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TAXATION
A Section of the American Bar Association

Section of Taxation

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March 15, 2018

The Honorable David Kautter
Acting Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20024

Re: Comments on Proposed Regulations Issued Under Section 514 (the "Fractions Rule")

Dear Acting Commissioner Kautter:

Enclosed please find comments on proposed regulations issued under section 514, addressing the extent to which a tax-exempt organization's income with respect to "debt-financed property" is treated as unrelated business taxable income in the case of real property held by certain tax-exempt organizations (the "Comments"). These Comments are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association.

The Section of Taxation will be pleased to discuss the Comments with you or your staff.

Sincerely,

Karen L. Hawkins
Chair, Section of Taxation

Enclosure

cc: William M. Paul, Acting Chief Counsel and Deputy Chief Counsel (Technical), Internal Revenue Service
Hon. David Kautter, Assistant Secretary, Office of Tax Policy, Department of the Treasury
Thomas West, Tax Legislative Counsel, Office of Tax Policy, Department of the Treasury
Audrey Ellis, Attorney-Advisor, Office of Tax Policy, Department of Treasury
Holly Porter, Associate Chief Counsel, Passthroughs and Special Industries Division, Internal Revenue Service
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AMERICAN BAR ASSOCIATION

SECTION OF TAXATION

COMMENTS ON PROPOSED REGULATIONS ON THE TREATMENT OF A TAX-EXEMPT ORGANIZATION'S INCOME WITH RESPECT TO DEBT-FINANCED REAL PROPERTY (THE "FRACTIONS RULE")

The following comments ("Comments") are submitted on behalf of the American Bar Association Section of Taxation (the "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 Adam Feuerstein and James Sowell. Substantive contributions were made by Shawna Tunnell and Karen Turk. The Comments were reviewed by Robert Honigman, Chair of the Real Estate Committee, and Julie Sassenrath, immediate past Chair of the Real Estate Committee. The Comments were further reviewed by Lisa Zarlenga, of the Section's Committee on Government Submissions, and by Adam M. Cohen, the Council Director for the Real Estate Committee.

Although the members of the Section who participated in preparing these Comments have clients who might be affected by the federal 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: March 15, 2018

EXECUTIVE SUMMARY

These Comments address the proposed regulations (the "Proposed Regulations") recommending changes to Treasury Regulation section 1.514(c)-2 (the "Regulations") relating to the "fractions rule".[1]

The Service and Treasury should be applauded for undertaking the project leading to the Proposed Regulations and for being responsive to prior comments regarding the non-abusive common business practices that raise issues under the current fractions rule regulations. The proposed regulations address and clarify many issues identified in prior comments of the Section.[2] Nevertheless, while the Proposed Regulations are responsive in many ways, we believe that there are some areas of the Proposed Regulations that could be revised and expanded prior to finalization in a manner, that would more effectively allow legitimate business transactions to take place that do not undermine the intent of the fractions rule.

By way of background, under Code section 514[3], 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) provides an exception in the case of real property held by certain tax-exempt organizations ("Qualified Organizations" or "QOs") if several requirements are met. When a partnership in which the tax-exempt organization is a partner holds the real property, the exception is generally only available if the partnership's allocations have substantial economic effect under section 704(b) and satisfy the "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 QO cannot result in that partner having a percentage share of overall partnership income for any partnership taxable year greater than such partner's percentage share of overall partnership loss for the partnership taxable year in which the partner's percentage share of overall partnership loss will be the smallest.[4]

In this letter, we focus our comments on the specific issues addressed in the Proposed Regulations and on other issues that arise under the fractions rule in transactions regularly undertaken by real estate funds with QOs as partners.

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[1] Prop. Reg. §1.514(c)-2, 81 Fed. Reg. 84518 (2016).

[2] Comment Letter submitted on January 19, 2010, regarding "Comments Concerning Partnership Allocations Permitted Under Section 514(c)(9)(E)," from Stuart M. Lewis, as Chair, Section of Taxation of the American Bar Association to the Hon. Douglas Shulman, the Commissioner of the Internal Revenue Service (the "Prior ABA Comment Letter"). Concepts and text in this Comment Letter use concepts and text from the Prior ABA Comment Letter where appropriate.

[3] References to the "Code" refer to the Internal Revenue Code of 1986, as amended, references to a "section" refer to a section of the Code, and references to "Regulations" refer to Treasury Regulations promulgated under the Code.

[4] I.R.C. § 514(c)(9)(E)(i)(1); Reg. §§ 1.514(c)-2(b)(1)(i), -2(c)(2).

Comments Relating to Disregarded Preferred Return Allocations.

Proposed Regulation section 1.514(c)-2(d)(2)(ii) provides that preferred returns may only be disregarded if the partnership agreement requires the partnership to first make distributions to pay the preferred return, except as otherwise provided. Proposed Regulation section 1.514(c)-2(d)(2)(iii) provides that a preferred return may still be disregarded for purposes of the fractions rule if certain tax distributions have been made. We recommend as follows:

- The rule that allows tax distributions to be made before distributions of preferred returns should be revised so that it allows for tax distributions: (i) based on an amount no greater than the sum of the highest federal, state, local and other tax rates that may be applicable to any person investing directly or indirectly in the partnership, as opposed to the federal, state and local tax rates applicable to the recipient of the tax distribution; and, (ii) based on estimates of the net partnership income and gain that would be allocated to a partner at the time of the distribution, as opposed to the actual net partnership income and gain.

- The preferred return exception should be revised to allow for the return of capital contributions prior to distributions in payment of a preferred return.

- The preferred return exception should provide that a reasonable preferred return may be calculated solely with respect to the unreturned capital of one or more special classes of partnership interest (*e.g.*, a preferred interest).

- The preferred return exception should be expanded so that it allows preferred returns to be disregarded if the partnership has made a distribution with respect to the preferred return as is allowed under the Regulations.

Comments Relating to Disregarded Partner-Specific Expenditures

Proposed Regulation section 1.514(c)-2(f)(4) adds "expenditures for management and similar fees, if such fees in the aggregate for the taxable year are not more than two percent of the partner's capital commitments" to the list of partner-specific expenditures that will be disregarded in determining overall partnership income or loss.

- We recommend replacing the list-based rule with a general rule that would disregard all reasonable allocations of 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 such agreement is not motivated by tax avoidance.

    - If a general rule is not adopted, we recommend that:

- the list be modified to include foreign taxes, costs and expenses attributable to the transfer or redemption of a partner's interest in the partnership and section 6225 obligations;

- the description of management and similar fees that will be disregarded include management fees charged on the basis of net asset value; and

- the two percent threshold related to management and similar fees (i) incorporate an averaging mechanism that allows management and similar fees in one year to exceed two percent if it is clear that the overall fees will remain at or below two percent and (ii) provide that the two percent threshold only applies to fees that are specially allocated among the partners.

Comments Relating to Disregarded Unlikely Losses

In the preamble to the Proposed Regulations, comments were requested regarding the appropriate standard to apply for determining when to disregard specially allocated unlikely losses or deductions.

- We strongly believe that a "more likely than not" standard, such as the standard outlined in Notice 90-41[5], is appropriate for the unlikely loss exception.

- We also believe that it should be permissible to specially allocate items of deduction or loss other than those that relate to the specific unlikely expenditure in order to reflect the intended sharing of the expenditures.

Comments Relating to Disregarded Chargebacks

While the Proposed Regulations expand the list of partner-specific expenditures that may be ignored and provide that income charging back such expenditures, along with unlikely losses, also may be ignored, the preamble to the Proposed Regulations requests comments on the interaction of the exclusion of partner-specific items and unlikely losses and the general chargeback provisions relating to prior disproportionately large allocations of overall partnership loss or prior disproportionately small allocations of overall partnership income.[6]

- We recommend that partnerships be provided multiple options for satisfying the referenced chargeback rules.

[5] Notice 1990-1, C.B. 350
[6] Reg. § 1.514(c)-2(e)(1).

- Under one option, a partnership could keep track of how allocations would have been made for all years as if the excluded items were deducted, and reverse prior year allocations on that basis.

- An alternative option would be to include the excluded items in overall income or loss for purposes of analyzing both the original and subsequent chargeback allocations, allowing a partnership to apply the chargeback rule on a partner-by-partner basis.

Comments Relating to Changes in Interests

Our comments on changes in interests can be divided into two categories: comments related to subsequent admissions of partners to the partnership; and, comments related to changes of interests in connection with a default.

Comments Relating to Subsequent Admissions

Proposed Regulation section 1.514(c)-2(i)(1)(ii) sets out a special rule that, if the conditions set forth therein are satisfied, will allow changes in allocations due to acquisitions of partnership interests after the initial formation of a partnership without close scrutiny under Regulation section 1.514(c)-2(k)(1). Instead, such changes in allocations will be considered only in determining partnership compliance with the fractions rule in the taxable year of the change and subsequent taxable years, and disproportionate allocations made for the purpose of reflecting the subsequent admission in the partners' capital accounts may be disregarded in computing overall partnership income or loss for purposes of the fractions rule.

We recommend that the Proposed Regulations be revised as follows:

- Provide that the applicable period extend to 24 months, rather than 18 months, following the formation of the partnership with additional extensions if commercially reasonable;

- Eliminate the requirement that the proposed interest rate charged to partners joining the partnership after the initial closing be determined by reference to the AFR, and instead provide that the interest rate for any applicable interest factor may not be greater than a commercially reasonable rate;

- Confirm that an interest rate, for an interest factor established by a partnership, that exceeds the preferred return rate paid by the same partnership may be a rate that will qualify under the Regulations for a reasonable preferred return.

- Clarify that a "new" partner includes existing partners who experience increases in their interests relative to other existing partners after the initial formation of a partnership;

- Clarify that "formation" means the initial admission of partners unrelated to the management of the partnership; and

- Delete the reference to the taxable year of the change so that the entire current taxable year, which includes allocation from both before and after the admission of new partners, is not compared to periods after the admission.

Comments Relating to Defaults

The Proposed Regulations contain a helpful exception to the "close scrutiny" rule in Treasury Regulations section 1.514(c)-2(k)(1)(i) and provide that:

> [c]hanges in partnership allocations that result from an unanticipated reduction in a partner's capital contribution commitment, that are effected pursuant to provisions prescribing treatment of such events in the partnership agreement, and that are not inconsistent with the purpose of the fractions rule under paragraph (k)(4) of this section, will not be closely scrutinized under paragraph (k)(1)(i) of this section, but will be taken into account only in determining whether the partnership satisfies the fractions rule in the taxable year of the change and subsequent taxable years.[7]

In addition, the Proposed Regulations clarify that allocations made pursuant to the partnership agreement to adjust the partners' capital accounts as a result of such defaults or reductions are disregarded in computing overall partnership income or loss in applying the fractions rule. We recommend as follows:

- The requirement that the allocations not be "inconsistent with the purpose of the fractions rule under paragraph (k)(4)" should be eliminated.

  - If that requirement is nevertheless retained, we request additional explanation as to what factors the Treasury Department and the Service intend taxpayers to consider by such a requirement.

- Final regulations should address priority contributions made in connection with partner capital call defaults and clarify that allocations of income to non-defaulting partners on a preferred or priority basis will be treated in a manner similar to how the Regulations treat the allocation of unlikely losses and deductions.[8]

- The close scrutiny exception should be expanded to apply, not just to unanticipated partner defaults on a capital commitment or an unanticipated reduction in a partner's capital contribution commitment, but also to the

[7] Prop. Reg. §1.514(c)-2(e)(5)(k)(1)(ii), 81 Fed. Reg. 84518 (2016).

[8] Reg. § 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.

unanticipated failure by a partner that is a service provider to comply with a provision of the partnership agreement where the remedy entails a reduction in such partner's otherwise disproportionately large profit share or carried interest (i.e., a share of profits in excess of its fractions rule percentage).

- The final regulations should provide that allocations of income, gain, loss or deduction will be disregarded in determining overall partnership income, and will not be required to satisfy the qualified chargeback requirements under Treasury Regulations § 1.514(c)-2(e), where the allocations are made pursuant to the partnership agreement to adjust the partners' capital accounts as a result of such default.

- Delete the reference to the taxable year of the change so that the entire current taxable year, which includes allocation from both before and after the default, is not compared to periods after the admission.

DISCUSSION

I. Background

Section 511(a) imposes tax on the unrelated business taxable income ("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 gain from the sale or exchange of property that is not "dealer" property generally are excluded from a tax-exempt organization's UBTI.[9] 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, with respect to gain on property 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" (sometimes referred to herein as "QOs"). Section 514(c)(9)(C) defines a "Qualified Organization" as: (1) a charitable

[9] I.R.C. § 512(b).

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.[10] In addition, when the real property is held by a partnership in which the QO owns an interest, (1) all partners must be QOs; (2) each allocation to a QO 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.[11] In practice, for most real estate partnerships in which QOs participate, it is necessary to satisfy this last alternative to take advantage of the exception contained in section 514(c)(9).

Under the fractions rule, the allocation of items to a QO cannot result in that partner having a percentage share of overall partnership income for any year greater than such partner's percentage share of overall partnership loss for the year in which the partner's percentage share of overall partnership loss will be the smallest.[12] 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 QO.[13]

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.[14]

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[10] I.R.C. § 514(c)(9)(B)(i) – (v).
[11] I.R.C. § 514(c)(9)(B)(vi).
[12] Reg. § 1.514(c)-2(b)(1)(i), -2(c)(2).
[13] I.R.C. § 514(c)(9)(E)(i)(1); Reg. § 1.514(c)-2(b)(2).
[14] 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 $1,000 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

The Regulations permit certain allocations to be ignored in applying the fractions rule.[15] 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).[16] Further, the Regulations contain rules relating to the application of the fractions rule in the context of tiered partnerships.[17]

The Proposed Regulations address many of comments raised in the Prior ABA Comment Letter. Our comments here are similar to our prior comments in that they suggest changes to the Proposed Regulations that will allow for ordinary non-abusive business arrangements to go forward without undermining the intent of the fractions rule and without subjecting QOs to UBTI taxation.

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 may be disregarded in determining overall partnership income or loss for purposes of the fractions rule.[18] Such an allocation, 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 (the "Historic Preferred Return Distribution Requirement").[19] This timing rule has been a part of the reasonable preferred return rule since the fractions rule was first outlined in Notice 90-41.[20] As was noted in the Prior ABA Comment Letter, we believe that this timing rule was promulgated to address a problem that does not exist, that it creates a disadvantage for QOs relative to non-fractions rule sensitive investors in real estate joint ventures, and that it is a departure from common business practice.

The Proposed Regulations addressed this issue by eliminating the Historic Preferred Return Distribution Requirement. However, the Proposed Regulations add a new requirement (the "Proposed Preferred Return Distribution Requirement"), which provides that, except for certain tax distributions, the partnership agreement must require the partnership first to make distributions to pay any accrued, cumulative and compounding unpaid preferred returns to the extent such preferred returns have not otherwise been reversed by a prior allocation of loss. The Proposed Regulations provide that the exception for tax distributions only applies if the tax distribution (1)

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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.

[15] Reg. § 1.514(c)-2(d) - (j).

[16] Reg. § 1.514(c)-2(c).

[17] Reg. § 1.514(c)-2(m).

[18] 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).

[19] Reg. § 1.514(c)-2(d)(6)(i).

[20] Notice 1990-1 C.B. 350.

is made pursuant to a provision in the partnership agreement intended to facilitate the partners' payment of taxes imposed on their allocable shares of partnership income or gain, (2) is treated as an advance against distributions to which the distributee partner would otherwise be entitled under the partnership agreement and (3) does not exceed the distributee partner's allocable share of net partnership income and gain multiplied by the sum of the highest statutory federal, state and local tax rates applicable to such partner.

B. Analysis

While we agree with relaxing the Historic Preferred Return Distribution Requirement, we believe the Proposed Preferred Return Distribution Requirement requires a few changes so that it does not impede common non-abusive business transactions.

Tax Distribution Exception

Tax distributions are a common and important feature in partnership agreements. These provisions change the normal distribution priorities to provide partners with cash to pay their tax liability for income allocated from the partnership.

For example, assume Partner A contributes $100 to a partnership and Partner A and B each split the profits 50-50. The partnership agreement generally provides that A first gets its capital ($100) back and then cash is distributed 50-50. Under the general distribution provision, if there is $10 of operating income and distributable cash flow in year 1, the cash would all go to A, but the taxable income would be allocated $5 to A and $5 to B. This would mean that B would have a tax liability but no cash to pay the liability.

To address this issue, partners will often agree to provide a tax distribution to B so that B has cash to pay its tax liability. This tax distribution is generally treated as an advance on future distributions that B would otherwise receive.

Given the prevalence and importance of tax distributions, we believe the Proposed Preferred Distribution Requirement correctly provides that allocations of income related to reasonable preferred returns may be disregarded for purposes of the fractions rule even though tax distributions may be made prior to distributions related to preferred returns.

While the Proposed Regulation provides an exception for tax distributions, this exception should be revised to align with provisions that are commonly found in partnership agreements. In particular, Proposed Treasury Regulation § 1.514(c)-2(d)(2)(iii)(C), which requires that the tax distribution may not exceed the distributee partner's allocable share of net partnership income and gain multiplied by the sum of the highest statutory federal, state and local tax rates applicable to such partner, should be revised so that the permitted distribution can be calculated by reference to rates in any jurisdiction specified in the partnership agreement and not the rates applicable to a particular partner. In addition, tax distributions should be allowed to be based on estimates of the net partnership income and gain that would be allocated to a partner at the time of the distribution, as opposed to the actual income.

In our experience, most partnership agreements do not calculate a tax distribution based on the particular tax rates applicable to the distributee partner but, instead, choose the rates applicable to a particular jurisdiction (which may include a foreign jurisdiction). Administrative concerns are one reason that partnerships usually rely on a single jurisdiction for purposes of calculating tax distributions.[21]

The administrative burdens that would be imposed on partnerships if they were required to make distributions based on the tax rates applicable to each particular partner would be significant and the reasons are multifold. First, it may be difficult to determine the rate applicable to a single partner as a single partner may be subject to tax in multiple jurisdictions. Further, the facts with respect to a single partner may change each year and during the course of a year. It may not even be possible for an individual partner to know with certainty the jurisdictions to which the partner may be subject to tax at the end of the year when a distribution is made earlier in the year.

As difficult as it may be to reach a conclusion for a single partner, this issue is obviously exacerbated for a partnership with many partners. For example, a partnership with 50 partners will need to conduct the above analysis 50 times and constantly update its information on its partners in connection with each distribution and would need to consider changing its procedures each time a new partner joins the partnership.

The complications noted above do not take into account the fact that the recipient of a tax distribution may itself be a partnership and that the distributee partnership received the tax distribution for the benefit of its partners. For example, assume that Partnership A desires to be fractions rule compliant and it is obligated to make a tax distribution to Partnership B. Once Partnership A calculates its income allocable to Partnership B, Partnership B would need to provide information about the tax rates that should apply to Partnership A's tax distribution.

We note as a preliminary matter that, under the Proposed Preferred Return Distribution Requirement, Partnership B, as a distributee partner, will not have a

[21] In addition to administrative concerns, there are also equitable concerns that cause partnerships to distribute the same tax distribution to all of its partners. For example, assume that the limited partners in a partnership contribute the capital and are entitled to a preferred return. There are two partners, A and B, who are not limited partners, who are entitled to a share of profits after the preferred return, and who are treated equally in all ways. A is in a high tax jurisdiction and B is in a low tax jurisdiction. In one year, A and B have taxable income allocated to them but, absent a tax distribution, no cash. From an economic perspective, if the cash goes to the limited partners, less preferred return would accrue. On the other hand, if there is a tax distribution, the preferred return would continue to accrue on the cash that was not distributed to the limited partners and instead was distributed to A and B. If a higher tax distribution is made to A than B, the higher distribution to A means that more of a preferred return will accrue because of the tax rate applicable to A and B will end up bearing some of the economic burden of that as the preferred return will continue to accrue for both A and B. Therefore, most agreements do not calculate individual tax distribution amounts simply to prevent one partner from subsidizing another, as illustrated in our example.

federal income tax rate applicable to it, and may not have a state or local tax rate applicable to it. Therefore, under the Proposed Preferred Return Distribution Requirement, Partnership B may not be eligible for any tax distributions even though such distributions are often made to partnerships, such as Partnership B, to provide cash to Partnership B's partners to pay their tax liabilities.Even if the Proposed Preferred Return Distribution Requirement looked to the jurisdiction of the partners in Partnership B, the administrative burdens involved would be sizeable and perhaps insurmountable.

First, Partnership B would need to determine the applicable tax rate for each of its partners which, as noted above, may be challenging. Even if Partnership B was able to identify the appropriate tax rate for each of its partners, Partnership B would need to determine how much of the income from Partnership A is allocated to each of Partnership B's partners. Assuming Partnership B has income or loss other than from Partnership A, it is not clear how Partnership B would make this determination solely with respect to the income from Partnership A. Further, even if a methodology was developed, Partnership A would need to wait for Partnership B (and any partnerships that are partners in Partnership B, and so on) to complete its allocations of income before any distributions could be made. As the simple example above illustrates, it is important for partnerships to be able to calculate tax distributions based on the rates applicable in a single jurisdiction, as opposed to the rates that may be applicable to each partner.

Another way in which the tax distribution exception in the Proposed Regulations differs from the provisions that are in many partnership agreements is that the Proposed Regulations require that the tax rates be multiplied by the actual income to determine the tax distributions. Very often the tax distribution is made based on estimated income. This may be done because the distribution is meant to pay estimated income taxes or simply because the timing of the distribution is made at a time before the calculation of the taxable income has been or can be finalized. Therefore, we recommend that the tax distribution provision currently contained in the Proposed Regulations permit it to be based on reasonable estimates of taxable income.

Return of Capital

The priority of a preferred return in relation to the return of capital may vary among partnerships. In some cases, a preferred return is paid before capital is returned. In other cases, capital is returned before a preferred return is paid. Often the order does not matter when the preferred return is paid on all capital.

For example, A and B are limited partners in a partnership with GP. A contributes capital of $100, and B contributes capital of $200, and both are entitled to a compounding preferred return of 10% each year. If there is income and positive cash flow of $15 in year one, income would be allocated $5 to A and $10 to B. The distribution waterfall might provide that available cash is distributed first to pay the preferred return ($5 to A and $10 to B) and then to return capital ($100 to A and $200 to B). Alternatively, the agreement could provide that available cash would be distributed first to return capital ($100 to A and $200 to B) and then to pay the preferred return ($5 to A and $10 to B). Because there is no practical difference, agreements may be drafted returning capital first, and the requirement that the preferred return be distributed first becomes a trap for the unwary.

Further, there are legitimate economic arrangements in which it is important for capital to be returned prior to the payment of a preferred return. For example, A has $100 of capital and has identified a real estate investment that will cost $300. B agrees to invest $200 of capital with the understanding that, while the partners will first get their capital back pro rata, B will get a preferred return of 10% on any profits. Setting aside the fractions rule, the parties would agree that distributions would first go, pro rata, $100 to A and $200 to B. Then, B would receive its preferred return of 10%. This is a non-abusive arrangement that should not be precluded by the fractions rule. While we believe that a preferred return should be disregarded even when the partnership agreement provides that capital can be returned prior to payment of the preferred return, to prevent distributions that might provide flexibility regarding the partner that receives the distribution, we recommend that any return of capital be required to be distributed pro rata in accordance with the unreturned capital contributions of the partners.[22]

Clarification for Partnerships with Multiple Classes of Partnership Interest

The Proposed Regulations do not specify how the Proposed Preferred Return Distribution Requirement should be applied to a partnership with multiple classes of interest.

We suggest clarifying that a reasonable preferred return calculated solely with respect to one or more special classes of partnership interest (*e.g.*, preferred interest) may be disregarded for purposes of the fractions rule, and that references to unreturned capital in the final regulations refer to the unreturned capital of the preferred class of interests. For example, a preferred return could satisfy the preferred return exception with respect to a particular class of partnership interest if the partnership agreement requires the partnership first to make distributions to pay a reasonable preferred return with respect to the unreturned capital for such class of partnership interest. In determining whether the preferred return is reasonable, the rate should be determined with reference to the particular class of partnership interest at issue, rather than all unreturned capital of the partnership.

[22] We recognize that in our comments issued prior to the Proposed Regulations, we suggested as one alternative to eliminating the timing rule, that reasonable preferred return allocations might be ignored if partnership agreement requires that distributions must be made first to match any accrued by unpaid preferred return. We stated that such a limitation would minimize the lapse of time between preferred return allocations and preferred return distributions and hence comfort could be taken that the purposes of the fractions rule were not being violated. We note that this suggestion was made as a second choice to simply eliminating the timing rule. As stated above, we believe it important that the legitimate economic arrangements described should not be prohibited and that the purposes of the fractions rule are not compromised as a result of allowing distributions first of unreturned capital contributions.

We note that real estate partnerships frequently include at least one class of preferred partnership interest that accrues a priority preferred return payable before invested capital. Partnerships create such classes of preferred partnership interest to address legitimate business concerns, such as to finance an ongoing development project or to make capital improvements. The priority preferred return feature encourages investment, typically in a situation where other forms of financing may be unavailable. In this regard, we recommend clarifying that the requirements with respect to preferred returns be applied to the capital that generates the preferred return and not to all of the capital of the partnership.

Allowing Partnerships to Disregard Preferred Returns if the Partnership Satisfies the Historic Preferred Return Distribution Requirement

As currently drafted, the Proposed Preferred Return Distribution Requirement is an alternative to the Historic Preferred Return Distribution Requirement. If the Proposed Regulations were finalized as drafted, a partnership could only disregard allocations related to a preferred return if the Proposed Preferred Return Distribution Requirement were satisfied. It is important to note that the changes reflected in the Proposed Preferred Return Distribution Requirement are intended to make it easier to engage in non-abusive commercial transactions and are not intended to eliminate any abuse under the Historic Preferred Return Distribution Requirement.

We recommend allowing partnerships to utilize the Historic Preferred Return Distribution Requirement for both historic and new partnerships. Partnerships that exist at the time the Proposed Regulation are finalized will have drafted their agreements to comply with the Historic Preferred Return Distribution Requirement and may not be able to revise their agreement to comply with the Proposed Preferred Return Distribution Requirement. If historic partnerships are not able to rely on the Historic Preferred Return Distribution Requirement when the Proposed Regulations are finalized, they may fail to satisfy the fractions rule simply because they relied on the regulations as they existed at the time that their partnership agreement was drafted.

We also think it would be important to allow partnerships formed after the Proposed Regulations are finalized to utilize the Historic Preferred Return Distribution Requirement as arrangements satisfying the current regulatory provision are not abusive, and there are commercial business reasons for some partnerships wanting to utilize the Historic Preferred Return Distribution Requirement. First, the parties may have entered into a prior fractions rule compliant agreement and may simply agree to keep the terms the same to prevent costly negotiations that may be necessitated by changes in terms. Second, the Proposed Preferred Return Distribution Requirement may prevent partnerships from entering into non-abusive arrangements (such as the arrangements discussed above related to returning capital and tax distributions). Since arrangements satisfying the Historic Preferred Return Distribution Requirement are presumably not abusive, there is no policy reason not to allow those partnerships to continue to utilize that method, as an alternative.

C. Recommendations

We recommend revising Proposed Regulation section 1.514(c)-2(d)(2)(iii)(C) so that it allows for tax distributions based on an amount no greater than the sum of the highest federal, state, local and other income tax rates that may be applicable in any jurisdiction.

We recommend revising Proposed Regulation section 1.514(c)-2(d)(2)(iii)(C) so that it allows for tax distributions based on estimates of the net partnership income and gain that would be allocated to a partner at the time of the distribution, as opposed to the actual net partnership income and gain.

We recommend revising Proposed Regulation section 1.514(c)-2(d)(2)(iii) to add a new exception that allows preferred returns to be disregarded even if distributions that return capital are required to be made prior to distributions in payment of a preferred return.

We recommend revising Regulation sections 1.514(c)-2(d)(4)(i) and 1.514(c)-2(d)(5) to clarify that a reasonable preferred return calculated solely with respect to a particular class of partnership interest may be disregarded for purposes of the fractions rule if it is computed with respect to the unreturned capital of that class.

We recommend revising Proposed Regulation section 1.514(c)-2(d)(2)(ii) so that the partnership either (1) is required to first pay any accrued, cumulative, and compounding unpaid preferred return or (2) has satisfied the distribution requirement that currently exists in Regulation section 1.514(c)-2(d)(6).

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. The Regulations include the following expenditures that will be disregarded:

i. 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;
ii. Administrative costs resulting from having a foreign partner;
iii. State and local taxes and expenditures related to those taxes; and

iv. Any other expenditures designated by the Service by revenue ruling, revenue procedure or private letter ruling.[23]

The Proposed Regulations add a fifth category of partner-specific expenditures that will be disregarded: "Expenditures for management and similar fees, if such fees in the aggregate for the taxable year are not more than 2 percent of the partner's capital commitments."[24]

B. Analysis

The Regulations and the Proposed Regulations disregarding certain partner-specific expenses use a list-based rule. Inherent in a list-based rule is an inability to evolve with markets and changes in law. A broader principles based standard would permit non-abusive commercially common allocations to be made without requiring a partnership to obtain a private letter ruling for partner-specific items that were not considered by the Regulations. Such a standard would also be better suited to address future issues that arise as a result of changing markets and new allocable items that may arise, such as the section 6225 partnership-level obligations. Therefore, we recommend that Treasury and the Service replace the current list-based rule regarding partner-specific items with a general principles based rule that disregards all reasonable allocations of 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 such agreement is not motivated by tax avoidance.

In the preamble to the Proposed Regulations, Treasury and the Service requested comments regarding whether imputed underpayments under section 6225 should be included in the list of partner-specific items that will be disregarded in determining overall partnership income or loss.[25] Section 6225, enacted by the Bipartisan Budget Act of 2015,[26] provides for an imputed underpayment payable by the partnership, and may be impacted by the tax characteristics of partners. It is expected that many partnership agreements will provide that the partners will share in this liability of the partnership disproportionately based on the partner's respective impacts on and allocable share of the imputed underpayment and section 6225(c)(3). For example, tax-exempt partners will expect that their status may result in a reduced liability for an imputed underpayment based on the Service considering their exempt status in calculating the partnership's imputed underpayment. Allowing partners to enjoy the benefit that their tax status should confer is an appropriate economic result and does not indicate avoidance of the purposes

[23] Reg. §1.514(c)-2(f).
[24] Prop. Reg. §1.514(c)-2(f)(4).
[25] Prop. Reg. §301.6241-4(a) treats payments of the assessment under section 6225 as a non-deductible non-capitalizable expenditure under section 705(a)(2)(B).
[26] Pub. L. 114-74, 114th Cong., 1st Sess. (2015).

of the fractions rule. Accordingly, the allocation of an imputed underpayment under section 6225 should be included in the list of disregarded allocations if the final Regulations use a list-based rule.

Similarly, foreign taxes paid by a partnership that are triggered by the residency or status of a partner would be appropriate to include in the list of partner-specific items that are disregarded. The same logic that led the Service and Treasury to include on the list administrative expenses resulting from having a foreign partner suggests that a partnership should be able to allocate foreign taxes disproportionately to the partners that cause the partnership to incur such tax liabilities.

The costs and expenses attributable to a transfer or redemption of an interest in a partnership would also be appropriate partner-specific items that should be disregarded. These costs may include, but are not limited to, the cost of drafting or reviewing transfer or redemption documents and obtaining legal or tax advice or opinions on the transfer or redemption. Allocating these costs to the partner that causes the partnership to incur the costs is commercially reasonable and not indicative of the types of abuses the fractions rule seeks to avoid.

The addition of management and similar fees paid by a partnership is a welcome change that will enable fractions rule compliant partnerships to offer terms consistent with fee structures typically offered by investment managers. Large investors in a partnership commonly negotiate reduced management fees, which results in special allocations of the management fee expense. As a result, a QO that has negotiated a share of management fees that is lower than its share of contributed capital will have allocations that reduce its lowest share of overall partnership loss relative to its percentage share of committed capital. Accordingly, the QO's share of overall partnership income will be greater than its lowest share of overall partnership loss, which violates the fractions rule.[27] The exception in the Proposed Regulations for management and similar fees is limited to fees that do not exceed, in the aggregate for the taxable year,

[27] 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 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 before 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.

two percent of a partner's capital commitments. The limitation raises a few nuanced issues in some circumstances.

First, investment partnerships often provide management fee offsets for transaction fees received by the management company from investments that the partnership makes, in order to avoid the management company receiving fees in excess of the agreed amount. The partnership agreement may delay the offset for a transaction fee received by the management company in one year to a subsequent year. As a result, in the year in which the transaction fee is received, the delay in the offset may cause the total of management and similar fees to exceed two percent in that year, even though management fees over the life of the fund would average two percent or less. Therefore, we recommend that the two percent threshold related to management and similar fees (1) incorporate an averaging mechanism that allows management and similar fees in one year to exceed two percent if it is clear that the overall fees will remain at or below two percent and, (2) provide that the two percent threshold only applies to fees that are specially allocated among the partners.

A second issue arises for partnerships that are charged a management fee based on the net asset value of the partnership rather than on the partners' capital commitments. A management fee of up to two percent of the net asset value may be less than two percent of capital commitments in some years but exceed two percent of capital commitments when the partnership's net asset value increases. Because of the variance in the management fee relative to the partners' capital commitments, partnerships with fees based on net asset value would not have certainty that the fee will never exceed two percent of capital commitments and therefore could not be fractions rule compliant. Therefore, we recommend that the description of management and similar fees that will be disregarded include management fees charged on the basis of net asset value of the partnership.

A third issue relates to the scope of the fees included in the two percent threshold. It is not clear under the Proposed Regulations whether the two percent threshold is determined solely by the amount of the management fees (and similar fees) charged by the partnership or whether it includes only those fees which are specially allocated to particular partners. If the management fees (or similar fees) in a particular year are merely the expenses actually incurred by the partnership, partnerships will be required to examine each expense to determine if it is similar to a management fee, even if it is being borne by all of the partners equally. We believe the better standard would be to include only fees charged to the partnership that are specially allocated to particular partners. For example, if the total management fees (and similar fees) of a partnership are three percent of the capital commitments, but the fees representing one percent of the capital commitments are not specially allocated to any partners, we recommend that the two percent threshold would be satisfied and those fees could be specially allocated among the partners.

C. Recommendation

We recommend that Treasury and the Service replace the current list-based rule regarding partner-specific items with a general principles based rule that disregards all reasonable allocations of 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 such agreement is not motivated by tax avoidance.

If Treasury and the Service retain a list of partner-specific items that will be disregarded, we recommend that:

- the list be modified to include foreign taxes, costs and expenses attributable to a transfer or redemption of an interest in the partnership and section 6225 obligations,

- the description of management and similar fees that will be disregarded include management fees charged on the basis of net asset value, and

- the two percent threshold related to management and similar fees (1) incorporate an averaging mechanism that allows management and similar fees in one year to exceed two percent if it is clear that the overall fees will remain at or below two percent and (2) provide that the two percent threshold only applies to fees that are specially allocated among the partners.

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.[28] 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)."[29] The Regulations provide the following examples of types of events that may give rise to unlikely losses or deductions:

> i. tort and other third-party litigation that gives rise to unforeseen liabilities in excess of reasonable insurance coverage;

[28] Reg. § 1.514(c)-2(g).
[29] *Id.*

ii. unanticipated labor strikes;

iii. unusual delays in securing required permits or licenses;

iv. abnormal weather conditions (considering the season and the job site);

v. significant delays in leasing property due to unanticipated severe economic downturn in the geographic area;

vi. unanticipated cost overruns; and

vii. the discovery of environmental conditions that require remediation.[30]

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.[31] 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."[32] This standard was eliminated without explanation when the fractions rule Regulations were proposed.

The Proposed Regulations noted that the Treasury Department and Service are considering changing the standard in Regulations section 1.514(c)-2(g) and request further comments explaining why "more likely than not" is a more appropriate standard than the current "low likelihood of occurring" or whether some standard in between these two standards is more appropriate.

B. <u>Analysis</u>

We strongly believe that the "more likely than not" standard is the appropriate standard. By definition, the odds are against the loss allocation occurring and taxpayers need a clear standard to rely on given the significant costs of failing the exception. The more likely than not standard has long standing application for income tax purposes.[33] In financial accounting, if a tax position does not reach the more likely than not standard, it is not recognized at all, much like unlikely losses are ignored for fractions rule purposes.

Further, because of the draconian results of failing the fractions rule, as a

[30] *Id*.
[31] Notice 90-41, 1990-1 C.B. 350, section IV.
[32] *Id.*
[33] We note, for example, that in *Merkel v. Commissioner*, the Tax Court adopted a "more likely than not" standard for purposes of evaluating whether a contingent liability will be considered in determining a taxpayer's insolvency. *Merkel v. Commissioner*, 109 T.C. 463, 484 (1997) (a "taxpayer claiming the benefit of the insolvency exclusion must prove (1) with respect to any obligation claimed to be a liability, that, as of the calculation date, it is more probable than not that he will be called upon to pay that obligation in the amount claimed and (2) that the total liabilities so proved exceed the fair market value of his assets"), *aff'd*, 192 F.3d 844 (9th Cir. 1999).

practical matter, taxpayers are going to be conservative in their interpretation of what satisfies the more likely than not standard, particularly the tax-exempt institutional investors at issue. Further, the Service's interests are well protected with a more likely than not standard because, if a taxpayer intentionally creates a prohibited special loss allocation, such intent would, almost by definition, fail the more likely than not standard for an unlikely loss.

For the same reasons, we would recommend a more likely than not standard, we recommend against a different standard "in between." Anything in between brings into account the same vagaries that were the problem with the "low likelihood" standard. There does not exist a well-established and readily measurable "in between" standard. Further, tax standards such as "reasonable possibility of success" and "substantial authority" are simply not relevant as they are legal position standards and not standards to measure the likelihood of an economic event. Taxpayers need a clear and workable standard to recognize the business realities of real world events like cost overruns.

One issue not addressed in our prior comments also warrants guidance. Certain expenditures described in the Regulations generally would not give rise to an immediate deduction. For example, unanticipated cost overruns in a construction project almost always would relate to costs that are capitalized into the adjusted basis of the building. A question arises in these situations as to whether other items of deduction or loss may be specially allocated among the partners in the year the cost overrun expenditures are incurred in order to reflect the intended sharing of the expenditures.

We believe that it should be permissible to allocate items other than those arising from the specific expenditure. Otherwise, it may not be possible to carry out the economic arrangement intended by the partners. Consider the following example: QO and Developer are equal partners, sharing all items 50-50, except that the partners have agreed that Developer will bear all cost overruns. Following construction, the property has an adjusted basis of $1.1 million, $100,000 of which reflect cost overruns. In this situation, QO would have funded $500,000 and Developer $600,000. The property is sold the following year for an amount equal to its adjusted basis of $1.1 million, reflecting no gain or loss. Assume that prior to sale, the property generates $100,000 of rental income and $100,000 of deductible operating expenses. By specially allocating the operating expenses to Developer and allocating the rental income consistent with the 50-50 sharing ratio, both partner's capital accounts would move to $550,000, which reflects the intended economic arrangement. If the partners are limited to the capitalized expenditures for purposes of making the special allocation, it would not be possible to carry out the intended economic arrangement while still liquidating in accordance with the partner's positive capital account balances.[34]

[34] We note also that it would be difficult to trace to the depreciation deductions that relate specifically to the cost overruns. Arguably, with real property depreciable over 39 years, it might be that the cost overruns would be deductible pro rata over that that period (*i.e.*, the basis attributable to the cost overruns would reflect a proportionate part of the basis that is depreciated in each year). In many cases, the property will be sold and the partnership liquidated before the property has been fully depreciated. If the property is not sold at a loss, there would not be sufficient deductions or loss items attributable to the cost overruns to allow the partners to reflect their intended economic arrangement.

C. Recommendation

We strongly believe that 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 change to the Regulations would permit QOs to participate in legitimate business arrangements and would make the fractions rule easier to apply in practice.

In addition, we believe that it should be permissible to specially allocate items of deduction or loss other than those that relate to the specific unlikely expenditure in order to reflect the intended sharing of the expenditures.

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

A. Background

The preamble to the Proposed Regulations states as follows:

> Notwithstanding the rule in the proposed regulations, an allocation of an unlikely loss or a partner-specific expenditure that is disregarded when allocated, but is taken into account for purposes of determining the partners' economic entitlement to a chargeback of such loss or expense may, in certain circumstances, give rise to complexities in determining applicable percentages for purposes of fractions rule compliance. Accordingly, the Treasury Department and the IRS request comments regarding the interaction of disregarded partner-specific expenditures and unlikely losses with chargebacks of such items with overall partnership income.[35]

While the Proposed Regulations provide helpful exceptions that permit the direct chargeback of unlikely losses and partner-specific items, the issue involved in this solicitation for comments relates to the interaction of the unlikely loss and partner-specific item exclusions and the more general chargeback exceptions. Those exceptions provide that an allocation of overall partnership loss to a QO may chargeback prior disproportionately small allocations of overall partnership income to a QO, or an allocation of overall partnership income to that QO may chargeback prior disproportionately large allocations of overall partnership loss to that QO.[36] For purposes of these chargeback exceptions, allocations may be reversed in full or in part, and in any order, but must be reversed in the same ratio as originally made.[37] In order to take advantage of a chargeback exception, however, the initial allocation to be charged back must consist of a pro rata share of each partnership item.[38] Accordingly, any special allocation of items that is part of that initial allocation will make the chargeback exception unavailable.

[35] Prop. Reg. §1.514(c)-2, 81 Fed. Reg. 84518 (2016) (preamble)
[36] Reg. §1.514(c)-2(e)(1)(i).
[37] Reg. §1.514(c)-2(e)(2)(i).
[38] Reg. §1.514(c)-2(e)(2)(ii).

B. Analysis

These "disproportionate allocation" chargeback rules are utilized in a majority of real estate partnerships that involve a carried interest and hence are of great importance. The issue relating to the interaction of the unlikely loss and partner-specific item rules and these chargeback rules is highly technical, and, in many ways, highlights the complex rules taxpayers are forced to navigate in dealing with the fractions rule.

The problem arises by virtue of ignoring the unlikely losses or partner-specific expense items in calculating overall partnership income or loss. Because the disproportionate allocation chargeback rules operate by reference to a prior allocation of overall partnership income or loss, under the rules as drafted, the chargeback presumably would be made with respect to prior allocations without consideration of the excluded items. But, in fact, the excluded items are included in determining the actual chargeback made by these partnerships. More specifically, the ratio of "overall partnership income" allocations in the initial year will be impacted by the exclusion of unlikely losses or partner-specific items, the allocation of section 704(b) "bottom-line" loss in the chargeback year will be made by reference to the allocation of section 704(b) "bottom-line" income from the prior year (which will have been made in a different ratio than "overall partnership income"), and the section 704(b) "bottom-line" loss allocation in the subsequent year then will be adjusted in calculating "overall partnership loss" to exclude unlikely losses or partner-specific items, resulting in still another set of allocation ratios. The challenge is to provide for operation of these chargeback rules in a manner that can accommodate these situations.

An example is helpful in illustrating the disconnect that can arise in comparing the initial allocation of overall partnership income that ignores unlikely losses and partner-specific items and the subsequent chargeback allocation of overall partnership loss that could be impacted by these previously incurred items.[39] Assume that QO1 commits $900 million to Fund and QO2 commits $100 million. All capital is contributed upon formation of Fund. QO1 will not bear a management fee, and QO2 will bear a management fee of two percent of committed capital. A preliminary allocation of items other than management fee expense will be made between QO1 and QO2 based upon percentage interests (*i.e.*, 90-10). Amounts then will be further allocated between the GP and each respective QO so that such QO will receive a 9% return on invested capital and thereafter amounts will be shared between each QO and GP 80-20. Management fee expense is specially allocated so that parties bear the agreed amount of such fees.[40]

In this situation, in year 1, Fund earns $100 million, ignoring management fees, which is preliminarily allocated $90 million to QO1 and $10 million to QO2. The management fee allocation ($2 million for QO2), makes the preliminary allocation $90

[39] The example analyzed in this report, and the discussion of this example, is derived, in part, from an example and discussion in J. Sowell, *New Fractions Rule Regulations: A Step in the Right Direction*, 2017 Tax Notes Today 53-8 (Mar. 21, 2017).

[40] The management fee is taken into account in determining whether QO2 has surpassed the 9% return hurdle before GP begins to share in its carried interest allocations and distributions.

million to QO1 and $8 million to QO2. The $90 million preliminarily allocated to QO1 exceeds the 9% return threshold (*i.e.*, $81 million), leading to 20% of the $9 million excess being allocated to GP. The $10 million allocation to QO2 (ignoring the management fee for purposes of determining overall partnership income) would exceed the 9% return threshold (*i.e.*, $9 million), but the $8 million actual allocation (taking into account the management fee) does not exceed the 9% return threshold.

Ignoring the management fee, as provided in Proposed Regulation §1.514(c)-2(f)(4), overall partnership income would be allocated $88.2 million to QO1 ($81 million preferred return + $7.2 million residual), $9.8 million to QO2 ($9 million preferred return + $.8 million residual), and $2.0 million to GP. The $90 million preferred return layer would be allocated first 90% to QO1 and 10% to QO2 and the $10 million carried interest layer is allocated 72% to QO1, 8% to QO2, and 20% to GP (the "Pre-Management Fee Allocations").

While a disproportionate loss will not violate the fractions rule if it is merely reversing overall partnership income in the same proportion, reversing income allocations in the same proportion may not be possible if there are variable management fees among the partners. While the Pre-Management Fee Allocations ignore the management fee items in calculating overall partnership income, subsequent allocations of overall partnership loss made by the partnership to charge back those prior allocations will be made by reference to the prior allocations actually made by the partnership (and therefore will include the previously allocated management fees).

Further, for purposes of applying the chargeback rule generally, it is necessary to analyze the separate allocation tranches and the ratios in which allocations are made within each tranche. Taking the special allocation of management fee items into account, however, it is not entirely clear how those ratios from the prior year would be determined for purposes of evaluating the charge-back allocations.

In the example, the allocations are broken down into an allocation of all items other than management fee expense based on a 90-10 ratio, and an allocation of the management fee expense that is specially allocated to the partner who economically bears the cost of that expense. For purposes of analyzing allocation layers, it is not clear if the special allocation should reduce the last dollars allocated to QO2, should reduce each dollar on a pro rata basis, or should reduce the first dollars allocated to QO2. As illustrated below, in any of the three scenarios, the chargeback rules apply in a manner that some chargeback allocations may not be able to be ignored for purposes of the fractions rule.

Management Fee Expense Reduces Last Dollars of Income

Under one approach, partnership income would represent the combination of all items, including the management fee expense, and such income would be allocated preliminarily between QO1 and QO2 under the distribution priority in the 90-10 ratio (which is stated as the baseline percentage-interest ratio in the partnership agreement) so long as income is available to each partner. Each partner would move to the carried interest layer at the point when the preferred return threshold has been satisfied, but because QO2 is allocated less income than its full 10% share (due to the special allocation of the management fee), at some point QO2 will run out of income while QO1 is still being allocated income. Under this approach, in effect, the partnership would allocate all items other than management fee expense 90-10 and then reduce the total amount allocated to QO2 under the distribution priority by the $2 million management fee expense that is specially allocated. After this, the remaining amounts would be run through the allocation waterfall.

Under this approach, allocations would be as follows: Partnership income would be allocated $88.2 million to QO1 ($81 million preferred return + $7.2 million residual), $8 million to QO2 ($8 million preferred return), and $1.8 million to GP. Note that QO2's allocation of $8 million falls short of the $9 million it would be entitled to under the preferred return layer. Thus, QO2 will not be participating in any allocation under the carried interest layer, and there will be a portion of the preferred return layer where QO1 participates and QO2 does not.

More specifically, income would be viewed as having been allocated in a 90-10 ratio until QO2 has been allocated its full share of overall partnership income, or $8 million. QO1's matching share of income would be $72 million in that case (*i.e.*, $80 million is allocated 90% to QO1, or $72 million, and 10% to QO2, or $8 million). But QO1 still is entitled to $18 million of additional income. Accordingly, QO1 would be allocated $9 million additional income under the preferred return layer unmatched by any corresponding allocation to QO2. In addition, the $9 million carried interest layer would be allocated $7.2 million to QO1 and $1.8 million to GP (the "90-10 Post-Management Fee Allocations"). To summarize, income would be allocated as follows:

Income	QO1	QO2	GP
$80mm	$72mm (90%)	$8mm (10%)	$0 (0%)
$9mm	$9mm (100%)	$0 (0%)	$0 (0%)
$9mm	$7.2mm (80%)	$0 (0%)	$1.8mm (20%)

In year 2, Fund incurs a $90 million loss, ignoring management fees, which is allocated on a preliminary basis $81 million to QO1 and $9 million to QO2. The management fee allocation ($2 million for QO2), makes the overall loss allocation $81 million to QO1 and $11 million to QO2.

The troublesome question that arises in following this approach is how the Fund should determine and allocate the year 2 loss for purposes of applying the general chargeback provision. The Fund will make actual allocations by applying the actual loss to charge back the 90-10 Post-Management Fee Allocations, taking into account the management fee as affecting only the loss allocated to QO2.

With respect to the first $10 million of loss, QO1's 90% preliminary share would eliminate the carried interest layer allocation, with $9 million being allocated $7.2 million to QO1 and $1.8 million to GP. QO2's 10% preliminary share of the first $10 million loss, or $1 million, would be allocated to QO2 to reduce its allocation under the preferred return layer. The next $80 million would be divided 90-10, with $72 million reducing QO1's prior preferred return allocation. With respect to QO2, $7 million of that allocation would reduce its prior preferred return allocation, and the remaining $1 million would reduce its capital. The $2 million of management fee allocated to QO2 would further reduce QO2's contributed capital.

If the Fund then analyzes its actual allocations for year 2 but excludes the deduction for management fees and compares those overall partnership loss allocations to the year 1 Pre-Management Fee Allocations of overall partnership income, the disproportionate allocation chargeback exception will be violated. Specifically, with respect to QO1, its 90% preliminary share of the first $10 million of loss would eliminate the carried interest layer allocation, with $9 million being allocated $7.2 million to QO1 and $1.8 million to GP. QO2's preliminary share of the first $10 million, or $1 million, would be allocated to QO2 to reduce its allocation under the preferred return layer. The next $80 million would be allocated 90-10, with $72 million reducing QO1's prior preferred return allocation. With respect to QO2, $7 million of that allocation would reduce its prior preferred return allocation, and the remaining $1 million would reduce its capital. Under this method, the first $10 million loss is allocated 72% to QO1, 10% to QO2, and 18% to GP. This allocation is not in the same ratio as any income allocation in year 1. As a result, because this year 2 overall partnership loss allocation is not in the same ratio as any corresponding year 1 income allocation, application of this method would result in the failure to satisfy the general chargeback rule.

Loss	QO1	QO2	GP
$10mm	$7.2mm (72%)	$1mm (10%)	$1.8mm (18%)
$80mm	$72mm (90%)	$8mm (10%)	$0 (0%)
$1mm (Cap)	$0 (0%)	$1 (100%)	$0 (0%)

Management Fee Expense Reduces Each Dollar of Income on a Proportionate Basis

A second manner in which the actual allocation layers might be analyzed would be to disregard the 90-10 ratio stated as the sharing percentage in the partnership agreement and instead to determine, on a year-by-year basis, each limited partner's preliminary share of income (before allocations to the GP) taking into account QO2's special allocation of the management fee. Instead of allocating the management fee deduction to reduce the last dollars that QO2 otherwise would be entitled to, the management fee deduction would reduce each dollar allocated to QO2 on a pro rata basis. Under this method, for year 1, QO1 would have a baseline percentage interest of 91.84% ($90 million/$98 million), and QO2 would have a baseline percentage interest of 8.16% ($8 million/$98 million). So rather than following the 90/10 ratio stated in the partnership agreement and having QO2 cease to receive allocations under the distribution priority at a time when QO1 is still receiving allocations, QO2 instead would receive a lower proportionate share of each dollar of income but would continue to match QO1 with its percentage share until the last dollar had been allocated. Under this approach, QO2 would still be receiving 8.16% of each dollar of partnership income, and applying such income against its preferred return entitlement, at the point where QO1 has satisfied its preferred return entitlement and is dividing its income with the GP under the carried interest layer. Under this approach, in year 2, QO1 would have a baseline allocation percentage interest of 88.04% ($81 million/$92 million), and QO2 would have a baseline percentage interest of 11.96% ($11 million/$92 million).

Note that in following this approach, the limited partners necessarily would have a different sharing ratio every year when total partnership income, excluding the management fee, is different since the fixed management fee will represent a different proportionate amount of the variable total partnership income. Obviously, there would be no way to satisfy the chargeback rules when the baseline allocation ratio is different in every year and also is different from the 90-10 ratio that is operative when the partner-specific items or unlikely losses are ignored.

Management Fee Expense Reduces First Dollars of Income

A third alternative would be to reduce the income allocated to partners that bear the management fees before running the income through the waterfall. Under this approach, the first $18 million of income would be allocated to QO1 (with the $2 million of income allocable to QO2 (excluding the management fee expense) being offset by QO2's $2 million share of the management fee deduction, leaving QO2 with $0 of income under the first layer). Under this approach, income would be allocated as follows.

Income	QO1	QO2	GP
$18mm	$18mm (90%)	$0 (0%)	$0 (0%)
$70mm	$63mm (90%)	$7 (10%)	$0 (0%)
$10mm	$7.2mm (72%)	$1 (10%)	$1.8mm (18%)

This method of allocation would solve the issue noted in the first alternative, as the $10mm loss allocation noted above that is allocated 72% to QO1, 10% to QO2 and 18% to the GP would reverse the income allocation in the alternative pro rata. However, if the facts change, the allocations in this alternative may not satisfy the fractions rule. For example, assume that the management fee allocable to QO2 is $10 million. In that case, no income would be allocated to QO2 (since all the income potentially allocable to QO2 would have gone to pay the management fee). The $90mm of net income after allocation of the management fee would be as follows.

Income	QO1	QO2	GP
$81mm	$81mm (100%)	$0 (0%)	$0 (0%)
$9mm	$7.2mm (90%)	$0 (0%)	$1.8 (0%)

In this case, if there was a loss of $10 million in year 2 (without accounting for the management fee) this would be allocated as follows under the waterfall.

Loss	QO1	QO2	GP
$10mm	$7.2mm (72%)	$1 (10%)	$1.8 (18%)

This loss allocation is not in proportion to the income allocations above and therefore could not be ignored for purposes of the fractions rule analysis.

Alternatives for Addressing Chargeback Allocations

There are multiple approaches that could satisfy the policy concerns reflected in the disproportionate allocation chargeback rules. Each approach has its drawbacks from a complexity or administrability perspective. Accordingly, we believe that if a partnership can satisfy one of the multiple approaches set forth below, the partnership should be considered to satisfy the fractions rule.

Hypothetical Allocations as if Partnership Pays No Management Fees

In order to create an "apples-to-apples" comparison where the initial and chargeback allocations both consider the same items for allocation, a partnership might keep track of how allocations would have been made for all years as if no management fees were deducted, and in the current year, reverse prior year allocations on that basis. For this purpose, Fund would allocate the year 2 overall partnership loss of $90 million (which excludes the management fee deduction) as if the year 1 income had actually been $100 million (which excludes the prior year management fee deduction). Under this scenario, in year 2, the first $10 million of loss would simply reverse the Pre-Management Fee Allocation for the carried interest layer of 72% to QO1, 8% to QO2, and 20% to GP. The next $80 million would reverse $80 million of the preferred return layer at a ratio of 90% to QO1 and 10% to QO2. The year 2 loss allocations are in the same ratios as the corresponding year 1 income allocations and hence would satisfy the general chargeback rule.[41]

Analysis under this approach may properly allow Fund to satisfy the fractions rule. Because management fees are ignored for purposes of hypothetical partnership economics and allocations, there is no need to confront ordering issues for management fees within the waterfall of allocations. The allocations, however, bear no resemblance to the allocations actually made by the partnership under section 704(b), and capital accounts maintained under this allocation methodology will bear no resemblance to the actual capital accounts of the partners maintained for purposes of section 704(b). It would be very burdensome to require partnerships to maintain a separate set of books illustrating such hypothetical allocations. Therefore, some alternative solution should be permitted.

Chargeback Analysis Under a Partner-by-Partner Approach

An alternative solution also creating an apples-to apples comparison would be to provide partnerships with the option to include the special allocations in overall partnership income or loss solely for purposes of analyzing subsequent chargeback allocations (*i.e.*, include the special allocations in both the original and chargeback-year

[41] Reg. §1.514(c)-2(e)(1)(i).

calculations), but to allow such partnerships to apply the disproportionate allocation chargeback rule on a partner-by-partner basis, analyzing the chargeback of allocations as between each limited partner/investor/QO and general partner/sponsor. This solution could accommodate scenarios where the disproportionate allocation chargeback rule is needed to facilitate a "carried interest" arrangement with the Fund general partner/sponsor.[42]

As a condition to utilizing this approach, it would be necessary that income or loss of the partnership (before consideration of special allocations of unlikely loss or partner-specific items) be allocated on a preliminary basis consistent with partnership baseline percentage interests that represent each QO partner's fractions rule percentage. Then, for each QO, the chargeback rule would be analyzed by reference to the QO's percentage share of income or loss as between the QO and general partner/sponsor. This approach would not require that allocations of overall partnership income or loss in a year must be in the same proportions among all partners as in the prior year for the allocation being charged back.[43] Instead, each QO that receives an allocation of income that is lower than its fractions rule percentage would be permitted to reverse such allocation as between such QO and the general partner/sponsor with losses in the same ratio as such items were previously allocated among such partners.

Such an approach should adequately protect the Government's interest. First, ignoring current-year allocations of unlikely losses or partner-specific items, each partner other than the general partner/sponsor would be limited in its highest possible share of income or loss to its baseline percentage interest in the partnership, which would represent the partner's fractions rule percentage. The only partner with whom those baseline allocations would be shared would be the general partner/sponsor, and hence it should be allocations between the QO and general partner/sponsor that could create issues under the fractions rule. So long as the allocations between the general partner/sponsor and the relevant QO are consistent with the principles of the chargeback rules, those rules should be satisfied.

For purposes of illustrating this approach, consider a modified version of the example set forth above. Assume that in year 1, Fund earns $200 million, ignoring management fees, which is preliminarily allocated $180 million to QO1 and $20 million to QO2. With respect to the portion preliminarily allocated to QO1, $90 million is applied to satisfy the preferred return, and the remaining $90 million is divided 80%, or $72 million, to QO1 and 20%, or $18 million, to GP. QO2's $20 million preliminary share is

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[42] We do not imply or suggest that entity specific terms (such as "limited partner" or "general partner") are recommended.

[43] As a result, it would not be necessary to determine the order for offsetting the management fee expense against income of a partner. That analysis is necessary only when allocations as between limited partners (*i.e.*, capital partners) are being compared. For purposes of the proposed partner-by-partner analysis, the only relevant "break points" in the allocation waterfall would be as between the limited partner and general partner (who has no capital generating allocations vis á vis the limited partner) within their allocation silo. The management fee simply reduces the income that is available within the limited partner/general partner allocation silo, and that reduced amount of income determines the "break points" as between the limited partner and general partner.

reduced by the $2 million of management fees borne by QO2, leaving $18 million for division between QO2 and GP. Of the $18 million, $9 million will satisfy QO2's preferred return, and the remaining $9 million would be divided 80%, or $7.2 million to QO2 and $1.8 million to GP. The $2 million management fee, however, is ignored for purposes of analyzing the fractions rule in the current year, so the income allocated under the carried interest layer for purposes of the fractions rule would be $11 million, going 80%, or $8.8 million to QO2 and 20%, or $2.2 million, to GP.

In year 2, Fund incurs a $100 million loss, ignoring management fees, which is allocated on a preliminary basis $90 million to QO1 and $10 million to QO2. With respect to QO1, the $90 million share would be applied entirely to charge back the $90 million carried interest (*i.e.*, 80-20) allocation between QO1 and GP, $72 million to QO1 and $18 million to GP. With respect to QO2, the $10 million loss would be increased by the $2 million management fee allocated to QO2, so that the total loss preliminarily allocated to QO2 is $12 million. For purposes of the fractions rule, however, the $2 million management fee would be ignored in the year incurred, so that the total loss allocated would be considered to be $10 million.[44] Of that $10 million loss, $9 million would chargeback the prior carried interest allocation on an 80-20 basis, with $7.2 million being allocated to QO2 and $1.8 million to GP. The remaining $1 million would be allocated to QO2 in chargeback of a portion of its preferred return.

Note that, for purposes of analyzing the fractions rule in year 1, the last $100 million of overall partnership income was allocated 72% to QO1, 8% to QO2, and 20% to GP. In year 2, the first $100 million of loss (ignoring the $2 million management fee charged to QO2 during the year) was allocated 72% to QO1, 8.2% to QO2, and 19.8% to GP. The variance in the ratio of allocations for QO2 and GP from the year 1 allocations is due to the fact that the management fees charged to QO2 were taken into account in measuring the income allocation that is subject to chargeback. Given that the variance is due to items that were properly ignored in the initial allocation, and the percentage share as between the QO and taxable partner who divided the initial allocation has remained constant, such a regime should be workable and consistent with the purposes of the fractions rule.

Under this alternative approach, because the unlikely loss and partner-specific items will be disproportionately allocated in the year when income is subject to chargeback, as compared to other items, it would be necessary to provide for an exception to the rule stating that allocations subject to chargeback must be comprised of a pro rata portion of each item of partnership income, gain, loss, and deduction (other than nonrecourse deductions or partner nonrecourse deductions and compensating allocations) that is included in computing overall partnership income or loss.[45] Again, the fact that these disproportionate allocations are otherwise sanctioned as not running afoul of the purposes of the fractions rule should provide comfort that the purposes of the

[44] If the current $2 million management fee expense item is not ignored in the year under analysis, the QO's preliminary share of overall loss would exceed QO2's 10% fractions rule percentage.
[45] Reg. §1.514(c)-2(e)(2)(ii).

disproportionate allocation chargeback rules will not be compromised by permitting consideration of these disproportionate allocations.[46]

While this partner-by-partner approach is both fair and efficient, and as a result, would likely be the choice of most real estate partnerships operating in the fund context, this approach will not likely work for everyone. For example, some partnerships may not divide all income and loss (other than unlikely losses or partner-specific items) on a preliminary basis consistent with the partners' fractions rule percentages. For those partnerships, the first approach discussed above (*i.e.*, apply the chargeback rule by reference to allocations that never included unlikely loss and/or partner-specific items) still should be made available. While the first approach is administratively burdensome in that it requires the partnership to maintain a set of books reflecting allocations that never actually happen (or at least to prove how those books would operate if properly maintained), there would seem to be no better approach for partnerships that cannot satisfy the partner-by-partner approach. Because the policies of the fractions rule also are properly served by application of this alternative approach, such an approach should be permissible.

C. Recommendation

In order to coordinate with the rules disregarding partner-specific items and unlikely losses, we recommend that the final Regulations modify the chargeback rules providing that an allocation of overall partnership loss to a QO may chargeback prior disproportionately small allocations of overall partnership income to a QO, or an allocation of overall partnership income to that QO may chargeback prior disproportionately large allocations of overall partnership loss to that QO. We suggest that these rules be modified to create a parallel comparison such that the original and chargeback allocations take account of the same items. We believe that final Regulations should permit taxpayers to choose one of two alternative rules.

Under one alternative, a partnership would keep track of how allocations would have been made for all years as if the excluded items were not deducted and compare the original and chargeback allocations on that basis.

Under the other alternative, the partnership would include the excluded items in overall partnership income or loss for purposes of analyzing both the original and subsequent chargeback allocations and would allow such partnerships to apply the chargeback rule on a partner-by-partner basis, effectively analyzing allocations in isolation as between each QO partner and the taxable partner that occupies the general partner/sponsor role in the partnership.

[46] Note that the Regulations already provide that exceptions may be made to the "pro rata portion" requirement by revenue ruling, revenue procedure, or, on a case-by-case basis, by letter ruling. *Id*.

VI. Acquisition of Partnership Interests after Initial Formation of Partnership

A. Background

The Regulations provide that changes in partnership allocations that result from transfers or shifts of partnership interests other than pursuant to the acquisition by one QO of the partnership interest of another QO will be closely scrutinized (to determine whether the transfer or shift stems from a prior agreement, understanding, or plan or could otherwise be expected given the structure of the transaction), but generally will be taken into account only in determining whether the partnership satisfies the fractions rule in the taxable year of the change and subsequent taxable years.[47]

As we described in the Prior ABA Comment Letter, many leveraged real estate funds in which QOs participate admit new partners in a number of rounds of closings (a "staged closing"). We described therein several common commercial arrangements pursuant to which partners provide capital at different times, with the common thread that all of the partners are economically treated as entering as of the date of the formation (*i.e.*, the initial closing of the fund) for purposes of sharing in profits and losses of the partnership, and the partners who entered earlier are generally reimbursed by the partners who entered later for the time value of money.

As we discussed in the Prior ABA Comment Letter, the tax impact on the partners depends on the particular structure of the staged closing. When new capital (plus interest) from later-admitted partners is distributed to the original capital-contributing partners, the transaction could be treated as a disguised sale of partnership interests, governed by section 707(b). The payment of an interest-type factor – either together with the capital or alone – to an original partner could be treated as a payment of an interest-like payment of ambiguous character or, more likely, if such payment is required under the partnership agreement, a guaranteed payment governed by section 707(c).[48] In cases when the partnership's initial operations are funded solely by debt, some partners are admitted on the basis of capital commitments but do not contribute their capital until the later partners are admitted. Presumably, the original partners would 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, and the later-admitted partners may need special allocations to bring their capital accounts into conformity with the previously-admitted partners.

A staged closing that occurs when a QO is a partner may trigger a fractions rule violation under the Regulations attributable to either of the following: (1) a partnership interest shift resulting from a closing that occurs subsequent to the closing at which the QO was admitted, or (2) the disproportionate allocations required to effectuate the economic intent that all of the partners be treated as having been admitted on the initial closing date.

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[47] Reg. § 1.514(c)-2(k)(1).

[48] 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).

In the first instance, when additional partners enter the partnership at a subsequent closing pursuant to terms set out in the partnership agreement, a QO'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. To determine fractions rule compliance, a partnership must rely on the special rule set out in Regulations section 1.514(c)-2(k)(1)(i), which provides 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), but 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 or could otherwise be expected given the structure of the transaction.[49] Because staged closings are almost always specifically provided for under the terms of the partnership agreement, there has been historic concern among advisors to QOs and real estate fund sponsors that shifts in connection with staged closings will be "closely scrutinized," given that they arguably stem from "a prior agreement, understanding, or plan or could otherwise be expected given the structure of the transaction."[50]

Prior to the Proposed Regulations, there was no guidance addressing the circumstances in which a shifting of interests would not cause a fractions rule violation, other than one private letter ruling[51] 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.[52]

Similarly, there is no authority in the Code or Regulations, or set out in other Service guidance relating to disproportionate allocations relating to 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 enters 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 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 will have to be adjusted by way of disproportionate allocations after the

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[49] Reg. § 1.514(c)-2(k)(1).
[50] *Id*.
[51] PLR 200351032 (Dec. 19, 2003).
[52] 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.

new partners enter the partnership, which may create a violation of the fractions rule.[53] Amounts treated as guaranteed payments may also create fractions rule issues.[54]

The Proposed Regulations address both of these fractions rule concerns that arise in connection with staged closings. Proposed Regulation section 1.514(c)-2(k)(1)(ii) sets out a special rule that, if applicable, will permit changes in allocations due to acquisitions of partnership interests after the initial formation of a partnership to not be closely scrutinized under Regulation section 1.514(c)-2(k)(1)(i) but only to be taken into account in determining partnership compliance with the fractions rule in the taxable year of the change and subsequent taxable years. Proposed Regulation section 1.514(c)-2(k)(1)(ii) provides further that, if the special rule applies, disproportionate allocations of tax items made to adjust the partners' capital accounts as a result of, and to reflect, the acquisition by the new partner will be disregarded in computing overall partnership income or loss for purposes of the fractions rule. To satisfy the special rule, the changes to the allocations due to the shifting in partnership interests and the disproportionate allocations must not be inconsistent with the anti-abuse rule of Regulations section 1.512(c)-2(k)(4),[55] and must meet the following additional conditions:

i. The partner ("new partner") acquires the partnership interest no later than 18 months following the formation of the partnership ("applicable period");

ii. The partnership agreement and other relevant documents anticipate the new partners acquiring the partnership interest during the

[53] The following example from the Prior ABA Comment Letter illustrates this 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 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 to 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.

[54] The following example from the Prior ABA Comment Letter illustrates this 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.

[55] See Section VII of these Comments for a discussion regarding this requirement.

applicable period, set forth the time frame in which the new partners will acquire the partnership interests, and provide for the amount of capital the partnership intends to raise;

iii. The partnership agreement and other relevant documents specifically set forth the method for determining any applicable interest factor and for allocating income, loss, or deduction to the partners to account for the economics of the arrangement in the partners' capital accounts after the new partner acquires the partnership interest; and

iv. The interest rate for any applicable interest factor is not greater than 150 percent of the highest applicable Federal rate, at the appropriate compounding period or periods, at the time the partnership was formed.[56]

Proposed Regulation Section 1.514(c)-2(k)(1)(iv), Example 1, illustrates the provisions of the special rule that applies to staged closings.

B. <u>Analysis</u>

We are very appreciative of the fact that, as described in the preamble to the Proposed Regulations, the Treasury Department and the Service have concluded that changes in allocations and disproportionate allocations resulting from staged closings and the subsequent admission of investors should not violate the fractions rule if the allocations are not inconsistent with the anti-abuse rule and satisfy the other conditions of Proposed Regulation section 1.514(c)-2(k)(1)(ii). It is clear that the intent of the special rule set forth in the Proposed Regulation is to help ensure that a leveraged real estate partnership may admit investors during a reasonable period of time under general commercial standards without concern as to the impact on investors that are QOs. We recommend a few modifications to the requirements outlined in the Proposed Regulation to permit the majority of commercial real estate ventures conducted in partnership form to rely on the new rule.

18-Month Applicable Period

Proposed Regulation section 1.514(c)-2(k)(1)(ii)(A) provides that new partners must be admitted no later than 18 months following the formation of the partnership. Although an 18-month fundraising period generally is sufficient for most real estate partnerships in our experience, there were a number of real estate partnerships with fundraising periods that extended well beyond 18 months during the economic downturn of 2008-2009. To provide flexibility in the event of future economic downturns and greater certainty to real estate partnerships and potential investors that the special rule applicable to allocations affected by staged closings will be accessible to them, we request that the applicable period be changed to 24 months, instead of 18 months. We recommended a 24-month period in the Prior ABA Comment Letter, and we continue to

[56] Prop. Reg. § 1.514(c)-2(k)(1)(ii).

believe that the 24-month period is a time frame that should cover most commercially common staged closing situations, even in the event of a downturn. In addition, we recommend that the regulations provide that such period (whether 18 or 24 months) may be extended if the extension is commercially reasonable, based on the relevant facts and circumstances. We believe that permitting this extension in excess of the specified period is reasonable, because the length of a real estate partnership's fundraising period is driven by the prevailing state of the real estate market and the availability of capital and not by any tax-avoidance motive.

Interest Factor

Proposed Regulation section 1.514(c)-2(k)(1)(ii)(D) provides that the interest rate for any applicable interest factor must not be greater than 150 percent of the highest applicable Federal rate ("AFR"), at the appropriate compounding period or periods, at the time the partnership was formed. The interest rate for an interest factor established by a real estate partnership is a function of investment return expectations and is not determined by reference to the AFR. In the vast majority of cases, the interest rate set by a real estate partnership for later-admitted partners is the same as the preferred return rate paid by the partnership. In some cases, though, a real estate partnership may set an interest rate that is higher than the preferred return rate to incentivize investors to invest earlier during the fundraising period. In any case, in our experience, there are very few, if any, real estate partnerships that will be able to satisfy the requirement specified in Proposed Regulation section 1.514(c)-2(k)(1)(ii)(D) as to the maximum interest rate. This rate has been extremely low for the past several years (for example, the annual long-term AFR for October 2017 was 2.5%) and is not reflective of the typical commercial interest factor rate, which currently is closer to 8%.

For that reason, we recommend that Proposed Regulation section 1.514(c)-2(k)(1)(ii)(D) be revised (1) to eliminate the requirement that the interest rate be determined by reference to the AFR and (2) to provide that the interest rate for any applicable interest factor may not be greater than a rate that would qualify under the Regulations for a reasonable preferred return. The interest rate can 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.

Further, we recommend that Proposed Regulation section 1.514(c)-2(i)(1)(ii)(D) be revised to confirm that an interest rate established by a partnership that exceeds the preferred return rate paid by the same partnership may be a rate that would qualify under the Regulations for a reasonable preferred return if it satisfies the standards provided in Regulation section 1.514(c)-2(d)(4)(i) and (ii).

New Partners; Formation

Proposed Regulation section 1.514(c)-2(k)(1)(ii) applies to "[c]hanges in partnership allocations due to an acquisition of a partnership interest by a partner (new partner) after the initial formation of a partnership . . .." Because existing partners are typically permitted to participate in later closings (*e.g.*, to increase their commitment or contribution), we recommend that this provision be modified to clarify that a “new” partner includes existing partners who experience increases in their interests relative to other existing partners after the initial formation of a partnership.

Proposed Regulation section 1.514(c)-2(k)(1)(ii)(A) provides that the “applicable period” begins on the date of the “formation” of the partnership. Because real estate partnerships (and other partnerships) may technically be formed as entities before investors are admitted, we recommend that Proposed Regulation section 1.514(c)-2(k)(1)(ii)(A) be revised to clarify that “formation” means the date on which partners that are not related to the management of the partnership are admitted to the partnership.

Taxable Year of Change Treatment

As noted above, the Proposed Regulations currently provide that certain acquisitions of partnership interests after the initial formation are not closely scrutinized and will be taken into account in the year of change and in subsequent taxable years. We believe that the year of change should not be included in the analysis as the year of change may include allocations from both the pre-admission period and the post-admission period. As a result, the allocations in the year of change may not be consistent with the allocations in the years after change. We recommend that the final Regulations only require that the partnership satisfy the fractions rule in the taxable years after the taxable year of the acquisition.

C. <u>Recommendations</u>

We recommend revising Proposed Regulation section 1.514(c)-2(k)(1)(ii)(A) to provide that the applicable period will extend to 24 months, rather than 18 months, following the formation of the partnership and may be extended further if commercially reasonable.

We recommend revising Proposed Regulation section 1.514(c)-2(k)(1)(ii)(D) to (1) eliminate the requirement that the interest rate be determined by reference to the AFR, (2) provide that the interest rate for any applicable interest factor may not be greater than a rate that would qualify under the Regulations for a reasonable preferred return, and (3) confirm that an interest rate established by a partnership that exceeds the preferred return rate paid by the same partnership may be a rate that would qualify under the Regulations for a reasonable preferred return.

We recommend revising Proposed Regulation section 1.514(c)-2(k)(1)(ii) to clarify that a “new” partner includes existing partners who experience increases in their interests relative to other existing partners after the initial formation of a partnership.

We recommend revising Proposed Regulation section 1.514(c)-2(k)(1)(ii)(A) to clarify that “formation” means the date on which partners that are not related to the management of the partnership are admitted to the partnership.

We recommend revising Proposed Regulation sections 1.514(c)-2(k)(1)(i) and (ii) to delete the reference to the taxable year of the change.

VII. Defaults and Capital Commitment Reductions

A. Background

Real estate fund partnership agreements and joint venture agreements typically contain provisions that apply in the event an investor defaults in its obligation to make a required contribution, including adjustments to allocations to give effect to such defaults or adjustments to the partners' sharing ratios. In addition, in the event that a general partner, or other partner providing services to the partnership, receives a disproportionately large (in comparison to its fractions rule percentage) share of profits from the partnership (*i.e.*, a "carried interest"), such partnership agreements also frequently provide for a reduction in such carried interest in the event the general partner is removed or the service provider fails to comply with its obligations under the partnership agreement.

Although the qualified chargeback rules in the Regulations permit certain types of adjustments to capital accounts in the event of a reduction to a partner's disproportionately large share of profits from the partnership, those rules are overly restrictive with respect to adjustments that may be needed to cause capital accounts to reflect the changes in partnership interests that are intended to result from an unanticipated reduction to the carried interest of a general partner or other service provider. As noted in the preamble to the Proposed Regulations[57], 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.

In connection with capital call defaults, the Proposed Regulations provide a helpful statement that "[t]he Treasury Department and the IRS have determined that changes in allocations resulting from unanticipated defaults or reductions do not run afoul of the purpose of the fractions rule if such changes are provided for in the partnership agreement." The Proposed Regulations contain an exception to the "close scrutiny" rule in Treasury Regulations section 1.514(c)-2(k)(1)(i) and provide that "[c]hanges in partnership allocations that result from an unanticipated reduction in a partner's capital contribution commitment, that are effected pursuant to provisions prescribing treatment of such events in the partnership agreement, and that are not inconsistent with the purpose of the fractions rule under paragraph (k)(4) of this section, will not be closely scrutinized under paragraph (k)(1)(i) of this section, but will be taken into account only in determining whether the partnership satisfies the fractions rule in the taxable year of the change and subsequent taxable years."[58] In addition, the Proposed Regulations clarify that allocations made pursuant to the partnership agreement to adjust the partners' capital accounts as a result of such defaults or reductions are disregarded in computing overall partnership income or loss in applying the fractions rule.

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[57] REG-136978-12 (preamble); 81 FR 84518.
[58] Prop. Reg. §1.514(c)-2(k)(1)(iii).

B. Analysis

Close Scrutiny Exception

The exception to the "close scrutiny" rule provides helpful clarification that adjustments 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 that are provided in the partnership agreement will not be closely scrutinized and that allocations made to adjust capital accounts as a result of unanticipated defaults or reductions will be disregarded in computing overall partnership income for purposes of the fractions rule. However, the inclusion of the requirement that such provisions "are not inconsistent with the purpose of the fractions rule under paragraph (k)(4)" creates uncertainty. In particular, it is unclear what the specific cross-reference to the anti-abuse rule is intended to accomplish, as the anti-abuse rule already presumptively applies. We believe that the requirements that a default or reduction in commitment be unanticipated and that the remedies be contained in the partnership agreement should be sufficient to ensure that adjustments among partners is not motivated by tax avoidance.

In addition, real estate fund partnership and joint venture agreements frequently contain provisions that apply in the event the general partner or other service provider is removed or otherwise defaults in respect of its obligations under the partnership agreement. In that case, the general partner or other service provider may forfeit its entitlement to receive a carried interest or other disproportionately large share of profits under the partnership agreement in a case where income allocations have already been made in respect of such profit share. We believe that the "close scrutiny" rule should be expanded to cover unanticipated defaults or failure by a partner to comply with its obligations under the partnership agreement in addition to adjustments that result from unanticipated partner defaults on capital contribution commitments or unanticipated reductions in contribution obligations.

In addition, we believe that final Regulations should provide that allocations made pursuant to the partnership agreement to adjust the partners' capital accounts as a result of a default will be disregarded in computing overall partnership income or loss in applying the fractions rule and not be subject to the qualified chargeback rules of Regulation section 1.514(c)-2(e).

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 or real estate joint venture over a five-year period. In year three, after each of A and B has contributed $400, the partnership 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 20% preferred return (assume this to be a rate that does not satisfy the preferred return safe harbor described in the Regulations)[59] 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. In any year, A may be allocated 100% of the fund's income in respect of the 20% preferred return, which 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.

Taxable Year of Change Treatment

As noted above, the Proposed Regulations currently provide that defaults that are not closely scrutinized will be taken into account in the year of change and in subsequent taxable years. We believe that the year of change should not be included in the analysis as the year of change may include allocations from both the pre-default period and the post-default period. As a result, the allocations in the year of change may not be consistent with the allocations in the years after change. We recommend that the final Regulations only require the partnership to satisfy the fractions rule in the taxable years after the taxable year of the default.

C. <u>Recommendations</u>

With respect to the close scrutiny exception contained in Proposed Treasury Regulations section 1.514(c)-2(k)(1)(iii), we recommend that the requirement that the allocations not be "inconsistent with the purpose of the fractions rule under paragraph (k)(4)" be eliminated. If that requirement is nevertheless retained, we request additional explanation as to what the Treasury Department and the Service intend taxpayers to consider by including such requirement.

In addition, we recommend that the close scrutiny exception be expanded to apply, not just to unanticipated partner defaults on a capital commitment or an unanticipated reduction in a partner's capital contribution commitment, but also to the unanticipated failure by a partner that is a service provider to comply with a provision of the partnership agreement where the remedy entails a reduction in such partner's otherwise disproportionately large profit share or carried interest (*i.e.*, a share of profits in excess of its fractions rule percentage). We further recommend that the Proposed Regulations be revised so that allocations of income, gain, loss or deduction will be disregarded in determining overall partnership income and will not be required to satisfy the qualified chargeback requirements under Regulation section 1.514(c)-2(e), where the allocations are made pursuant to the partnership agreement to adjust the partners' capital accounts as a result of a default.

We also recommend that final regulations address the allocation of income to

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[59] In the current market, it is quite possible that a 20% return (or higher) may actually represent a reasonable return, particularly if capital is being called for an investment that is experiencing problems.

non-defaulting partners on a preferred or priority basis and clarify that such income will be treated in a manner similar to how the Regulations treat the allocation of unlikely losses and deductions.[60] Accordingly, we recommend that the Proposed Regulations be revised so that 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 (1) the result of the occurrence of an unlikely event such as the default of another partner (an unlikely occurrence considering the onerous remedies available to the partnership) and (2) made pursuant to a provision of a partnership agreement addressing capital contribution defaults.

We also recommend that Proposed Regulation section 1.514(c)-2(k)(1)(i) and (iii) be revised to delete the reference to the taxable year of the change.

[60] Reg. § 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.