other relevant documents specifically set forth the method of determining any applicable interest factor and other provisions for allocating income or loss to rationalize capital accounts.<sup>60</sup>

These requirements will help ensure that any disproportionate allocation of income or loss is not inconsistent with the purposes of the fractions rule but rather is designed to allow a real estate fund to admit its investors during a reasonable period of time under general commercial standards, without concern as to whether and when Qualified Organizations are admitted to the partnership.

## **VII. Defaults and Capital Commitment Reductions**

### **A. Background**

In the current economic environment, fund managers are facing the prospect of limited partners defaulting on their capital contribution commitments or are being asked by

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<sup>57</sup> The anti-abuse rule of Regulation section 1.514(c)-2(k)(4) could be referenced in connection with the standard for a tax avoidance motive in the context of the fractions rule.

<sup>58</sup> The interest rate would be tested for reasonableness under the standard of Regulation section 1.514(c)-2(d)(4)(i), and if the interest rate meets the criteria of Regulation section 1.514(c)-2(d)(4)(ii), the interest rate would be deemed to be reasonable.

<sup>59</sup> See PLR 200351032 (Dec. 19, 2003).

<sup>60</sup> Currently, such rationalization of the overall arrangement often is undertaken pursuant to discretion provided to the general partner to properly determine allocations in such situations.

limited partners to allow them to contribute less capital than they had committed. Similar to issues discussed in the prior section dealing with “staged closings,” there is little, if any, guidance for determining whether changes to the partners’ shares of income and losses resulting from either a default or reduction in committed or contributed capital causes a partnership to violate, on a prospective basis (after the default or lowered capital contribution), the fractions rule.

Generally, a limited partner in a real estate fund does not contribute its entire investment upon its being admitted as a partner. Rather, the limited partner “commits” to contribute a certain dollar amount over a fixed period of time. The general partner “calls” on the committed, but uncontributed, capital on an as-needed basis (*e.g.*, as it finds real estate to invest in). Such capital calls are made of all partners in proportion to their commitments and at which time the limited partners are required to make the called-for contribution. For example, if partners A, B, and C commit \$50, \$30, and \$20, respectively, the general partner will call 50% of its needed capital from A, 30% from B, and 20% from C. These percentages usually represent each partner’s “fractions rule percentage” as determined in the Regulations.<sup>61</sup>

If a partner fails to contribute any or all of its share of a capital call, the fund’s partnership agreement generally provides the remedies available.<sup>62</sup> These remedies include, but are not limited to, (i) allowing the non-defaulting partner(s) to contribute additional capital (to make up for the defaulting partner) and receiving a preferred priority return on such additional capital, (ii) causing the defaulting partner to forfeit all or a portion of its interest in the fund, (iii) forcing the defaulting partner to sell its interest in the fund, or (iv) excluding the defaulting partner from making future capital contributions.<sup>63</sup> These remedies all result in a reduction of the defaulting partner’s share of fund income and losses (and in the case of (i) above, causes the non-defaulting and contributing partner to recognize preferred income on a priority basis).

As an alternative to defaulting (and, in a sense, a negotiated default), a fund may allow a limited partner to decrease its undrawn commitment to the fund. If such reduction is made on a pro rata basis to all the partners (including a general partner that has undrawn commitments), there should be no fractions rule concerns, given that each partner’s share of partnership income and loss remains unchanged. However, if the reduction in commitments is not proportionate (either not all the partners’ commitments are reduced or the percent of such reduction is not the same for all partners), the partners’ share of partnership income and loss changes. If, in the above example, A (after already contributing 50% of the contributed capital) is allowed to reduce its commitment to \$40, its share of income and loss would be reduced to 44.4% (on a fully contributed basis). These

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<sup>61</sup> That is, the parties generally will bear losses in proportion to contributed capital. These loss sharing ratios will establish the partners’ fractions rule percentages.

<sup>62</sup> These provisions are common to all types of private equity investment funds, not just real estate funds.

<sup>63</sup> In many partnership agreements, these remedies are not exclusive. Rather, the general partner may seek to impose more than one remedy.

changes, along with those resulting from a default, raise the concern as to whether they cause a prospective violation of the fractions rule.

## **B. Analysis**

### **1. Shifting Allocations**

Shifts in the partners' shares of overall partnership income and loss that result from either a default by a limited partner or a reduction in a partner's commitment should not, either retroactively<sup>64</sup> or prospectively, result in a violation of the fractions rule. The abuse that the fractions rule is intended to prevent is the avoidance of tax by transferring tax benefits available to tax-exempt persons to taxable persons by means of special allocations of income to tax-exempt partners or special allocations of losses to taxable partners.<sup>65</sup> Changes in allocation percentages resulting from a partner default or a reduction in a partner's commitment because of unanticipated changes in its economic situations are not part of a scheme to avoid taxes.

This lack of tax avoidance motive is shown by the following example. In year one, a Qualified Organization commits to contribute \$1,000 to a real property fund subject to capital calls over a five-year period (representing ten percent of all commitments). The \$1,000 represents 50% of the Qualified Organization's assets. The other 50% is currently invested by the Qualified Organization in a stock fund with a value of \$1,000. The Qualified Organization's by-laws provide that not more than 50% of the Qualified Organization's assets can be invested in real property. In year two, after the Qualified Organization has already invested \$250 in the real estate fund (representing ten percent of all contributed capital), the value of the Qualified Organization's stock fund drops by 50% to \$500. Accordingly, the Qualified Organization, pursuant to its by-laws, is only permitted to contribute an additional \$250 to the real property fund (for a total investment of \$500 or five percent of committed capital) even though it had previously committed a total of \$1,000.<sup>66</sup> The Qualified Organization may either default on all or a portion of any future capital calls or negotiate with the fund to reduce its commitment.<sup>67</sup>

As a result of either a default by the Qualified Organization in the above example or a reduction in its commitments, the partners' shares of partnership income and losses will be adjusted (with the Qualified Organization being allocated less than ten percent of future income and losses).

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<sup>64</sup> Regulation section 1.514(c)-(2)(k)(1) supports the view that these changes do not cause a retroactive violation if such changes do not stem from a prior agreement, plan or understanding. It might be argued, however, that a partnership agreement containing a default remedy constitutes a prior plan.

<sup>65</sup> Reg. § 1.514(c)-(2)(k)(4).

<sup>66</sup> The Qualified Organization's need to reduce its commitment may arise from a reason that does not rise to the level of a legal obligation, such as a desire to meet asset-allocation guidelines.

<sup>67</sup> The Qualified Organization might attempt to sell its partnership interest to another party who could fund the capital commitment, although many real estate fund agreements contain significant limitations on the ability of partners to transfer their interests.

Funds handle these situations in different ways. In some cases, the partner whose capital commitment is reduced may retain the profit previously allocated, based on the notion that it had contributed capital for the prior investments in such proportion. The partner's share of income will be adjusted on a prospective basis. In this situation, the issue presented would be much like the issue for staged closings discussed above. That is, there is concern that shifts in connection with capital commitment defaults or renegotiations, given that such events often are provided for in the partnership agreement, may be viewed as stemming from "a prior agreement, understanding, or plan or could otherwise be expected given the structure of the transaction."<sup>68</sup>

Alternatively, however, this change in the partners' interest in the partnership may be treated as effective from the outset of the fund (*i.e.*, the Qualified Organization in the example above may be treated under the partnership agreement as having a five-percent interest in the partnership from its commencement). Although the partner in the example above had contributed ten percent of the capital with respect to existing investments, it will fund less than five percent of the capital with respect to future investments. In effect, some of its earlier capital will be attributed to later investments. To account for the lower credit for earlier investments, the fund may specially allocate income and losses to the partners to adjust their capital accounts to reflect this dynamic.<sup>69</sup> Although this special allocation may result in a technical violation of the fractions rule, these changes arise solely as a result of an unintended situation (and not a plan to avoid or reduce taxes) and are made pursuant to an actual change in the economic investments by the partners.

Shifts in partners' shares of partnership income and loss resulting from defaults or reduced commitments may become common in all types of real property funds, including those that do not have Qualified Organizations as partners. Clarifying the Service's position in the manner recommended below would allow fractions rule sensitive funds to deal with the issue in the same manner as funds that are not subject to fractions rule constraints. Accordingly, we suggest that changes in allocations resulting from a default or reduction in a partner's commitment should be disregarded for purposes of determining whether a fund complies with the fractions rule.<sup>70</sup>

## **2. Non-Defaulting Partner Preferred Priority**

In addition to the shift in allocable shares of the partners resulting from a default, a non-defaulting partner may be allocated additional income with respect to its funding of the capital that would have otherwise been contributed by the defaulting partner. For example, assume partners A and B each commit to contribute \$1,000 to a fund over a five-year

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<sup>68</sup> Reg. § 1.514(c)-2(k)(1).

<sup>69</sup> This situation is not unlike the scenario with staged closings when one-time special allocations are undertaken to achieve appropriate parity in capital accounts consistent with the committed investment of the parties.

<sup>70</sup> In addition to actual economic changes that occur by reason of a default or reduction in commitment, a partner who may be thinking of defaulting on its commitment may be able to hold the other partners "hostage" to its demands, knowing that its default could cause the partnership to violate the fractions rule.

period. In year 3, after each of A and B has contributed \$400, the fund makes a capital call of \$200 from each of A and B. If B defaults on its obligations, the partnership agreement may provide that A may elect to contribute \$400, \$200 that it owes and \$200 to cover B's default. However, in exchange for making the \$400 contribution, A would be entitled to a priority with respect to the return of such capital contribution and a 25% preferred return (assume this to be a rate that does not satisfy the preferred return safe harbor described in the Regulations)<sup>71</sup> on the excess \$200 it contributed (or alternately on the full amount contributed) and the allocation and payment of such preferred return would be made prior to any allocations or payments to B. Because in any year A may be allocated 100% of the fund's income in respect of the 25% preferred return, this would result in a technical violation of the fractions rule. However, because such allocation is made pursuant to a commercially reasonable term in respect of an unlikely occurrence (namely the default of a partner), we believe the allocation of income should be disregarded in determining fractions rule compliance.

### **C. Recommendations**

With respect to rectifying the problem caused by a shifting allocation, we recommend that Regulation section 1.514(c)-(2)(k)(1) or Regulation section 1.514(c)-(2)(k)(4) be amended, or other guidance issued, to provide that a change in allocations of partnership income and loss will be disregarded, on both a retroactive and prospective basis, provided that such changes are not part of a plan to avoid taxes and further provided that the "post-change" allocations continue to satisfy the fractions rule. Solely for purposes of determining fractions rule compliance, we suggest that the proposed rule effectively treat the partnership as two separate entities, a partnership that terminates on the day before the change in the allocable percentages and a new partnership formed as of the date of such changes. In addition, we recommend that any such guidance provide that allocations will be disregarded in testing fractions rule compliance if such allocations are made to balance capital accounts as if the funded commitments had been made at the outset of the fund.

We further recommend that any such guidance provide specific examples of those events that result in changes to the partners' shares of income and loss that would not be treated as part of a plan to reduce taxes (and accordingly, not cause a fractions rule violation). We suggest that these examples address a default by a limited partner or a change in the committed or contributed capital of a limited partner when an unanticipated event occurs (such as changes to the limited partner's fiscal health).

In connection with the allocation of income to non-defaulting partners on a preferred or priority basis, we recommend that guidance be issued indicating that such income will be treated in a manner similar to how the Regulations treat the allocation of

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<sup>71</sup> In the current market, it is quite possible that a 25% return may actually represent a reasonable return, particularly if capital is being called for an investment that is experiencing problems.

unlikely losses and deductions.<sup>72</sup> Accordingly, we recommend that a new Regulation (or other guidance) be issued under which the allocation of income to a partner will be disregarded in determining whether such allocation is in excess of the partner's fractions rule percentage if such income allocation is (i) the result of the occurrence of an unlikely event such as the default of another partner (an unlikely occurrence considering the onerous remedies available) and (ii) made pursuant to a provision of a partnership agreement addressing capital contribution defaults.

## **VIII. Tiered Partnership Rules**

### **A. Background**

The general rule set forth in the final Regulations relating to tiered partnerships provides as follows:

If a Qualified Organization holds an indirect interest in real property through one or more tiers of partnerships (a chain), the fractions rule is satisfied only if-

(i) The avoidance of tax is not a principal purpose for using the tiered-ownership structure (investing in separate real properties through separate chains of partnerships so that section 514(c)(9)(E) is, effectively, applied on a property-by-property basis is not, in and of itself, a tax avoidance purpose); and

(ii) The relevant partnerships can demonstrate under any reasonable method that the relevant chains satisfy the requirements of paragraphs (b)(2) through (k) of this section.<sup>73</sup>

The Regulations contain three examples that illustrate the application of this general rule. The first example illustrates the “collapsing approach,” which collapses the tiers of partnerships and analyzes the effective allocations of the multiple tiered partnerships on a combined basis.<sup>74</sup> If the fractions rule is satisfied based on an analysis of the combined allocations, the tiered partnership rule is satisfied.

The second example illustrates the entity-by-entity approach.<sup>75</sup> This approach analyzes a situation in which multiple chains of partnerships, each with a Qualified Organization as a partner, are partners in a single lower-tier partnership that also has a direct taxable partner. Under this example, if the lower-tier partnership satisfies the fractions rule treating each chain with a Qualified Organization as a Qualified Organization, a chain that independently satisfies the fractions rule will not be tainted by

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<sup>72</sup> Regulation section 1.514(c)-(2)(g) provides that allocation of losses that have a low likelihood of occurrence are disregarded if such losses are allocated to the partner bearing the economic burden of such loss or deduction provided that the allocation does not have as a principal purpose the avoidance of taxation. *See supra* Section IV of these Comments.

<sup>73</sup> Reg. § 1.514(c)-2(m)(1).

<sup>74</sup> Reg. § 1.514(c)-2(m)(2), Ex. 1.

<sup>75</sup> Reg. § 1.514(c)-2(m)(2), Ex. 2.

another chain that does not. Effectively, the entity-by-entity approach operates such that, if the allocation provisions of the lowest-tier partnership from which the multiple chains originate satisfy the fractions rule, then a chain that allocates income or loss from the lowest-tier partnership consistent with the fractions rule does not have to worry about whether allocations in another chain violate the fractions rule.

The third example (“Example 3”) illustrates the independent-chain approach.<sup>76</sup> This example analyzes an upper-tier partnership with two partners, one taxable and the other a Qualified Organization, when the upper-tier partnership is invested in two lower-tier partnerships. Under the independent-chain approach, the upper-tier partnership analyzes its qualification with respect to each chain of lower-tier partnerships separately. The example concludes that the violation of the fractions rule with respect to one chain will not cause the fractions rule to be violated with respect to the other chain. As a proviso, however, the example states that this result will follow “only if the [upper-tier] partnership agreement allocates those items allocated to the [upper-tier partnership] by [the non-compliant lower-tier partnership] separately from those items allocated to [the upper-tier partnership] by [the compliant lower-tier partnership].”<sup>77</sup>

## **B. Analysis**

The tiered partnership rules contained in the final Regulations raise the question whether, in a typical fund arrangement, a single investment in a lower-tier partnership that is not fractions rule compliant may jeopardize fractions rule compliance with respect to the entire fund. The concern arises primarily as a result of changes that were made to Example 3 when the Regulations were finalized.

As described immediately above, Example 3 illustrates the “independent-chain” approach and addresses situations in which an upper-tier partnership invests in multiple lower-tier partnerships. The example illustrates facts under which a failure by one chain of partnerships to satisfy the fractions rule will not necessarily affect the qualification of income flowing through the upper-tier partnership from another chain of partnerships.

In the Proposed Regulations, the results were quite simple. That is, the failure of one chain would not taint other chains with regard to fractions rule qualification.<sup>78</sup> In the Final Regulations, however, the “separate allocation” proviso was added. As described above, under this proviso, if one chain is not fractions rule compliant, allocations made by the upper-tier partnership with respect to another chain could satisfy the fractions rule “only if” allocations made by the upper-tier partnership with respect to the non-compliant chain are made separately from allocations made with respect to the other chains that are otherwise compliant. In explaining this change to the Final Regulations, the preamble

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<sup>76</sup> Reg. § 1.514(c)-2(m)(2), Ex. 3.

<sup>77</sup> *Id.*

<sup>78</sup> Former Prop. Reg. § 1.514(c)-2(m)(2), Ex. 3 (1993).

stated that, “as a practical matter, partnerships would not otherwise be able to demonstrate that the requirements of the fractions rule are complied with.”<sup>79</sup>

The examples in the Regulations illustrate methods by which the general tiered partnership rule may be satisfied. We believe the examples should not be viewed as the exclusive means for showing compliance with this rule. Nonetheless, the “only if” proviso coupled with the preamble language accompanying the Final Regulations raises a significant concern that the “separate allocation” provision is viewed by the Service as an operative rule for arrangements similar to the one described in Example 3.<sup>80</sup>

In understanding the significance of this “separate allocation” requirement, it is important to realize how the economics of a typical real estate fund are structured. A real estate fund generally will invest in a significant number of properties, often through joint ventures with other partners. The fund will provide an overall preferred rate of return to its cash investors with respect their total investments in the overall portfolio. After the investors have received their preferred return, the sponsor of the fund will receive a percentage share of the residual profits (*i.e.*, a carried interest, which often is 20%). Because the return to the cash investors is cumulative across all of the investments, it is not feasible to draft the partnership agreement in a manner that “separately” allocates items with respect to any single investment. Depending on when a specific investment is sold and how successful other properties in the venture have been up to that time, any profit with respect to that property may be utilized to (1) fund the preferred return, (2) fund the residual carried interest sharing level, (3) chargeback a prior sharing in losses by the partners, or (4) some combination of the above. Similarly, any loss with respect to that property may be used to (1) chargeback profit allocated to the preferred return, (2) chargeback profit allocated with respect to the residual carried interest sharing level, or (3) reduce the partners’ capital.

The proviso added to Example 3 raises a number of difficult issues. Most importantly, is the proviso intended to provide that a typical real estate fund will violate the fractions rule with respect to all of its investments if it violates the fractions rule with respect to any of them? More specifically, if an upper-tier partnership does not satisfy the fractions rule with respect to a lower-tier partnership (or chain of partnerships) under the collapsing approach, and the lower-tier partnership (or each partnership in the chain of partnerships) does not otherwise satisfy the fractions rule on a stand-alone basis (alternatively testing as if the upper-tier partnership is a Qualified Organization and not a Qualified Organization, assuming that the upper-tier partnership has both types of partners), then is it only possible for the upper-tier partnership to satisfy the fractions rule with respect to its other investments if it separately allocates items with respect to the violating lower-tier partnership (or chain of partnerships) and satisfies the fractions rule ignoring the allocations from the violating lower-tier partnership (or chain of partnerships)?

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<sup>79</sup> T.D. 8539 (preamble), 1994-1 C.B. 157.

<sup>80</sup> Reg. § 1.514(c)-2(m)(2), Ex. 3.

By stating in the preamble that partnerships could not otherwise demonstrate compliance with the fractions rule without the separate allocation, Treasury arguably implied that the upper-tier partnership must be able to analyze the allocations with respect to its other investments separately and affirmatively show that those allocations would satisfy the fractions rule. Under this view, the fact that the upper-tier partnership's allocation provisions are drafted in a manner that satisfies the fractions rule, taking all income and loss into account, on a stand-alone basis would not appear to protect the other investments.

If Treasury and the Service did intend this result, presumably it was based on a belief that the allocations in the lower-tier partnership (or chain of partnerships) destroyed the integrity of the overall allocations of the upper-tier partnership. Although we understand the need to prevent parties from structuring tiered arrangements that are intended to violate the purposes of the fractions rule, we do not believe that, to protect the integrity of the fractions rule, it is necessary to treat the upper-tier partnership as violating the fractions rule with respect to all of its investments when the upper-tier partnership does not separately allocate items with respect to a violating investment.

As an initial matter, we believe it is important to recognize that the fractions rule does not apply on a property-by-property basis, as is generally the case with respect to debt-financed property. Instead, the fractions rule analyzes allocations made with respect to "overall partnership income or loss." This includes income from debt-financed property and income from property that is not debt-financed. This also includes income that will not be treated as UBTI so long as the fractions rule is satisfied as well as income that will be treated as UBTI regardless of fractions rule compliance (*e.g.*, gain from the sale of "dealer" property). We believe that these points are significant because they illustrate that the fractions rule does not typically apply in a way that isolates income related to certain investments from that of other investments. This is the case even though the fractions rule is concerned only with converting income with respect to debt-financed property held by a partnership into UBTI for partners that are Qualified Organizations.

We believe that, if the allocations provided by an upper-tier partnership agreement satisfy the fractions rule on a stand-alone basis, then an arrangement with a lower-tier partnership should not cause a violation of the fractions rule with respect to the other investments of the upper-tier partnership so long as avoidance of tax is not a principal purpose for using the tiered-ownership structure. The lack of a tax-avoidance purpose would satisfy the first prong of the tiered-partnership rule.<sup>81</sup> Similarly, when the upper-tier partnership agreement satisfies the fractions rule on a stand-alone basis, and the income and loss from the other investments that do not otherwise violate the fractions rule<sup>82</sup> are taken into account under the upper-tier partnership agreement, we believe the second prong of the

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<sup>81</sup> Reg. § 1.514(c)-2(m)(1)(i).

<sup>82</sup> That is, income and loss from the lower-tier partnership (or chain of partnerships) is allocated in a way that, if the upper-tier partnership is treated as either a Qualified Organization or a taxable partner, the lower-tier partnership (or chain of partnerships) would satisfy the fractions rule.

tiered partnership rule<sup>83</sup> should be treated as satisfied. Just as income that does not relate to debt-financed property and income that is treated as UBTI in all events must be considered in analyzing fractions rule compliance with respect to the overall income or loss of a partnership, we believe it is entirely appropriate to consider the income or loss from a lower-tier investment that does not satisfy the fractions rule (*i.e.*, not require that such items must be separately allocated) in analyzing compliance with respect to the other investments. We suggest that the only exception should be when the arrangement with a lower-tier partnership is devised so as to compromise the overall allocation scheme of the upper-tier partnership.

Two examples can illustrate how the proposed approach would apply in divergent factual situations. First, consider a typical real estate fund with Qualified Organizations as investors that provides a cumulative preferred return to its cash investors followed by a residual sharing with a 20% carried interest to the sponsor. The fund has invested \$3 billion in 50 projects on behalf of its investors. The advisors have been careful to draft the fund agreement so as to satisfy the fractions rule and have structured each investment to satisfy the fractions rule as well. But, with respect to one of the investments in a lower-tier partnership (which accounts for less than one percent of the fund's overall investments), a small taxable partner fails to honor a capital call obligation. This failure causes the partner to default on its capital commitment requirement. Under the lower-tier partnership agreement, the non-defaulting partners (including the fund) receive a higher return to compensate them for contributing further capital on behalf of the defaulting partner. In addition, the capital contributed by the non-defaulting partners pursuant to this capital call will be preferred as to other capital previously contributed to the partnership. This isolated event could cause the fund to receive a higher share of income with respect to the lower-tier partnership than its lowest share of loss and thus potentially violate the fractions rule with respect to the lower-tier arrangement.<sup>84</sup>

With respect to this investment, the fund would report UBTI to the extent that the property is debt-financed and the fractions rule is in fact violated for the lower-tier partnership. Under existing Regulations, the arguable acceleration of income to the Qualified Organizations in the fund with respect to this property and deferral for the taxable partner in the lower-tier partnership provides some justification for treating the fractions

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<sup>83</sup> Reg. § 1.514(c)-2(m)(1)(ii).

<sup>84</sup> More specifically, the fractions rule violation potentially occurs in this situation with respect to the lower-tier partnership for the following reason. If the fund contributes its share of the defaulting partner's capital commitment, it will receive an increased return on that portion of its capital that is not shared by the defaulting partner. The defaulting partner, however, continues to share in a pro rata amount of the partnership losses until its previously contributed capital is eliminated. Accordingly, unless allocations attributable to the increased return paid on defaulted capital may be ignored under one of the exceptions contained in the Regulations, that return will provide the fund with a highest share of income that is greater than its lowest share of loss, thus creating a violation of the fractions rule. A similar situation is discussed above in connection with capital call defaults. *See* Section VI of these Comments.

rule as violated at that level.<sup>85</sup> But the result with respect to this lower-tier investment creates no benefit for any other taxable partner in the entire structure. The arguable benefit that the fractions rule implies with respect to the taxable partner is completely isolated in this instance to the single lower-tier investment. We suggest that the purposes of the fractions rule are not served by causing UBTI to accrue with respect to all of the other investments of the fund, and such a result would not follow under the proposed interpretation of the tiered-partnership rule advocated by these Comments. But, as described above, given the cumulative nature of the allocation provisions at the fund level, it is not feasible to draft the allocation provisions so as to isolate the income or loss from a particular investment.<sup>86</sup> So without further guidance, there is concern that the fractions rule would be violated in this instance for all of the fund investments.

Contrast the foregoing example with the following situation: A Qualified Organization and a taxable partner agree to acquire a large apartment complex that is made up of two towers. History shows that the financial performance of the two towers is virtually identical and the rental history of each tower has been highly stable. The parties would like to accelerate income to the Qualified Organization for the first six years of the investment, and to allocate a corresponding amount of income to the taxable partner for the following six years. The parties realize, however, that such an allocation scheme with respect to the project would cause a fractions rule violation for all income of the partnership. So instead, the parties form an upper-tier partnership that will invest separately in each tower. The Qualified Organization invests \$90 in the upper-tier partnership, and the taxable partner invests \$10 in that partnership. All allocations and distributions made by this partnership are pro rata based on invested capital. The taxable partner also separately invests \$40 in each of the lower-tier partnerships that owns one of the towers, so that the taxable partner has 50% of the direct and indirect capital invested with respect to each of the towers. One of the lower-tier partnerships allocates income and loss based on contributed capital. The other partnership allocates 100% of the income from the tower to the upper-tier partnership for the first six years and allocates 80% of the income to the taxable partner and 20% to the fund for the following six years, with income being allocated in proportion to capital after 12 years.

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<sup>85</sup> See *supra* note 72 and accompanying text recommending that such an event arising from a capital commitment default should not give rise to a violation of the fractions rule.

<sup>86</sup> Arguably, if the fund agreement contains a fractions rule “savings” clause, the income or loss from the violating lower-tier partnership may properly be analyzed as being allocated separately from other investments. A typical real estate fund agreement, however, relies on the chargeback exception under Regulation section 1.514(c)-2(e)(1)(i) for compliance with the fractions rule, and this can create problems even if the violating income is treated as separately allocated. If income that is allocated by the violating lower-tier partnership through the fund must be ignored in determining whether the fund agreement can satisfy the fractions rule, then a loss that is subsequently allocated under the fund agreement to chargeback that prior income could not be ignored under the chargeback exception. Because the fractions rule is applied on both a prospective and actual basis (Reg. § 1.514(c)-2(b)(2)(i)), it is possible that the mere prospect of this scenario would cause the fund agreement to be treated as violating the fractions rule with respect to the other investments.

In this example, although the parties could show compliance with the fractions rule with respect to the chain of partnerships that allocates all income and loss based on contributed capital, the overall arrangement is such that we believe it would be appropriate to treat the upper-tier partnership as failing the fractions rule with respect to all income and loss flowing through such partnership. Because of the tax avoidance purpose underlying the use of the tiered arrangement, the test that we advocate would reach this result.

### **C. Recommendation**

Because of the confusion created by the language in Example 3, we recommend that guidance be issued to provide clarification of the analysis. We recommend that this guidance provide that a violation of the fractions rule with respect to a lower-tier partnership (or chain of partnerships) will not cause all investments of the upper-tier partnership to violate the fractions rule simply because the upper-tier partnership does not separately allocate items relating to the lower-tier partnership (or chain of partnerships) that violates the fractions rule. We recommend that such guidance provide that the tiered partnership rule will be interpreted in a manner so that, if the allocations provided by an upper-tier partnership agreement satisfy the fractions rule on a stand-alone basis, then any allocations made by the lower-tier partnership would not cause a violation of the fractions rule with respect to the other investments of the upper-tier partnership so long as avoidance of tax is not a principal purpose for using the tiered-ownership structure.