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The "Fractions Rule" in Partnership Agreements: Drafting Section 514(c)(9)(E) Compliant Allocations

Avoiding UBTI Triggers Through Savings Clauses and Other Structuring Tools

TUESDAY, NOVEMBER 28, 2017

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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The Fractions Rule – Planning Opportunities and Pitfalls Under Proposed IRS Regulations

Presented on:

November 28, 2017

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Topics Covered

I. Background
II. The Fractions Rule – Basics
III. Specific Exceptions to the Fractions Rule
IV. Practical Administrative Issues
V. Drafting Approaches
VI. Questions?

I. Background

Background – UBTI

- **<u>Unrelated Business Taxable Income (UBTI)</u>** -- generally means gross income derived from any unrelated trade or business regularly conducted by a tax-exempt organization, which will be taxable notwithstanding the organization's general tax-exempt status. Code § 512.
  - E.g. University decides to compete with Apple and manufacture and sell iPhones – IRS does not want tax-exempt organization to unfairly compete by taking advantage of its tax-exempt status to engage in activities unrelated to its charitable purpose.
- **<u>Exclusion for Passive Income</u>**: UBTI <u>does not</u> include various forms of income generally associated with passive investment activities (e.g. dividends, interest, capital gains, rents). Code § 512(b).
- **<u>Debt-Financed Income</u>**: Otherwise tax-free passive investment income is treated as UBTI if debt-financed. Code § 514(b).
  - Generally, the ratio of the "average acquisition indebtedness," as defined in § 514(c)(7), divided by the taxpayer's average adjusted basis in the underlying property, as defined in Treas. Reg. § 1.514(a)-1(a)(2), determines the portion of gross income from debt-financed property that is required to be treated as UBTI.
  - Debt-financed property is broadly defined as any property held for the production of income for which there is acquisition indebtedness.
    - E.g. real estate purchased with a combination of cash and new mortgage debt

Background – Real Estate Exception to UBTI

- **<u>Real Estate Exception</u>**: Exception to UBTI debt-financed property exclusion for real estate owned by "qualified organizations". Code § 514(c)(9).
  - Allows tax exempt entity to make leveraged real estate investments without incurring debt-financed UBTI.
- **<u>Requirements</u>**: To meet requirements of real estate exception, the investment must meet a number of criteria:
  - Price for asset must be fixed at the date of acquisition (i.e. no contingent payments/earn-outs);
  - The amount of debt on the property is not dependent on revenue, income or profits from the property (i.e. no participating debt);
  - The real property must not be leased back to the seller or a related party;
    - Except where property represents less than 25% of the floor space in a building, and lease is on commercially reasonable terms.
  - The real property is not leased to, acquired from or financed by certain related parties, where the qualified organization is an ERISA pension plan;
    - Except where property represents less than 25% of the floor space in a building, and lease is on commercially reasonable terms.
  - The seller does not provide acquisition financing, except on commercially reasonable terms, <u>and</u>
  - If the investment is owned by a partnership, the allocation rules described below must also be met. Code § 514(c)(9)(B)

Background – Qualified Organizations

- **<u>Who is a "Qualified Organization"?</u>**
  - Educational institutions (e.g. University endowments or private high schools)
  - ERISA pension trusts
  - Certain group trusts formed to own real estate and owned entirely by ERISA plans, governmental entities, and other 501(c)(3) organizations
    - However, a nonqualified organization (e.g., hospital) holding an interest in a group trust is taxed on a pro rata share of the items of income, net of deductions, that would be treated as UBTI absent the Fractions Rule.
  - Certain church retirement plans
- **<u>Not Covered by Fractions Rule (i.e. not "Qualified Organizations"):</u>**
  - Non-educational charities
  - Hospitals and healthcare charities
  - Religious charities other than 403(b)(9) church retirement plans
  - State and federal governmental entities (although these may separately be exempt from UBTI under Code § 115).

Background – Allocation Rules

- **Allocation Rules:** To qualify for the Code § 514(c)(9) exception, a partnership holding real property must meet one of the following rules:
  - All the partnership's partners must be "qualified organizations"
    - Unusual for a real estate joint venture
    - Would preclude a taxable developer or sponsor participating in JV as an equity member
  - Each allocation to partner that is a qualified organization is a "qualified allocation" under Code § 168(h)(6)
    - Generally, this requires that the qualified organization be allocated a fixed and unchanging share of each item of income, gain, loss, deduction, credit, and basis in the partnership;
    - Not practical for a real estate joint venture with a promoted partner, carried interest, or special allocations of certain items (i.e. most real estate joint ventures)
    - **OR**
  - The Fractions Rule is met (see below…).

II. The Fractions Rule -- Basics

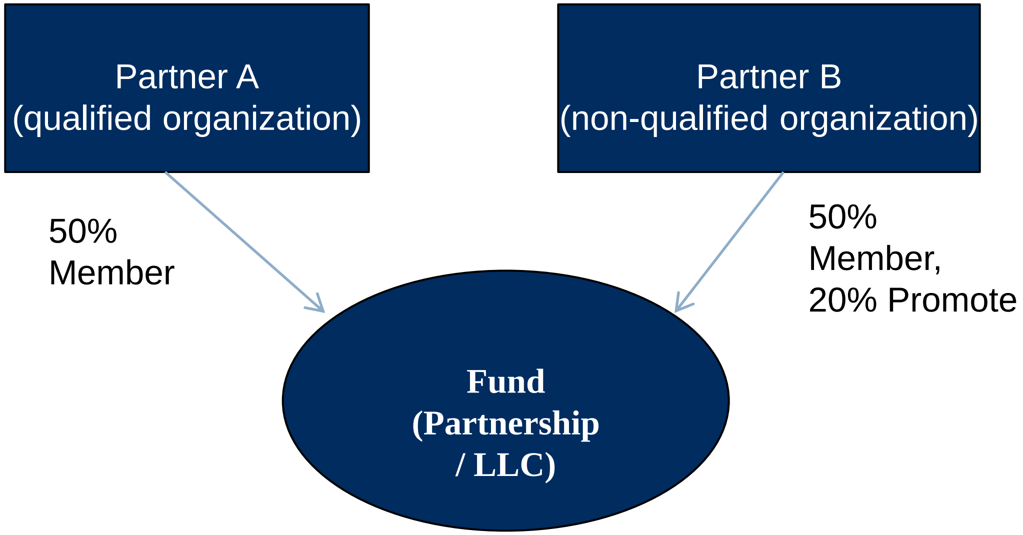
Fractions Rule

- **<u>Fractions Rule Requirements</u>**
  - A qualified organization must not be allocated net taxable income or gain for any taxable year <u>in excess of</u> its fractions rule percentage
  - AND
  - Each partnership allocation must have “substantial economic effect” pursuant to § 704(b)(2).
- **<u>Fractions Rule percentage</u>**: A qualified organization’s percentage share of overall partnership loss for the partnership tax year in which that percentage is the <u>smallest</u>.
- **<u>Purpose</u>**: The Fractions Rule prevents a fund, joint venture or other partnership from disproportionately allocating taxable income to tax-exempt investors (who are not taxed on it), while disproportionately allocating losses to taxable investors (who can potentially use those losses as a deduction against other income).
- **<u>Overall partnership income</u>** is the net amount by which aggregate partnership income and gain exceeds the aggregate partnership loss and deduction for a taxable year (while **<u>overall partnership loss</u>** is the converse)
  - Overall partnership income and overall partnership loss include all items of partnership income, gain, loss and deduction that impact partners’ 704(b) capital accounts (i.e. including certain items of tax-exempt income and non-deductible losses).

Fractions Rule Specifics

- **Testing Dates** – A partnership must satisfy the Fractions Rule on both an actual and prospective basis for each taxable year that it holds debt-financed property and has a qualified organization partner.
- **Partnership-Wide Testing** -- The Fractions Rule is applied on a partnership-wide basis, not to each partner separately. Thus, if partnership allocations to one qualified organization partner fail to satisfy the requirements of the Fractions Rule, that partner and other qualified organization partners in the partnership are subject to the debt-financed rules, even if allocations to those other qualified organization partners would otherwise have complied with the requirements of the Fractions Rule.
- **Typical real estate fund and joint venture waterfalls** are often consistent with the Fractions Rule as an economic matter, if qualified organizations are not the developer/sponsor who is receiving a promote or carried interest, but each deal requires careful examination given the numerous pitfalls set forth below.
- **Qualifying Investments**: While the Fractions Rule is available for all real estate investments, it provides the greatest benefits for debt-financed investment assets (e.g. rental properties that will be held as investment property, generating rents during holding period and capital gains upon sale). Assets that generate trade or business income or dealer property income, such as condo assets and hotels, generate UBTI that cannot be cleansed by compliance with the Fractions Rule.

Fractions Rule – Example



Fractions Rule – Example (Cont.)

Year	Step	Partner A (50% Member, Qualifying Organization)	Partner B Result (50% Member, 20% Promote, no Hurdle)
1	Partners contribute $100 of cash to Fund	$50 cash contribution ---------------------- $50 ending capital account balance	$50 cash contribution ---------------------- $50 ending capital account balance
2	Fund generates ($20) of losses	($10) loss allocation ($20 * 50%) ---------------------- $40 ending capital account balance *** Partner A's Fractions Rule Percentage is 50%, its lowest share of Fund losses**	($10) loss allocation ($20 * 50%) ---------------------- $40 ending capital account balance
3	Fund generates $120 of income	$10 income allocation (chargeback of prior losses) $40 income allocation (50% * $80 residual income after paying promote to Partner B) ---------------------- $90 ending capital account balance *** No Fractions Rule Violation, because Partner A's 42% ($50 / $120) share of income is less than its Fractions Rule Percentage (50%)**	$10 income allocation (chargeback of prior losses) $60 income allocation (20% promote * $100 of income + 50% * $80 residual income after paying promote to Partner B) ---------------------- $110 ending capital account balance
4	Fund generates $50 of income, which is specially allocated to Partner A	$50 of income allocation (specially allocated to Partner A) ---------------------- $140 ending capital account balance *** Fractions Rule Violation, because Partner A's 100% share of income in Year 4 exceeds its Fractions Rule Percentage (50%)**	No income allocation ---------------------- $110 ending capital account balance
5	Fund liquidates and distributes $250 cash to Partners	$140 distribution to Partner A in accordance with its capital account balance *** Liquidating distributions to Partners in accordance with capital account balances is required under the Fractions Rule in order to meet substantial economic effect requirement**	$110 distribution to Partner A in accordance with its capital account balance *** Liquidating distributions to Partners in accordance with capital account balances is required under the Fractions Rule in order to meet substantial economic effect requirement**

III. Exceptions to the Fractions Rule

Chargeback of Prior Losses

- **<u>Chargeback of Prior Losses</u>** – A partnership may allocate income to chargeback prior disproportionate losses allocated to qualified organization partners (or disproportionate income allocations to non-qualified organizations) without violating the fractions rule.
  - As a result, if a partnership suffers losses in early years that are allocated disproportionately to qualified organizations, charging back those losses in subsequent taxable years does not create a fractions rule violation.
- **<u>Disproportionate Allocation Chargeback</u>** – Disproportionate allocations may be reversed in full or in part, and in any order, but must be reversed in the same ratio as originally made and cannot exceed amount of prior allocation.
  - Prior allocation is treated as disproportionately large/small if the qualified organization's percentage share of that allocation is greater/less than its fractions rule percentage.
  - A prior allocation would be treated as disproportionate only if the balance of the overall partnership income or loss for the taxable year of the allocation is allocated in a manner that would independently satisfy the fractions rule.
  - Unless provided otherwise by IRS ruling, chargebacks permitted only with respect to a pro rata share of overall partnership income or loss -- and <u>not</u> with respect to selected items included in computing overall partnership income or loss.

Chargebacks and Offset – Example

- **General Waterfall**: Partnership allocates each item of partnership income, gain, loss, or deduction 50/50 between tax-exempt partner and taxable partner, except the first $1,000 of overall partnership loss allocated 80% to tax-exempt partner and 20% to taxable partner.
- **2016:** In 2016, partnership has overall partnership loss of $1,000, of which $800 allocated to tax-exempt partner and $200 to taxable partner.
- **2017:** In 2017, partnership had overall partnership income of $500 that may be disproportionately allocated to the tax-exempt partner to offset the disproportionate allocation of loss to such partner in 2016 without violating the general rule.
  - This income charge-back must be made in the same 80/20 ratio at which the disproportionate allocation of loss was made to comply with the special rule for charge-backs.
  - Thus, no more than $400 of income could be charged back to the tax-exempt partner in 2017 to comply with the Fractions Rule.

Chargebacks and Offset – Proposed Regs.

- **November 2016 proposed regulations**, if finalized, would modify the chargeback exception
  - Proposed regulations disregard in computing overall partnership income or loss for purposes of the Fractions Rule an allocation of overall partnership income to reverse a special allocation of a partner-specific expenditure or a special allocation of an unlikely loss (see further discussion on these topics further below).
  - I.e. a partner-specific chargeback of an item that was specially allocated to that particular partner may also be ignored for purposes of the chargeback exception to the fractions rule.

Preferred Returns

- **<u>Preferred Returns for Capital</u>** payable to a qualified organization partner might ordinarily cause a partnership agreement to fail the Fractions Rule; however, the Code and regulations carve out exceptions for those items, <u>provided</u> the following conditions are met:
  - Preferred return is set forth in binding, written partnership agreement;
  - Preferred return is calculated only on weighted average unreturned partner capital;
  - Preferred return does not exceed relevant limitation (see next slide);
  - Preferred return is "commercially reasonable"
- Two approaches to establishing commercial reasonableness:
  - Commercially reasonable in light of all relevant facts and circumstances; **<u>or</u>**
  - Safe Harbor: rate is commercially reasonable if (i) no greater than 4% more than **<u>or</u>** (ii) no greater than 150% of the relevant applicable federal rate for the month the partner's right to a preferred return or guaranteed payment is first established or for any month in partnership taxable year for which the return or payment on capital is computed. Treas. Reg. § 1.514(c)-2(d)(4).
    - This Safe Harbor rate is generally considered far too low, given that the long-term AFR for December 2016 is 2.26%

Preferred Returns (Contd.)

- **<u>Limitation on preferred return</u>**: The amount of income and gain allocated with respect to a preferred return that could be disregarded for Fractions Rule purposes is limited to:
  - the aggregate of the amount that has been distributed to the partner as a reasonable preferred return for the taxable year of the allocation and prior taxable years on/before the due date (not including extensions) for filing the partnership's return for the taxable year of the allocation

    <u>minus</u>

  - the aggregate amount of corresponding income and gain allocated to the partner in all prior years.
- I.e., reasonable preferred exception applies only to income allocations to a preferred return to the extent that the preferred return is distributed currently (not accrued and left undistributed until a future year)
  - Viewed as unreasonable by practitioners, given that partnership agreements often permit preferred return to accrue un-distributed, but allocate income based on the current liquidation value of the accrued distribution preference, and this rule requires continuous testing of whether the distribution requirement was met each year (or else a Fractions Rule violation may have occurred).

Preferred Returns – Example

- **Facts**: Qualified organization partner contributes $9,000 and a taxable corp. partner contributes $1,000 to a partnership, which borrows $50,000 from unrelated 3rd party, and partnership buys office building for $55,000.
- **Assumptions**: Suppose safe-harbor rate is 10%.
- **Partnership Agreement**: Written partnership agreement provides:
  - Qualified organization partner is to receive a preferred distribution equal to 10% of its unreturned capital.
  - If insufficient cash available for such preferred return of capital, preferred return is compounded at 10%.
  - Income is only allocated to the preferred return to the extent of cash distributions.
  - All other allocations of profit and loss made 50% to each partner.
- **Conclusions:**
  - Partnership satisfies the Fractions Rule because the preferred return is reasonable.
  - Because preferred return is disregarded, the qualified organization's fractions percentage is 50%.

Preferred Returns – Proposed Regs.

- **<u>November 2016 proposed regulations</u>** remove current distribution requirement and instead disregard allocations of items of income and gain with respect to a preferred return for purposes of the Fractions Rule, but only if:

    - the partnership agreement requires that the partnership make distributions first to pay any accrued, cumulative, and compounding unpaid preferred return to the extent such accrued, unpaid preferred return has not otherwise been reversed by an allocation of loss prior to such distribution (i.e. the preferred return must truly be payable in preference to other equity distributions).

- **<u>Tax Distribution Exception</u>** -- The above requirement is subject to a limitation: tax distributions are still permitted to a partner that are intended to facilitate payment of taxes imposed on the partner's allocable share of partnership income or gain if the distributions:

    - are made pursuant to a provision in the partnership agreement;
    - are treated as an advance against distributions to which the partner would otherwise be entitled under the partnership agreement; and
    - do not exceed 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.

Guaranteed Payments

- **General Concept:** Rules for reasonable guaranteed payments generally mirror those for preferred returns (with some variations).
  - Guaranteed payments required to be set forth in binding, written partnership agreement.
  - Regulations treat current or cumulative reasonable guaranteed payments to qualified organization partners for capital or services as deductible item in computing overall partnership income or loss, while guaranteed payment itself not treated as an allocable share of overall partnership income or loss in hands of recipient qualified organization
  - Guaranteed payment for services treated as reasonable in amount if it is reasonable compensation under Treas. Reg. § 1.162-7
- **Safe Harbor:** Same safe harbor rate (AFR * 150%) that applies to preferred returns applies to guaranteed payments for capital.
- **Deduction Timing:** Partnership may deduct a reasonable guaranteed payment to a qualified organization only in the taxable year in which it has been paid in cash. Qualified organization partner recognizes guaranteed payment as income in the taxable year of the cash payment.
  - For this purpose, a guaranteed payment treated as having been made during a taxable year if it is made on or before the due date, not including extensions, for filing the partnership's return for the taxable year. I.e. payment made in February 2016 may be treated as made in 2015, where tax return is not filed until March 2016.

Guaranteed Payments -- Example

- **Partnership Economics**: Written partnership agreement provides that 50% of all income and loss would be allocated to qualified organization partner and 50% to the taxable corp. partner.
- **Guaranteed Payment**: Qualified organization partner is to receive a 10% guaranteed payment on unreturned capital, and any unpaid amount of such guaranteed payment is to be compounded at 10%.
- **Guaranteed Payment**: Suppose safe-harbor rate is 10%.
- **Conclusions**:
  - Guaranteed payment is disregarded for purposes of Fractions Rule because it is computed using the safe-harbor rate.
  - The guaranteed payment is treated as an item of deduction in computing the overall partnership income or loss and is not treated as a portion of the qualified organization partner’s allocable share.
  - Consequently, the qualified organization’s Fractions Rule percentage is 50%.

Changes in Partners' Interests

- **Transfers between QOs:** A qualified organization that acquires a partnership interest from another qualified organization is treated as a continuation of the selling qualified organization
- **Transfers not between QOs:** Other changes in partnership allocations that result from transfers or shifts of partnership interests will be closely scrutinized to determine whether the transfer or shift stems from a prior agreement, understanding, or plan, or whether there was an expectation based upon the structure of the transactions. Treas. Reg. § 1.514(c)-2(k)(1).
  - However, generally, the transfer or shifts would be taken into account only for determining compliance with the Fractions Rule in the taxable year of the transfer or shift and in subsequent taxable years.
  - This general exception for changes in partners' interests may not be applied in a manner inconsistent with the purpose of the Fractions Rule, namely to prevent tax avoidance by limiting the permanent or temporary transfer of tax benefits from tax-exempt partners to taxable partners.
  - In other words, assuming there was no prearranged plan to avoid the Fractions Rule, sales between a QO and a non-QO partner will only be evaluated on a prospective basis (i.e. compared to future years), to determine any Fractions Rule violation.

Changes in Partners' Interests (Contd.)

- **Practical Issues and Concerns**: Many real estate partnerships with qualified organization partners admit new partners in a number of rounds of closing, but treat the partners as having entered at the same time for purposes of sharing profits and losses (staged closings).
  - For example, a real estate private equity fund may hold multiple closings over the course of several years, with special "true-up" mechanisms to make later investors pari passu with earlier investors.
- **For example**:
  - Initial operations of the partnership may be funded entirely through debt financing, with all partners contributing their committed capital at a later date.
  - Or some investors may fund capital on Date 1, with other investors funding capital on Date 2. Later entering partners may contribute capital and an interest factor, some or both of which is then distributed to the earlier admitted partners to compensate them for the time value of their earlier contributions.
- Under existing regulations, staged closings could cause violations of the Fractions Rule in two ways:
  1. When new partners are admitted to a partnership, shifts of partnership interests occur. Changes in allocations that result from shifts of partnership interests are closely scrutinized if pursuant to a prior agreement and could be deemed to violate Fractions Rule. Unclear if partnership agreement permitting staged closing is such an agreement.

  2. After admitting new partners, partnerships may disproportionately allocate income or loss to the partners to adjust partners' capital accounts as a result of staged closings.

Changes in Partners' Interests – Proposed Regs.

- **<u>Under November 2016 proposed regulations</u>**, Treasury and IRS have determined that changes in allocations and disproportionate allocations resulting from common commercial staged closings should not violate the Fractions Rule if they are consistent with the purpose of the Fractions Rule and satisfy the following conditions:
  - new partner acquires interest no later than 18 months after partnership formation;
  - partnership agreement and other relevant documents anticipate new partners acquiring partnership interests no later than 18 months after partnership formation, 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;
  - partnership agreement and any other relevant documents specifically set forth the method of determining any applicable interest factor and for allocating income, loss, or deduction to the partners to adjust partners' capital accounts after the new partner acquires an interest; AND
  - the interest rate for any applicable interest factor is not greater than 150% of the highest applicable Federal rate, at the appropriate compounding period or periods, at the time the partnership was formed.
- **<u>Safe Harbor</u> --** If conditions above met, IRS will not closely scrutinize changes in allocations resulting from staged closings and will disregard, in computing income or loss for purposes of the Fractions Rule, disproportionate allocations of income, loss, or deduction made to adjust the capital accounts when new partner acquires interest after the partnership's formation.

Changes in Partners' Interests – Proposed Regs.

- **<u>Practitioner Concern with Proposed Regulations</u>** – Proposed Regulations set forth a safe harbor that is not particularly useful in practice:
  - 18 months from the date of formation of a partnership is not a particularly useful date. Many funds and joint ventures have multiple closings over a period of multiple years, and 18 months is too short of a period.
  - Partnership may be formed as a shell entity for months or years before the first closing, rendering the exception technically useless in some cases.
  - Interest factors of AFR * 150% are far lower than the 7% - 9% interest factors often seen in the marketplace.
  - Proposed regulations do not address secondary sales or other transfers of interests that may be contemplated by the Partnership Agreement but for valid commercial reasons occur more than 18 months after the first closing of a fund.

Unlikely Losses

- **<u>Exception for Unlikely Losses</u>**: IRS regulations exclude from the determination of whether the Fractions Rule is satisfied any allocation of items of loss or deduction that may be made to partners other than qualified organizations only if at the time the allocation provision became part of the partnership agreement, it was unlikely that such an allocation would be made.

- To be "unlikely" for this purpose, a 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 (e.g., 3rd-party litigation giving rise to unforeseen liabilities in excess of reasonable insurance coverage).

- **<u>Examples:</u>** Regulations provide the following examples of events resulting in unlikely deductions or losses:

  - Tort and other 3rd-party litigation giving rise to unforeseen liabilities in excess of reasonable insurance coverage; Unanticipated labor strikes; Unusual delays in securing required permits or licenses; Abnormal weather conditions (considering the season and the job site); Significant delays in leasing property due to an unanticipated severe economic downturn in the geographic area; Unanticipated cost overruns; AND The discovery of environmental conditions requiring remediation.

- Providing a special allocation for a deduction or loss in the partnership agreement does not support any inference as to the unlikely nature of such item for purposes of this exclusion. Pre-funding, however, not sanctioned by the regulations. TD 8539 states that "[g]enerally, pre-funding is incompatible with a conclusion that a loss or deduction is unlikely."

Unlikely Losses – Proposed Regs.

- **<u>November 2016 Proposed Regulations</u>** Revised the current standard for determining likelihood of loss, which was previously "low likelihood of occurring."
- Treasury and IRS received comments claiming that this standard is too vague and should instead be "more likely than not."
- Treasury and IRS are considering changing the standard and request further comments explaining why "more likely than not" is more appropriate than the "low likelihood of occurring," or whether another standard describing a level of risk between those two might be more appropriate.

Tiered Partnership Arrangements

- **<u>Tiered partnership arrangements</u>**: Tiered partnership arrangements will satisfy the Fractions Rule only if the following two anti-abuse requirements are met:
  Tax avoidance is not a principal purpose for using the tiered ownership structure
  - <u>AND</u>
  - Partnership demonstrates satisfaction of regulations via a “reasonable method”.
- **<u>Reasonable methods for investing in lower-tier partnerships</u>**:
  - Collapsing Approach (viewing the chain of partnerships as a collapsed single partnership, with Fractions Rule compliant allocations on an aggregate basis)
  - Entity-by-Entity Approach (ensuring that each lower-tier partnership is compliant)
    - Most common approach – scrutinize each lower-tier venture
  - Independent Chain Approach (separately allocating any UBTI from a non-Fractions Rule compliant lower-tier JV)
- **<u>Practical Note</u>** -- Structuring Fractions Rule compliance more complicated if fund enters into joint ventures, uses a master-feeder structure, or pays carried interest from a partnership organized below a blocker corp. owned by the fund.
  - Fund generally cannot <u>receive</u> carried interest or promote from lower-tier JVs

Tiered Partnership Arrangements – Proposed Regs.

- **<u>Practitioner Comments</u>**: Treasury and IRS received a comment noting that in practice, a real estate partnership generally invests in a significant number of properties, often through joint ventures with other partners, some of which may not comply with the Fractions Rule
  - Hence, a typical real estate partnership will not make separate allocations to its partners of lower-tier partnership items.
- **<u>November 2016 Proposed Regulations</u>** amended the rules for tiered partnerships, such that upper-tier partnership not required to separately allocate partnership items from separate lower-tier partnerships that do not comply with the Fractions Rule.
  - Instead, the income from such partnerships will simply be identified as UBTI that does not qualify for the Fractions Rule on partners' K-1s.

Partner-Specific Expenditures

- Regulations provide a list of certain partner-specific expenditures that are disregarded in computing overall partnership income or loss for purposes of the Fractions Rule.
- Provided they are allocated to the partners to whom they are attributable, the following types of expenditures are disregarded for purposes of the Fractions Rule:
  - Expenditures for additional record keeping or accounting incurred in connection with the transfer of a partnership interest;
  - Additional administrative costs resulting from the presence of a non-U.S. partner;
  - State and local taxes, and expenditures related to such taxes; AND
  - Other expenditures designated by the IRS through revenue ruling, revenue procedure, or private letter ruling.

De Minimis Exceptions

- **De minimis interest exception** excuses complying with the Fractions Rule altogether if:
  - Qualified organizations, in the aggregate, do not hold > 5% of the partnership's capital or profits

  AND

  - Taxable partners owns a substantial interest in the partnership and participate in the partnership on substantially the same terms as the qualified organization partners.
    - "Substantial interest" and "substantially the same terms" are not defined.
- **De minimis allocation exception**: qualified organization's share of partnership items of loss and deduction that are allocated away from the qualified organization to other partners are disregarded for purposes of determining such qualified organization's Fractions Rule percentage if:
  - the allocations were neither planned nor motivated by tax avoidance

  AND

  - the total amount of loss or deduction so allocated is less than both (a) 1% of the partnership's aggregate items of gross loss and deduction for the year and (b) $50,000.
    - $50,000 is such a small number as to be nearly useless for many large real estate JVs

De Minimis Exceptions (Contd.)

- According to Preamble to Treasury Regulations implementing the fractions rule, the purpose of the de minimis exclusion is to provide relief for what would otherwise be minor inadvertent violations of the Fractions Rule.

  - E.g.,, a plumber’s bill that a taxable partner pays directly or that the partnership pays but is overlooked until after the partnership’s allocations have been computed and then is allocated entirely to the taxable partner.

  - Provision not intended to be used routinely by partnerships to allocate some of the partnership’s losses and deductions.

- Special allocations of nonrecourse and partner nonrecourse deductions are not covered by this exclusion and are not included as special allocations in computing the de minimis limitation.

De Minimis Exceptions – Proposed Regs.

- **Under November 2016 proposed regulations**, Fractions Rule also does not apply to a partnership in which non-qualified organization partners do not hold (directly or indirectly through a partnership), in the aggregate, interests of greater than 5% in the capital or profits of the partnership, so long as the partnership's allocations have substantial economic effect.
  - I.e. the requirement that taxable partners hold a "substantial interest" has been eliminated.

- **Increased De Minimis Threshold:** Existing regulations also address the de minimis allocation exception threshold:
  - Proposed regulations still require that allocations not exceed 1% of the partnership's aggregate items of gross loss and deduction for the taxable year, but raise the dollar threshold from $50,000 to $1,000,000.
  - This change reflects the view that, in current business practices, a $50,000 threshold does not provide sufficient relief for de minimis allocations away from a qualified organization partner.

Anti-Abuse Rule

- **Smell Test**: While technical compliance is certainly necessary, meeting a more basic smell test is always important as well.
- **General Rule**: Fractions Rule section may not be applied in a manner that is inconsistent with its purpose of preventing 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 in any similar manner.
  - Allocations not included in computing overall partnership income or loss may be relevant in determining whether a partnership violates the anti-abuse rule.

IV. Practical Administrative Issues

Management Fee Breaks

- **Discounted Fees for Large Investors** -- Very often, real estate funds and JVs allow investors to receive a management fee discount in comparison to other investors.
  - If a fund grants and pays for a management fee break to a qualified organization, the resulting special allocations of the management fee expense among the LPs to account for the fee break may cause the fund's allocations to violate the Fractions Rule.
- **Solution under Current Regs – Pay Scaled Fees Outside the Fund:** In the most common structural solution to this issue, a Fractions Rule compliant fund's management fees are paid directly by LPs to the GP. This has the result of moving all management fee expenses to the LP level, and avoids a situation where the Fund has to allocate differential management fees to its LPs.
  - However, this approach may result in some drafting and accounting complexities (since capital contributions to pay management fees typically attract a preferred return that has to be repaid in the Fund's waterfall).

Management Fee Breaks – Proposed Regs.

- **Under November 2016 proposed regulations**, management (and similar) fees were added to the list of partner-specific expenditures that are ignored for purposes of determining fractions rule compliance.
- **Limit on Fee Rate --** These fees are excluded to the extent they do not, in the aggregate, exceed 2% of the partner’s aggregate capital commitments.
  - It is relatively unusual to see a real estate private equity fund that charges a management fee in excess of 2% (1.5-2% is more common), so in most cases, this is a complete solution to a previously vexing issue.

Investor Defaults or Reductions

- **<u>Default Mechanisms:</u>** In a typical real estate private equity fund, if an investor fails to fund its share of a capital call, the partnership agreement will provide the general partner with a variety of remedies, including:
  - Allowing the non-default partner(s) to contribute additional capital in return for a preferred return on that additional capital;
  - Causing the defaulting partner to forfeit all or a portion of its interest in the partnership;
  - Forcing the defaulting partner to sell its interest in the partnership, often at a punitive discount;
  - Excluding the defaulting partner from making future capital contributions; OR
  - Allowing non-defaulting partners to reduce their commitment amounts in proportion to the amount of the default.
- Any of these remedies could raise Fractions Rule concerns due to the resulting change in investors' interests in the fund.
- Under existing law, practitioners and qualified organizations have had to become comfortable that the exercise of typical default remedies does not practically violate the fractions rule (either under the "unlikely loss" or "change in partner's interest" exceptions), and should not create a violation as a practical matter, but concerns have persisted in some quarters that there has been a technical violation of the fractions rule.

Capital Commitment Defaults or Reductions – Proposed Regs.

- **Under November 2016 proposed regulations**, if the partnership agreement provides for changes to allocations due to an unanticipated partner default on a capital contribution commitment or an unanticipated reduction in a partner's capital contribution commitment, and those changes in allocations are consistent with the Fractions Rule's purposes, then:
  - changes to partnership allocations provided in the agreement will not be closely scrutinized,

    AND

  - partnership allocations of income, loss, or deduction to partners to adjust the partners' capital accounts as a result of unanticipated capital contribution defaults or reductions will be disregarded in computing overall partnership income or loss for Fractions Rule purposes.
- Proposed regulations provide helpful clarity that typical commercial default provisions do not create a technical fractions rule violation.

Clawbacks

- **Clawback of Excess Carried Interest/Promote** – Many real estate private equity funds and JVs contain a clawback provision, wherein the sponsor must return carried interest distributions to fund or JV upon liquidation to the extent either (i) LPs did not achieve a certain preferred return hurdle and/or (ii) sponsor received excessive carried or promote distributions in comparison to amounts it would have been entitled to receive if all carried interest distributions were calculated on liquidation (e.g. if early deals have been sold at a gain, but on a net basis across the life of the fund, there has been a loss or insufficient gain)
  - Fund then distributes returned carry/promote among LPs.
- **Risk of Technical Fractions Rule Violation** -- Because distribution may cause limited partners to receive amount exceeding their respective positive capital account balances, clawback may prevent allocations from having substantial economic effect and thus technically violate the Fractions Rule.
  - But many Big 4 accounting firms now comfortable with reporting a fund with a clawback as Fractions Rule compliant despite this technical noncompliance.
  - The vast majority of Fractions Rule compliant funds include a clawback.
- **No Clarity in Proposed Regulations** -- Practitioners had hoped that IRS proposed regulations would address this issue, and provide a safe harbor for clawbacks. Unfortunately, November 2016 proposed regulations did not speak to this issue.

V. Drafting Approaches

Targeted Allocations

- **<u>Targeted Allocations in Real Estate Private Equity Funds and JVs</u>** – It is relatively common for modern real estate partnership agreements to contain waterfall arrangement governing distributions and then to employ a "forced" or "targeted" allocation provision, where partner's capital accounts are "forced' to equal each partner's distribution entitlement in a hypothetical liquidation of the fund or JV.

- **<u>Example</u>**: "Items of Partnership income, gain, loss, expense or deduction for any fiscal period shall be allocated among the Partners in such manner that, as of the end of such fiscal period and to the greatest extent possible, the Capital Account of each Partner shall be equal to the respective net amount, positive or negative, that would be distributed to such Partner from the Partnership or for which such Partner would be liable to the Partnership under this Agreement, determined as if, on the last day of such fiscal period, the Partnership were to (a) liquidate the Partnership's assets for an amount equal to their book value (determined according to the rules of U.S. Department of Treasury Reg. §1.704-1(b)(2)(iv)) and (b) distribute the proceeds in liquidation in accordance with <u>Section [__].</u>"

Targeted Allocations

- Issues raised by targeted allocations:

  - While practitioners are generally comfortable that targeted allocations have "substantial economic effect," they do not strictly require the partnership to liquidate in accordance with partners' capital account balances, creating some doubt about Fractions Rule compliance;
  - If distribution provisions result in a shift of capital among partners, it may be characterized as a guaranteed payment under § 707;
  - Whether, if the partnership has a tax-exempt partner, the allocations would satisfy the Fractions Rule and the distribution requirements of this rule if the tax-exempt partner receives a preferred return; AND
  - Whether, if partnership has liabilities, allocations comply with IRS rules regarding allocations with respect to nonrecourse debt and partner nonrecourse debt.

- While some practitioners and accounting firms are comfortable with a Fractions Rule compliant vehicle that uses "targeted allocations," many practitioners insist on using long-form "layer-cake" allocations, which more strictly comply with the letter of the Fractions Rule and substantial economic effect rules.
  - Liquidation provision should require liquidation in accordance with partners' capital account balances.

Layer-cake Allocations

- Example of Layer-Cake Allocations for Fractions Rule Compliant Fund
  - **5.03(a):** Net Income shall be apportioned among the Partners in proportion to their Percentages. Amounts so apportioned shall be allocated in the following order and priority:

    I. First, to the extent Net Loss has been allocated to such Partner pursuant to Section 5.03(b)(iv), to such Partner until the cumulative Net Income then and previously allocated to such Partner pursuant to this Section 5.03(a)(i) equals the cumulative Net Loss then and previously allocated to such Partner pursuant to Section 5.03(b)(iv);

    II. Second, to such Partner until the cumulative Net Income then and previously allocated to such Partner pursuant to this Section 5.03(a)(ii) equals the sum of (x) the cumulative Net Loss previously allocated to such Partner pursuant to Section 5.03(b)(iii); (y) the cumulative amount then distributable to such Partner for the current and prior periods (whether or not then distributed and irrespective of the existence of Distributable Proceeds) and previously distributed to such Partner pursuant to Section 5.02(a)(i)(D) and (z) the cumulative amount distributed to such Partner on or before the due date (not including extensions) for filing the Partnership's federal tax return for the taxable year for which the allocation to such Partner under this Section 5.03(a)(ii) is being made or which has been previously distributed to such Partner pursuant to Section 5.02(a)(i) to the extent such amounts are attributable to the return of the portion of such Partner's Funded Contributions representing such Partner's allocable share of amounts funded to pay the Management Fee;

Layer-cake Allocations Cont'd

III. Third, (A) 60% to the General Partner and (B) 40% to such Partner until the cumulative Net Income then and previously allocated with respect to such Partner pursuant to this Section 5.03(a)(iii) equals the sum of (x) the cumulative Net Loss previously allocated with respect to such Partner pursuant to Section 5.03(b)(b)(ii) and (y) the cumulative amount then distributable with respect to such Partner (whether or not then distributed and irrespective of the existence of Distributable Proceeds) and previously distributed with respect to such Partner pursuant to Section 5.02(a)(ii); and

IV. Fourth, (A) 20% to the General Partner and (B) 80% to such Partner.

- **5.03(b):** Net Loss shall be apportioned among the Partners in proportion to their Percentages. Amounts so apportioned shall be allocated in the following order and priority:

I. First, to the extent Net Income has been allocated 20% to the General Partner and 80% to such Partner pursuant to Section 5.03(a)(iv), (A) 20% to the General Partner and (B) 80% to such Partner, until the cumulative Net Loss then and previously allocated with respect to such Partner pursuant to clause (A) of this Section 5.03(b)(i) equals the cumulative Net Income then and previously allocated with respect to such Partner on such 20% basis pursuant to Section 5.03(a)(iv)(A);

Layer-cake Allocations Cont'd – 5.03(b)

II. Second, to the extent Net Income has been allocated with respect to such Partner pursuant to Section 5.03(a)(iii) hereof, (A) 60% to the General Partner and (B) 40% to such Partner until the cumulative Net Loss allocated with respect to such Partner pursuant to this Section 5.03(b)(ii) equals the cumulative Net Income then and previously allocated with respect to such Partner pursuant to Section 5.03(a)(iii);

III. Third, to such Partner until the cumulative Net Loss then and previously allocated to such Partner pursuant to this Section 5.03(b)(iii) equals the cumulative amount of Net Income previously allocated to such Partner pursuant to Section 5.03(a)(ii); and

IV. Fourth, to such Partner.

Savings Clauses

- Savings clauses typically provide that a partnership agreement is intended to comply with the Fractions Rule and that the agreement's provision will be interpreted or applied in a manner that makes that objective possible.
- Most partnership agreements neither clearly meet nor fail to meet the requirements of the Fractions Rule, due to technical issues outlined above. Savings clause could make clear partners' intent that agreement satisfy the Fractions Rule and assist the parties in interpreting provisions of the agreement that might otherwise be ambiguous.
- Example:
  - The foregoing provisions and the other provisions of this Agreement (including <u>Section [__]</u>) relating to the maintenance of Accounts and allocations to Partners (collectively, the "<u>Allocation Provisions</u>") are intended to comply with Code Section 514(c)(9)(E) and the Treasury Regulations thereunder (the "<u>Fractions Rule</u>") and Code Section 704(b) and the Treasury Regulations thereunder, and shall be interpreted and applied in a manner consistent with the Fractions Rule. Notwithstanding anything to the contrary in this Agreement, the Allocation Provisions are deemed modified, with effect from the date of the Initial Closing, to the extent necessary to comply with the Fractions Rule (including creating a separate allocation waterfall pursuant to the provisions of Treasury Regulation § 1.514(c)-2(m)(2), example 3(ii), with respect to certain investments in non-Fractions Rule compliant joint ventures, partnerships, limited liability companies, or other flow-through entities) and without limiting the foregoing, any allocation for a particular year pursuant to the Allocation Provisions that would violate the requirements of the Fractions Rule shall not be made and shall be disregarded, and there shall instead be made (i) allocations for such year consistent with the Fractions Rule, but to the extent consistent with the Fractions Rule such allocations shall deviate as little as possible from the allocations generally provided herein as determined by the General Partner and (ii) adjustments pursuant to <u>Section [__]</u>.

VI. Questions?

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