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The Long-Awaited Return to the Fractions Rule: Proposed Regulations Under §514(c)(9)(E)

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INTRODUCTION

Since enactment of the Fractions Rule of §514(c)(9)[1] in its current form in 1988 and adoption of regulations (proposed in 1992 and finalized in 1994), it can be said that the Fractions Rule has achieved its goal of deterring use of debt-financed investment in real estate partnerships as tax avoidance devices. The reason this can be said is that tax practitioners have identified this rule as a trap for the unwary deterring legitimate investments along with the illegitimate.[2]

In 1999, the Chair of the American Bar Association Section of Taxation in 1999 called for repeal of the Fractions Rule, stating:

> The provision has become a trap for the unwary as well as a tremendous source of planning complexity even for those familiar with it. Anecdotal evidence suggests that few practitioners understand the provision completely, and almost no IRS agents or auditors raise it as an issue on audits. Instead, because of its daunting complexity, it has become a barrier to legitimate investment in real estate by exempt organizations. At the same time, other provisions in the tax law (such as the requirement of substantial economic effect under Section 704(b)) substantially limit the ability to shift tax benefits among partners. Therefore, Section 514(c)(9)(E) could be repealed without substantial risk of abuse.[3]

About a decade later, the tax bar was still calling for major reform of the rules regarding debt-financed investments.[4] Many other reports have been written and this article will make no attempt to catalog them all, with apologies to the masses of tax practitioners who have worked on such reports.

Thus, tax practitioners have made an uneasy peace with the Fractions Rule. So while the Fractions Rules intended to ensure that real estate partnerships between taxable and tax-exempt investors could not be used as opportunities for tax avoidance, it also contained gaps that made ordinary business arrangements problematic.

Whether the gaps between the rules and practice interested the Department of the Treasury or the IRS is another matter. There has been a noticeable dearth of administrative guidance other than a handful of private letter rulings, some discussed herein, in which requests for blessings of ordinary business arrangements were granted. This is a good indicator that the Department of the Treasury and the IRS were not upset by this state of affairs.

So there was significant interest when the Department of the Treasury and the IRS issued proposed

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[1] Except as otherwise indicated, references to ''Section'' or ''§'' are to the Internal Revenue Code of 1986, as amended (the ''Code''), and references to ''Reg. §'' and ''Prop. Reg. §'' are to Treasury regulations and proposed Treasury regulations, respectively, issued under the Code.

[2] Statement of Stefan F. Tucker on behalf of the American Bar Association Section of Taxation before the Subcommittee on Oversight of the Committee on Ways and Means House of Representatives on the subject of The Impact of Complexity in the Tax Code on Individual Taxpayers and Small Businesses on May 25, 1999, available at http://www.americanbar.org/groups/taxation/policy/public_policy/525comp99.html.

[3] *Id.*

[4] New York State Bar Association Tax Section, *Report on Section 514: Debt-Financed Income Subject to UBIT* (Aug. 12, 2010).

regulations on the Fractions Rule on November 22, 2016. In order to understand how the proposed regulations provide further clarification, it is necessary to set forth the current state of the law and guidance.

BACKGROUND

The Fractions Rule, explained in detail below, makes sense only in the context of the unrelated business taxable income (''UBTI'') rules and unrelated debt-financed income (''UDFI'') rules. These rules were enacted to combat abuses that played off of rules that have long ceased to exist. The UBTI rules were enacted in 1950 to combat abusive transactions such as those in *C.F. Mueller Co. v. Commissioner*,[5] which were based on the ''destination of income'' test of tax-exemption. The motivation was not so much tax avoidance by charitable organizations as what was regarded as the unfair advantage that businesses owned by not-for-profits had over businesses owned by taxable persons.[6] Likewise, the UDFI rules had their origins in the Clay Brown transactions that were the subject of *Commissioner v. Brown*,[7] and which made sense in the world before the *General Utilities* repeal of the 1986 tax reform.[8]

Accordingly, under §511, tax-exempt organizations (''TEOs'') are subject to taxation on their unrelated business taxable income. There is an important modification for passive income such as capital gains, dividends, interest and rent meeting certain specifications, as these allow TEOs to invest and grow their endowments.[9] The passive income exception generally does not apply when the investments are financed with debt.[10]

Certain types of TEOs, ''qualified'' TEOs, however, are permitted to invest in real estate using debt financing.[11] These qualified TEOs are educational organizations (and their affiliated support organizations), qualified trusts under §401, §501(c)(25) title-holding organizations, and church retirement plans under §403(b)(9).[12] There are several enumerated conditions under which a qualified TEO is not able to invest in debt-financed property on a tax-free basis, one of which is when the investment is through a partnership and fails to meet several requirements, which includes, most relevantly, the Fractions Rule.[13]

CURRENT LAW OF THE FRACTIONS RULE

The Fractions Rule requires that, in order for qualified TEOs to be able to invest in debt-financed real estate via a partnership, the tax allocations do not result in a qualified TEO having a share of income greater than the share of overall partnership loss for the taxable year for which the share of loss is the smallest.[14] The allocations are also required to have substantial economic effect under §704(b)(2), without regard to §704(c).[15]

Overall partnership income and overall partnership losses are best described as net income and net losses.[16] Computation of net income and net loss are required to take into account items from §705(a)(2)(B) and Reg. §1.704-1(b)(2)(iv), but not §704(c) or Treas. Reg. §1.704-1(b)(2)(iv)(f)(4).[17]

The Fractions Rule must be satisfied on both an actual basis and a prospective basis for all years, starting with the first year that the partnership owns debt-financed property.[18] If an allocation violates the Fractions Rule, that causes a violation not just for the year of that allocation, but for all subsequent years as well.[19]

As there are business situations that occur in which allocations can be disproportionate for reasons that are not abusive, the Code lists important exceptions to the Fractions Rule.

An important exception to the Fractions Rule is that chargebacks of income to qualified TEOs are permitted with respect to prior disproportionate allocation of losses to qualified TEOs and chargebacks of losses to taxable investors are permitted with respect to prior disproportionate allocations of losses to taxable investors.[20] Chargebacks must not be at a rate in excess of the original disproportionate allocation that is being reversed.[21] Other examples of chargebacks that are disregarded are minimum gain chargebacks to reverse prior nonrecourse deductions and partner nonrecourse deductions, and allocations pursuant to qualified in-

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[5] 190 F.2d 120 (3d Cir. 1951).

[6] 1950 U.S.C.C.A.N. 3053, 3081.

[7] 380 U.S. 563, 573 (1965).

[8] The doctrine under *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935), allowed a corporation to distribute appreciated assets to its shareholders or sell appreciated assets in certain cases without recognizing gain. The *General Utilities* doctrine was repealed by the Tax Reform Act of 1986, Pub. L. No. 99-514, Subtitle D.

[9] §512.

[10] §514.

[11] §514(c)(9)(E).

[12] §514(c)(9)(C).

[13] §514(c)(9)(B)(vi)(III).

[14] §514(c)(9)(E)(i)(I).

[15] §514(c)(9)(E)(i)(II).

[16] Reg. §1.514(c)-2(c)(1).

[17] *Id.*

[18] Reg. §1.514(c)-2(b)(2)(i).

[19] *Id.*

[20] §514(c)(9)(E)(ii)(I).

[21] *Id.*

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come offsets.[22] Such chargebacks must be made in the same ratio that disproportionate allocations being reversed were made.[23] Allocations being reversed may be disproportionately large or small, compared to the Fractions Rule percentage, but allocations will not be considered to violate the Fractions Rule unless the balance of net income or loss for the year is considered to violate the Fractions Rule.[24]

Another important exception is for reasonable preferred returns on capital and for reasonable guaranteed payments, which are disregarded for Fractions Rule purposes.[25] Specifically, the allocations with respect to current or cumulative preferred returns are disregarded when testing whether allocations comply with the Fractions Rule.[26] Likewise, the mechanism for disregarding reasonable guaranteed payments is to disregard deductions with respect to such guaranteed payments.[27] Reasonable preferred returns or guaranteed payments must be set forth in a binding, written partnership agreement.[28]

Guaranteed payments for services are considered to be reasonable only to the extent that such payments would be considered to be reasonable compensation under Reg. §1.162-7.[29] Preferred returns for capital are considered reasonable if returns on returned capital are set at commercially reasonable rates.[30] There is a safe harbor which treats as commercially reasonable preferred returns that are either no greater than four percentage points more than the applicable federal rate or no greater than 150% of the highest long-term applicable federal rate (as determined under §1274(d)(4)).[31]

Unreturned capital is calculated on a weighted average basis and is the amount of money and the net fair market value of property contributed minus money and net fair market value of property distributed.[32]

Under current rules, allocations with respect to reasonable preferred returns are disregarded only to the extent they do not exceed aggregate preferred returns actually paid minus amounts previously allocated in connection with reasonable preferred returns.[33] Likewise, reasonable guaranteed payments may be deducted only when paid in cash.[34]

Partner-specific deductions that reflect certain reasonable business expenses specifically enumerated in the regulations may also be disregarded for Fractions Rule analysis.[35] Examples of such expenses are (1) expenditures for compliance and accounting incurred in connection with the transfer of a partnership interest; (2) additional administrative costs from having a foreign partner; (3) state and local taxes and expenses from preparing tax returns therefor; and (4) other expenses permitted by the IRS in a private letter ruling.[36]

Additionally, losses or deductions may be allocated to partners without violating the Fractions Rule if the partners would bear the economic risks of such expenses and such losses or deductions had ''a low likelihood of occurring,'' even if the partnership agreement anticipated their possibility.[37] Examples from the regulations of such losses or deductions when unanticipated include tort liabilities in excess of reasonable insurance coverage; labor strikes; delays in obtaining required permits or licenses; weather conditions, consequences of unanticipated severe economic downturn in the geographic area; cost overruns; and the discovery of environmental conditions that require remediation.[38]

Allocations of deduction and loss away from qualified TEOs are permitted when the allocation would result in a deficit capital account balance that such qualified TEOs would not be obligated to restore.[39]

The regulations provide for close scrutiny of changes in allocations. Although a transfer of a partnership interest by a qualified TEO to another qualified TEO is considered to be a continuation of the first qualified TEO's interest, other transfers or shifts of partnership interests will not be and will be carefully reviewed.[40]

The regulations also contain two exceptions to the Fractions Rule based on de minimis situations. One exception is where qualified TEOs do not own an interest of more 5% of the capital or profits of the partnership, while taxable partners own substantial interests and ''participate in the partnership on substan-

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[22] Reg. §1.514(c)-2(e)(1).
[23] Reg. §1.514(c)-2(e)(2)(i).
[24] *Id.*
[25] §514(c)(9)(E)(ii)(II).
[26] Reg. §1.514(c)-2(d)(2).
[27] Reg. §1.514(c)-2(d)(3).
[28] Reg. §1.514(c)-2(d)(1).
[29] Reg. §1.514(c)-2(d)(4)(i).
[30] *Id.*
[31] Reg. §1.514(c)-2(d)(4)(ii).
[32] Reg. §1.514(c)-2(d)(5).
[33] Reg. §1.514(c)-2(d)(6)(i).
[34] Reg. §1.514(c)-2(d)(6)(ii).
[35] Reg. §1.514(c)-2(f).
[36] *Id.*
[37] Reg. §1.514(c)-2(g).
[38] *Id.*
[39] Reg. §1.514(c)-2(h).
[40] Reg. §1.514(c)-2(k)(1).

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tially the same terms'' as the qualified TEOs.[41] The other is for allocations of loss and deduction away from qualified TEOs that are not motivated by tax avoidance and that are less than both (1) 1% of the partnership's gross loss and deductions for the taxable year and (2) $50,000.

With respect to qualified TEOs that have interests in real property through chains of partnerships, the Fractions Rule is satisfied if tax avoidance is not a principal purpose of tiered ownership and the partnerships can demonstrate by any reasonable method that they satisfy the Fractions Rule.[42] Examples provided in regulations show approaches that would be considered to satisfy the Fractions Rule for tiered partnerships. One example illustrated satisfying the Fractions Rule using a ''collapsing approach'' in which compliance is reviewed by reference to ultimate owners' percentage interests in net income and net losses.[43] Another example used an ''entity-by-entity'' approach in which intermediate entities are treated by lower-tier as qualified TEOs and ensure allocations are in compliance with the Fractions Rule.[44] A third approach is the independent chain approach in which intermediate entities provide separately complying allocations on a property by property basis.[45]

ADMINISTRATIVE GUIDANCE

Consistent with the purpose of the Fractions Rule being to prevent use of partnerships for tax avoidance purposes, the IRS has been flexible when taxpayers have requested rulings regarding proposed arrangements. One example of this is PLR 9128020, in which the taxpayer requested the IRS rule that compliance with allocation according to partners' interests in the partnership would be deemed to meet the requirement for substantial economic effect, for purposes of the Fractions Rule. The IRS granted the ruling.

Other rulings have come in response to requests regarding whether elections under §754 could be disregarded for Fractions Rule purposes[46] and whether changes in allocations based on changes in ownership could be disregarded.[47] The author is not aware of any instance in which the IRS provided adverse guidance with respect to any business arrangement.

Proposed Regulations

Against this background comes guidance that aims to update the guidance for industry developments.[48] While these proposed regulations would be effective when published as final regulations, the preamble states that partnerships and partners may apply all the rules of the proposed regulations for taxable years ending after the date of publication of the proposed regulations in the Federal Register.

Most notably, commenters have stated that most real estate partnerships with debt-financed property made allocations to partners as preferred returns accrued, rather than as they were paid out. Based on this, the IRS revisited its earlier concern that permitting allocations for preferred returns without payment could lead to abuses.[49] The result was that the proposed regulations no longer require distribution of preferred returns for corresponding allocations to be disregarded, as long as the partnership agreement requires that distributions first go to pay ''accrued, cumulative, and compounding unpaid'' preferred returns that have not been reduced by allocations of net losses.[50]

This loosened requirement is further attuned to standard fund practices of paying tax distributions (distributions of case as advances that give partners enough cash to pay taxes on allocations of income).[51] The tax distributions are required to be set forth in the partnership agreement, treat such distributions as advances against distributions otherwise to be made according to the partnership agreement's waterfall.[52] The tax distributions must be limited to the ''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 that partner,'' which is a commonly drafted tax distribution provision in partnership agreements.[53]

The proposed regulations also build on existing regulations regarding partner-specific expenses. Deduction of management fees and other similar fees may be allocated to specific partners and disregarded for Fractions Rule analysis, if such fees are less than 2% of such partners' capital commitments.[54] With respect to unlikely losses, The IRS and the Treasury Department have requested comments on whether the standard of ''low likelihood of occurring'' for partner-specific losses should be changed to ''more likely than not,'' per comments already received.

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[41] Reg. §1.514(c)-2(k)(2)(i).
[42] Reg. §1.514(c)-2(m)(1).
[43] Reg. §1.514(c)-2(m)(2) *Ex.* 1.
[44] Reg. §1.514(c)-2(m)(2) *Ex.* 2.
[45] Reg. §1.514(c)-2(m)(2) *Ex.* 3.
[46] PLR 9002030.
[47] PLR 200351032.
[48] REG-136978-12, 81 Fed. Reg. 84,518 (Nov. 23, 2016).
[49] REG-136978-12, Preamble.
[50] Prop. Reg. §1.514(c)-2(d)(2)(ii).
[51] Prop. Reg. §1.514(c)-2(d)(2)(iii).
[52] *Id.*
[53] *Id.*
[54] Prop. Reg. §1.514(c)-2(f)(4).

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With respect to chargebacks, the proposed regulations attempt to manage the interaction between partner-specific deductions and charging back net income to specific partners regarding such deductions.[55] As current regulations only permit disregarding chargebacks of net income that reverse allocations of net loss or nonrecourse deductions, the proposed regulations provide comfort that chargebacks that fall outside these specific circumstances and have valid business, non-avoidance purposes will not risk Fractions Rule violations.[56]

With respect to changes in partnership allocations from shifts of ownership of partnership interests, the IRS and Treasury Department have proposed regulations that take into account common fund practices such as staged closings that necessarily cause shifts in ownership of interests in partnerships.[57] Therefore, under the proposed regulations, the IRS will not closely scrutinize changes in ownership of partnership and resulting disproportionate allocations if four conditions are met: (1) the new partner acquires a partnership interest within 18 months of formation of the partnership; (2) the partnership agreement and related documents anticipating such acquisitions set forth the intended amounts of capital to be raised and the period in which it is expected that new investors will become partners; (3) the partnership agreement and related documents specifically state the method for determining interest factors and for allocating income, loss or deduction to adjust capital accounts upon the investment of new partners; and (4) set an interest rate factor no greater than 150% of the applicable federal rate at the time of partnership formation.[58]

Similarly, many partnerships do not provide for immediate funding of investments by partners and instead provide for ''capital commitments'' that will be fulfilled upon ''capital calls'' made by the partnership. To enforce these commitments, partnership agreements often provide a set of incentives and penalties, such as excluding the partner from opportunities to make contributions, having the defaulting partner forfeit interests or even have to sell interests, or provide that other partners who do not default become entitled to preferred returns upon meeting the capital call. To avoid having these common business arrangements cause Fractions Rule violations, the proposed regulations also provide that shifts in connection with such defaults and their consequences will not be closely scrutinized and the resulting changes in allocations will be disregarded for Fractions Rule purposes.[59]

The proposed regulations update the de minimis exceptions to coverage of the Fractions Rule. With the current rules already providing exceptions for de minimis ownership by qualified TEOs, the proposed regulations also cover the reverse situation in which taxable investors have de minimis partnership interests while qualified TEOs hold the remaining partnership interests.[60] Therefore, the proposed regulations state that if investors other than qualified TEOs hold 5% or less of the partnership interests and allocations have substantial economic effect, the Fractions Rule will not apply.[61]

Another update to the de minimis exceptions to coverage of the Fractions Rule concerns allocations away from qualified TEOs. Where under current rules, allocations that are less than both 1% of aggregate gross loss and deduction and less than $50,000 are disregarded, the proposed regulations raise the $50,000 limit to $1,000,000.[62]

CONCLUSIONS

While some TEOs, including qualified TEOs, have become accustomed to the idea that some investments may be taxable, not all have. When the sums involved are significant, that raises the stakes and also the anxiety, even in an area that is reputed to have little audit activity. After all, it is hard and unwise to say to those with fiduciary responsibility for investing large sums, ''Don't worry, the IRS is known not to have done much here anyway.''

Therefore, in promulgating proposed regulations that remove a number of traps for the unwary that previously arose out of standard business practices, the Department of the Treasury and the IRS have provided some overdue assurance to institutions that have large sums to invest. This is also a reminder that some regulations help investment, rather than hinder it. One may hope that the new administration's current freeze on new regulations will not prevent these proposed regulations from taking effect.

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[55] REG-136978-12, Preamble.

[56] Prop. Reg. §1.514(c)-2(e)(1)(vi), §1.514(c)-2(e)(1)(vii).

[57] REG-136978-12, Preamble.

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

[59] Prop. Reg. §1.514(c)-2(k)(1)(iii).

[60] REG-136978-12, Preamble.

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

[62] Prop. Reg. §1.514(c)-2(k)(3)(ii)(B).

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