IRS Relaxes Fractions Rule Regulations

By Andrew Short & Matthew Tippett

Introduction

The Treasury Department and Internal Revenue Service (the "IRS") recently published proposed regulations (the "Proposed Regulations") facilitating the ability of real estate partnerships to buy and hold debt-financed property without causing partners that are qualified organizations (a "QO") to recognize unrelated business taxable income ("UBTI"). QO-partners include, among others, university endowments and pension plans. Specifically, the Proposed Regulations modify existing regulations under Section 514(c)(9)(E) of the Internal Revenue Code, as amended, the so-called fractions rule, to permit certain allocations resulting from common business practices that may have otherwise violated the fractions rule.

Background on the Fractions Rule

Organizations otherwise exempt from U.S. federal income taxation are subject to federal income tax at graduated corporate tax rates on UBTI. UBTI includes gross income derived from debt-financed property. However, if certain requirements are met, a QO can incur debt to acquire or improve real property without recognizing UBTI.

The rules are more complicated when a QO owns debt-financed property indirectly through one or more partnerships. One method for partnerships to avoid generating UBTI for their QO-partners is to comply with the statutory allocation provisions of the fractions rule. The fractions rule limits the ability of a partnership to allocate income disproportionately to QO’s and loss disproportionately to taxable partners.

Proposed Regulations

Tax practitioners have been concerned that many common arrangements in real estate partnerships, such as the use of targeted tax allocations and negotiated management fees, could violate the fractions rule and cause QO-partners to recognize UBTI. While the Proposed Regulations do not address the impact of targeted allocations on the fractions rule, the Proposed Regulations provide relief for other specific areas of concern.

The Proposed Regulations will apply to tax years ending on or after the date that the regulations are published as final regulations. However, real estate partnerships and their partners may elect apply the Proposed Regulations for tax years ending on or after November 23, 2016.
Preferred Returns

Under current law, items of partnership income and gain with respect to a reasonable preferred return are disregarded when computing overall partnership income for purposes of the fractions rule if certain requirements are satisfied. Regulations limit the amount disregarded to the aggregate amount that has been distributed to the partner as a reasonable preferred return in the current and prior taxable years, less the aggregate amount of corresponding income and gain allocated to the partner in all prior years.

The Proposed Regulations eliminate the current distribution requirement and disregard allocations of income and gain attributable to a reasonable preferred return if the partnership agreement requires accrued preferred returns to be distributed prior to all other distributions (other than tax distributions) to the extent any such accrued but unpaid preferred return has not otherwise been reversed by an allocation of loss.

Partner-Specific Management Fees

Large partnerships often provide certain investors with reduced management fees. Variable management fees would require disproportionate allocations of items of deduction attributable to these management expenses in a manner that follows the economic arrangement. These disproportionate allocations would violate the fractions rule.

The Proposed Regulations permit disproportionate allocations attributable to variable management fees by adding management and similar fees to the list of partner-specific expenditures that are excluded in computing overall partnership income or loss for purposes of the fractions rule. The aggregate amount of fees excluded cannot exceed two percent of the partner’s committed capital.

Unlikely Losses

Existing regulations generally disregard specially allocated losses or deductions in computing overall partnership income or loss under the fractions rule if such item of loss or deduction has a “low likelihood of occurring” based on all of the facts and circumstances. The Proposed Regulations note that the Treasury Department and the IRS have received comments suggesting that a “more likely than not” standard is more appropriate for determining whether an item of loss or deduction should be disregarded. The Treasury Department and the IRS are considering changing the standard and request additional comments explaining why a “more likely than not” standard is appropriate.

Chargebacks of Partner-Specific Expenditures and Unlikely Losses

As noted above, allocations of partner-specific expenditures and special allocations of unlikely losses are generally disregarded in computing overall partnership income or loss for purposes of the fractions rule. However, allocations of items of income or gain to reverse prior allocations of partner-specific expenditures or unlikely loss could violate the fractions rule. Existing regulations generally disregard an allocation of part of the overall partnership income or loss to chargeback a prior disproportionate allocation only if that part consists of a proportionate amount of each item included in computing overall partnership income or loss.

The Proposed Regulations modify the existing chargeback exception to disregard an allocation of what would otherwise have been an allocation of overall partnership income to chargeback a prior special allocation of a partnership-specific expenditure or unlikely loss.
Acquisition of Partnership Interests after Initial Formation of Partnership

It is common for real estate partnerships to admit partners in sequential closings but treat all partners as having been admitted at the same time for purposes of allocating profits and losses. The use of staged closings could have violated the fractions rule in two ways under current law. First, as partners are admitted to the partnership in later closings, partnership interests are necessarily redistributed among the partners. Changes in allocations resulting from these shifts in partnership interests are closely scrutinized and could potentially violate the fractions rule. Second, the partnership may disproportionately allocate income or loss to the partners as a means to readjust partners’ capital accounts to account for the staged closings. These disproportionate allocations could also violate the fractions rule.

The Proposed Regulations permit changes in allocations and certain disproportionate allocations which result from staged closings. In addition, disproportionate allocations made to adjust partners’ capital accounts will be disregarded if: (i) the new partner acquires its interest no later than 18 months following the formation of the partnership, (ii) the partnership documents contemplate staged closings by outlining the terms of the various closings, (iii) the partnership agreement identifies the method of determining any applicable interest factor to adjust partners’ capital accounts, and (iv) the interest rate for such applicable interest factor is not greater than 150 percent of the highest applicable federal rate at the time the partnership was formed.

Capital Commitment Defaults or Reductions

Real estate partnerships generally do not require limited partners to contribute their entire investment immediately upon being admitted to the partnership. Instead, limited partners will commit to contributing a fixed dollar amount over time. The general partner will then call upon the limited partners to contribute committed, but uncontributed, capital as needed. When a limited partner fails to contribute all or a portion of its committed capital, the common remedies include: (i) allowing the non-defaulting partners to make additional contributions in exchange for a preferred return, (ii) causing the defaulting partner to forfeit or sell its partnership interest, (iii) excluding the defaulting partner from the right to make additional capital contributions, or (iv) allowing the partners to reduce their capital commitments.

The Treasury Department’s and IRS’s view is that changes in allocations resulting from unanticipated defaults do not violate the fractions rule if such changes are provided for in the partnership agreement. Therefore, the Proposed Regulations provide that allocations of partnership income or loss to adjust the partners’ capital accounts will be disregarded in computing overall partnership income or loss for purposes of the fractions rule.

Applying the Fractions Rule to Tiered Partnerships

Where a QO-partner holds an indirect interest in real property through a chain of one or more partnerships, existing regulations provide that the fractions rule is satisfied where tax avoidance is not the principal purpose of using the tiered-partnership structure and the relevant partnerships can demonstrate compliance with the regulations under one of three methods. Under the independent chain approach, different lower-tier partnership chains are examined independently of each other only if the upper-tier partnership allocates the items of each lower-tier partnership separately from the items of another lower-tier partnership.

In practice, real estate partnerships will not make separate allocations to its partners of items of income or loss from lower-tier partnership. The Proposed Regulations remove the requirement that an
upper-tier partnership allocate items from lower-tier partnerships separately from one another under the independent chain approach.

**De Minimis Exceptions from Application of the Fractions Rule**

Existing regulations provide two de minimis exceptions under the fractions rule. First, if QO-partners own, in the aggregate, no more than five percent in the capital or profits of the partnership and taxable partners own a substantial amount of interests, the partnership is not required to comply with the fractions rule and the partnership can acquire debt-financed property without causing its QO-partners to recognize UBTI.

Under the Proposed Regulations, the inverse is also true—if QOs own, in the aggregate, ninety-five percent or more in the capital or profits of the partnership, the partnership can acquire debt-financed property without causing its QO-partners to recognize UBTI.

Second, certain allocations of partnership loss and deduction away from QO-partners that might otherwise have violated the fractions rule will be treated as having been allocated to the QO-partners if: (i) such allocations are unplanned and not motivated by tax avoidance, and (ii) the total amount of such items of partnership loss and deduction are less than both one percent of the partnership’s aggregate amount of partnership loss or deduction for the taxable year and $50,000. This de minimis exception is designed to provide relief for minor inadvertent violations of the fractions rule, such as when a routine bill is paid directly by a taxable partner, or is paid by the partnership but is overlooked until after the partnership’s allocations have been computed and then is allocated entirely to the taxable partner.

The Proposed Regulations increase the threshold to $1,000,000, but such allocations still must be less than one percent of the partnership’s aggregate amount of loss or deduction for the taxable year.

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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