

TAX SECTION

New York State Bar Association

Report on Notice 90-41
and Certain Other Issues Arising
Under Section 514(c)(9) of the
Internal Revenue Code Relating to
Debt-Financed Real Estate Investments
by Tax-Exempt Organizations

March 26, 1991

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March 26, 1991

The Honorable Fred T. Goldberg, Jr.
Commissioner of Internal Revenue
1111 Constitution Avenue N.W.
Washington, D.C. 20024

Re: Debt-Financed Real Estate Investments
by Tax Exempt Organizations

Dear Commissioner Goldberg:

I enclose our report on IRS Notice 90-41 and certain other important issues arising under Code section 514(c)(9), which relates to debt-financed real estate investments by pension plans and other "qualified organizations". The report was prepared by an ad hoc committee comprised of members of the Committees on Partnerships, Income from Real Property, and Tax Exempt Entities.

As an initial matter, the report suggests that Congress and the Treasury undertake a comprehensive review of Code section 514(c)(9). The current statute is overly formalistic and complex. We recognize that the prevention of abusive transactions is a clearly legitimate concern, but believe that changes in the tax law and in the economy over the past few years have created a need to reexamine the statutory treatment of this area.

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The report also urges the Treasury, in promulgating regulations under the existing statute, to make every effort to provide rules that operate fairly and reasonably. For example, the comments on the Notice's treatment of preferred returns and "unlikely allocations" note that, in addition to requirements that are useful and reasonable mechanisms for preventing tax abuses, the Notice would impose further requirements that are difficult to satisfy as a practical matter, even for well intentioned taxpayers, and appear to add little in preventing abuse.

In terms of specific issues, the report offers comment on six general areas: the treatment of preferred returns and guaranteed payments, the "unlikely allocation exclusion", chargebacks, tiered partnerships, de minimis rules, and other miscellaneous issues.

We would be pleased to discuss the report and its recommendations with your staff at their convenience.

Very truly yours,

James M. Peaslee
Chair

Enclosure

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NEW YORK STATE BAR ASSOCIATION

TAX SECTION

Report on Notice 90-41 and Certain Other
Issues Arising Under Section 514(c)(9)
of the Internal Revenue Code
Relating to Debt-Financed Real Estate
Investments by Tax-Exempt Organizations*/

I. Introduction

For a tax-exempt organization contemplating any type of investment, the critical tax issue is whether the investment will generate "unrelated business taxable income" ("UBTI") within the meaning of Section 512. If the investment would generate UBTI, which would trigger what are perceived to be burdensome tax return preparation and tax payment requirements, the investment usually will not be made. For a tax-exempt organization contemplating an investment in real estate through a partnership that has debt financing--perhaps the most common form of real estate investment--the difficult UBTI issues that arise under Section 514(c)(9) will often prevent the investment from being made.

*/ This report was prepared by an ad hoc committee comprising members of the Committees on Partnerships, Income from Real Property and Tax-Exempt Entities. The preparation of this report was coordinated by William B. Brannan. The principal authors of the report were Mark E. Berg, William B. Brannan, Carolyn J. L. Ichel, Joel Scharfstein, Robert S. Schwartz and Alan J. Tarr. Helpful comments were received from Peter C. Canellos, John A. Corry, Arthur A. Feder, Simon Friedman, Richard J. Hiegel, Michael Hirschfeld, Rochelle Korman, James A. Levitan, Stephen L. Millman, James M. Peaslee, Elliot Pisem, Sanford C. Present, Michael L. Schler and Marc D. Teitelbaum. Unless otherwise indicated, all section references herein are to the Internal Revenue Code of 1986, as amended (the "Code").

In June 1990, the Internal Revenue Service issued Notice 90-41 to provide guidance on certain of the issues presented by Section 514(c)(9). The area remains, however, a legal quagmire. This report comments on Notice 90-41 and discusses certain other important issues under Section 514(c)(9) that are not covered in Notice 90-41 but that confront tax-exempt organizations investing in debt-financed real estate through partnerships.

A. Legislative Background. While Section 511 provides that a tax-exempt organization generally is subject to tax on any income from an unrelated trade or business, Section 512(b) provides that several types of income, including rent from real property and gain from the sale of real property, generally are not treated as UBTI. However, under Section 512(b)(4), if such income is derived from real estate that is subject to "acquisition indebtedness" (as defined in Section 514(c)), a portion of such income generally is treated as UBTI. The portion of income subject to UBTI is determined based upon the ratio that the amount of the acquisition indebtedness bears to the adjusted basis of the property.

Notwithstanding the rule of Section 512(b)(4), Section 514(c)(9) provides that acquisition indebtedness does not include debt incurred to finance a real estate investment by any "qualified organization" (a "QO"), provided that the investment satisfies certain requirements. A QO is a pension fund qualified under Section 401, an educational organization described in Section 170(b)(1)(A)(ii) or 509(a)(3) or a title holding company described in Section 501(c)(25).

Section 514(c)(9) was originally added to the Code in 1980 to promote debt-financed real estate investments by pension funds. ^{1/} Congress believed that this was an important objective, since pension funds traditionally have invested large amounts of their assets in real estate and real estate investments usually are made with some amount of debt financing. ^{2/} In 1984, in response to concerns that QOs were making debt-financed investments through partnerships with taxable investors and allocating a disproportionately large share of the resulting tax losses to the taxable investors to shelter their other income, Congress added Section 514(c)(9)(B)(vi) to the Code to prevent such transactions. ^{3/} In its current form, Section 514(c)(9)(B)(vi) provides that the Section 514(c)(9) exception does not apply where the QO holds its debt-financed real estate investment through a partnership that includes non-QO partners unless either (i) each tax allocation by the partnership to its

^{1/} Miscellaneous Revenue Act of 1980, Pub. L. No. 96-605, § 110(a). The reference to educational organizations in Section 514(c)(9) was added by Section 1034(a) of the Tax Reform Act of 1984, Pub. L. No. 98-369 (the "1984 Act"). The reference to Section 501(c)(25) organizations was added by Section 1603(b) of the Tax Reform Act of 1986, Pub. L. No. 99-514 (the "1986 Act"), although subsequent legislation effectively made the Section 514(c)(9) exception unavailable for real estate partnership investments by Section 501(c)(25) organizations.

^{2/} See S. Rep. No. 1036, 96th Cong., 2d Sess. 29 (1980). A recent study indicates that pension funds have approximately \$75 billion of their assets invested in real estate. See Bureau of National Affairs, Daily Tax Report (January 7, 1991) at H-1.

^{3/} 1984 Act § 1034(a). The original 1984 Act version of Section 514(c)(9)(B)(vi) simply required that the partnership's tax allocations be "qualified allocations" within the meaning of the predecessor of Section 168(h)(6). (The 1984 Act Conference Committee significantly softened the Senate version of the provision, which would have denied the benefit of Section 514(c)(9) in the case of any partnership having any partner that is not a QO.) Section 1878(e)(3) of the 1986 Act, in a "technical correction" to the 1984 Act, added the alternative test that "the principal purpose" of any nonqualified allocation not be "the avoidance of income tax". Section 10214(a) of the Revenue Act of 1987, Pub.L. No. 100-203 (the "1987 Act"), substituted the Fractions Rule for the 1986 Act "principal purpose" test, and Section 2004(h) of the Technical and Miscellaneous Revenue Act of 1988, Pub.L. No. 100-647, made various liberalizing changes to the Fractions Rule.

QO partners is a "qualified allocation" within the meaning of Section 168(h)(6) (the "Qualified Allocations Rule") or (ii) the tax allocations by the partnership satisfy the requirements of Section 514(c)(9)(E) (the "Fractions Rule").

In general, a "qualified allocation" is an allocation that (i) results in each QO partner having the same percentage interest in each item of partnership income, gain, loss, deduction and credit at all times through the life of the partnership and (ii) has "substantial economic effect" within the meaning of Section 704(b)(2). In general, a partnership's allocations satisfy the Fractions Rule if (i) such allocations cannot result in a QO partner having a share of "overall partnership income" for any taxable year that is greater than such partner's share of "overall partnership loss" for the taxable year during which such partner's loss share is the smallest and (ii) such allocations have substantial economic effect.

In June 1990, the Internal Revenue Service issued Notice 90-41. The Notice provides guidance on several technical issues arising under the Fractions Rule and describes future regulations to be issued under that Rule. In addition, the Notice requests comments on other issues under Section 514(c)(9). Notice 90-41 approaches several of the problems under the Fractions Rule in a reasonable and creative manner, and this is laudable; the Notice is indeed helpful in structuring transactions. As described in this Report, however, there are some areas that are not adequately addressed in the Notice and other important issues that are not addressed at all.

B. Threshold Problems with This Area. The Qualified Allocations Rule and the Fractions Rule raise a number of exceedingly complex technical issues under Subchapter K of the Code, as the very complexity of this Report illustrates. Experience suggests that the inordinate complexity and many uncertainties associated with these rules operate as a real disincentive for QOs to invest in partnerships with debt-financed real estate. Indeed, it is simply impossible, even after the issuance of Notice 90-41, to be comfortable that the tax allocations involved in many common and legitimate partnership transactions pass muster under every possible scenario (which is how allocations must be tested). And the regulations to be issued under Section 514(c)(9)(B)(vi) have the potential to spawn additional complexity.

Without question, the fisc has a legitimate interest in preventing the disproportionate allocation of tax benefits from real estate partnerships with QO partners to taxable investors. We believe, however, that the heavily mechanical approach of the current form of Section 514(c)(9) is a considerably bigger stick than is needed to stem that flow. Since Section 514(c)(9)(B)(vi) first surfaced in 1984, numerous limitations have been imposed on both the amount of tax benefits that are generated by real estate partnership transactions and taxable partners' ability to utilize

such benefits to offset other income.^{4/} Many of those limitations were in effect when Section 514(c)(9)(B)(vi) was amended in 1986, 1987 and 1988, but it may be that the tremendous dampening effect of those limitations on tax-motivated real estate transactions was not fully appreciated by Congress during this annual amendment process. In light of the decline in the utility of real estate shelters to taxable investors, the need for severe UBIT-related limitations on their QO partners may now be considerably less.

Finally, given the current economic climate, especially the serious "credit crunch" affecting the real estate markets in the United States, it is particularly inopportune for the tax laws to be providing another disincentive to partnership investments by QOs in the absence of a clearly demonstrated policy need. In the current incarnation of Section 514(c)(9)(B)(vi), the pendulum has swung so far in the direction of preventing abuses by taxable investors that the original Congressional purpose underlying that provision--to encourage pension funds to invest in real property--has effectively been lost.

For these reasons, there is a strong sense among the members of the Committee that the current statutory provisions are in many respects simply unworkable, and as a result have had a chilling effect not just on the kinds of transactions at which Section 514(c)(9)(B)(vi) is justifiably directed, but on all

^{4/} Those limitations include lengthening of the depreciation period for real estate (from 18 to up to 40 years), the strengthening of the Section 704(b) regulations (especially the new "substantiality" test), the enactment of the passive activity loss limitation, the extension of the at-risk limitation to real estate investments, the reduction in the maximum tax rates on ordinary income and the strengthening of the alternative minimum tax.

forms of QO investment in real estate partnerships. Therefore, the Committee believes that a legislative reevaluation of these rules should be undertaken, and the Committee urges the Treasury Department to take the lead in initiating that review. Most of the complexity in this area would have been avoided had Congress retained the "principal purpose" test enacted in 1986, under which partnerships with nonqualified tax allocations could nonetheless avoid generating UBTI unless "the principal purpose of any [nonqualified] allocation ... is the avoidance of income tax".^{5/} The Committee recognizes that such a subjective test is more difficult to apply, both in planning and on audit. It does, however, have the distinct advantage of allowing well-intentioned QOs and their taxable partners to proceed with transactions without the fear that some arcane, undetected or un contemplated flaw in their partnership allocations will invoke a tremendous change in the QO's tax position.

As an alternative, consideration should be given to devising a system under which the focus of the Qualified Allocations Rule and the Fractions Rule is shifted to the taxable partners, with the burden of nonqualifying allocations resulting in disallowed losses to the taxable partners. One possibility would be the proposal by Arthur Feder and Joel Scharfstein for an elective system whereby Section 514(c)(9)(B)(vi) would be satisfied regardless of the partnership's tax allocations if all taxable partners in the partnership elected to not use any tax losses from the partnership except to offset future partnership

^{5/} See note 3 above

income (similar to the treatment of "master limited partnerships" under Section 469(k)). ^{6/} Finally, consideration also should be given to the complete repeal of Section 514(c)(9)(B)(vi).

In the meantime, in working with the current Code provisions, we urge the Treasury Department to make every effort to promulgate regulations that are as simple and reasonable as possible. For the reasons articulated above, we believe it is extremely important that regulations promulgated under Section 514(c)(9) not adopt an approach that appears to react to every conceivable possibility of abuse by imposing multiple safeguards.

The balance of this Report comments on specific issues arising under Section 514(c)(9). To illustrate the context of the issues, it may be helpful to consider an example of a typical real estate partnership between taxable investors and QOs: A limited partnership is formed with a developer as the general partner and outside investors, including QOs, as the limited partners. The limited partners contribute substantially all the partnership's equity capital. The partnership acquires a building with that equity capital and the proceeds of a nonrecourse loan from a third-party financial institution. Partnership cash

^{6/} See generally Feder and Scharfstein, Leveraged Investment in Real Property Through Partnerships by Tax Exempt Organizations After the Revenue Act of 1987—A Lesson in How the Legislative Process Should Not Work, 42 Tax Lawyer 55, 89-91 (1988) (hereinafter "Feder and Scharfstein"). The Committee acknowledges that the Section 469(k)-type approach would allow taxable partners to achieve "inside shelter" of partnership income and cash flow with special allocations of partnership loss and deductions, but regards that as a limited problem the prevention of which apparently was not one of the original purposes of Section 514(c)(9)(B)(vi). Moreover, the prevention of that abuse may not justify the retention of the current provision and all its associated complexity.

flow from ordinary operations is distributed first to the limited partners until they have received a specified rate of a return on their equity capital, and then x% to the limited partners and y% to the general partner. Proceeds from any capital transaction (i.e., a sale, financing or refinancing) are distributed first to the limited partners until they have received the specified rate of return on their equity capital and a return of such capital, and then x% to the limited partners and y% to the general partner (except that such proceeds are distributed in accordance with the capital account balances of the partners on the liquidation of the partnership). The limited partners have no negative capital account restoration obligation, but the general partner has a limited negative capital account restoration obligation that satisfies the requirements of Section 4.04 of Revenue Procedure 89-12, 1989-1 C.B. 798. Taxable income generally is allocated first to the limited partners to the extent of their accrued preferred return, and then x% to the limited partners and y% to the general partners; tax losses are generally allocated a% to the general partner and b% to the limited partners.

II. Reasonable Preferred Returns

Section 514(c)(9)(E)(ii)(II) of the Code grants the Treasury Department the authority to issue regulations allowing partnerships to pay "reasonable preferred returns or reasonable guaranteed payments" to their QO partners without violating the Fractions Rule. Section III of Notice 90-41 states that regulations will be issued pursuant to that authority providing that preferred returns and guaranteed payments to QO partners (and any associated allocations of gross or net income) will be

disregarded in applying the Fractions Rule if they satisfy certain requirements. While the Committee generally agrees with the approach taken in Notice 90-41 in this regard and strongly encourages the Treasury Department to issue regulations allowing reasonable preferred returns and reasonable guaranteed payments, it has the following comments on the approach described in Notice 90-41.

A. 120% of AFR Test Rate. Notice 90-41 indicates that a preferred return or guaranteed payment will satisfy the regulations only if the return to the QO for any taxable year does not exceed the amount of its unreturned capital (plus any accrued but unpaid preferred return or guaranteed payment from prior years) multiplied by the "maximum acceptable interest rate". The maximum acceptable interest rate is 120% of the highest applicable Federal rate (the "AFR") determined under Section 1274(d) that is in effect at any time during the period beginning when the right to the preferred return or guaranteed payment is first established pursuant to a binding written agreement and ending at the beginning of the period for which the return is computed. For this purpose, the taxpayer apparently may choose the highest of the short-term, mid-term or long-term AFR (without regard to the expected term of the investment).

The purpose behind imposing a cap on the amount of reasonable preferred returns presumably is to prevent the allocation of income to QO partners in excess of the amount of income that corresponds to a market rate of return for the debt-like component of their return on equity. Given that purpose, the

Committee believes that a test rate of 120% of the AFR to determine the reasonableness of a preferred return is too low.^{7/} That judgment is based in part upon the experience of the Committee members with ordinary real estate transactions. However, it should be intuitively obvious that the 120% of AFR test rate is too low, given that it is just 20% above the Federal government's borrowing rate and is lower than the borrowing rate for many real estate partnerships. In the context of a preferred return on an equity investment in a real estate partnership that, by definition, is subordinate to all partnership liabilities and inherently risky, one would expect a significantly higher rate of return. While the exact rate of preferred return an investor would demand from an equity investment in leveraged real estate would depend upon the nature of the property, the investor's share of residual profits, the amount of debt financing and other factors, experience suggests that a typical equity investor often would demand a preferred return on equity higher than 120% of the AFR.^{8/}

Since the members of the Committee are not economists, the Committee does not feel competent to recommend a particular test rate for the reasonableness of a preferred return. However, the Committee would like to make a few observations in this regard. Some members of the Committee believe that the interest disallowance rules in Section 163(e)(5) provide a helpful

^{7/} For reference, 120% of the highest annually-compounded AFR for March 1991 is 9.89%, which is not much more than the current prime rate of 9%.

^{8/} According to a recent survey of institutional real estate investors, investors currently expect a cash-on-cash return of 10.5% to 14% from their new real estate investments, depending on the property type. See Investors Putting Cash at the TOP of Their Deal Lists, 19 Pensions & Investments 8 (February 18, 1991). Even the lowest rate of return in that range would not satisfy the maximum acceptable interest rate test contained in Notice 90-41 based on the current AFR. See note 7 above.

benchmark. In essence, those rules treat returns on high-yield debt instruments in excess of the AFR plus six percentage points as being in the nature of returns on equity. Accordingly, such members recommend that the test rate under the regulations be the AFR plus six percentage points. ^{9/} However, the Section 163(e)(5) test obviously relates to the total return on the instrument, not just the preferred component of the total return. Also, the approach of simply adding six percentage points to the AFR may produce an inappropriately high test rate when the AFR is low and an inappropriately low test rate when the AFR is high. Other Committee members believe that it may be appropriate for the test rate to be tied to the returns on fixed-rate mortgage loans on real estate, since those returns are more closely related to returns on equity investments in real estate than the AFR. It should be noted that the American Bar Association has suggested the test rate might be 130% of the return on conventional first mortgage loans. ^{10/}

Some members of the Committee are troubled by the fact that the reasonable preferred return regulations will result in the Treasury fixing the maximum rate of preferred return for all types of real estate partnerships -- whether troubled or healthy, fully leased or under construction, heavily leveraged or heavily capitalized with equity and so on. Such members suggest that the reasonable preferred return regulations might follow the approach of the regulations under Section 168(h)(6), which use the AFR as an example of a reasonable rate of return for a guaranteed payment and state that guaranteed payments at a higher rate will

^{9/} For March 1991, that rate would be 14.21% with annual compounding.

^{10/} See letter dated January 10, 1991, from the American Bar Association Section of Taxation to Fred T. Goldberg, Jr., reproduced in Tax Analysts, Highlights & Documents (January 16, 1991) at 507-513. As an alternative, the American Bar Association suggested 160% of the AFR.

be "closely scrutinized". ^{11/} That approach essentially uses an AFR-based rate as a safe harbor, but does not preclude the possibility of other rates being treated as reasonable under appropriate circumstances. Such flexibility would be particularly important if the 120% of AFR test rate proposed in Notice 90-41 is not increased significantly.

B. Current Distribution Problem. Notice 90-41 provides that the allocation of gross or net income to give effect to a QO's reasonable preferred return for any taxable year will not be disregarded in applying the Fractions Rule if the amount of income so allocated exceeds the excess of (i) the aggregate amount of distributions of such preferred return to the QO partner through the end of such taxable year over (ii) the aggregate amount of income allocated to the QO partner in respect of such preferred return in prior taxable years. ^{12/} In other words, if a partnership does not make distributions that are at least equal to the accrued preferred return, the income allocated to the QO to give effect to the preferred return will be taken into account in applying the Fractions Rule (and will likely cause the partnership to fail the Fractions Rule test).

Since a QO may not be allocated any income in respect of the amount of any accrued but unpaid return as of the end of any taxable year, it cannot increase its capital account balance on a current basis to reflect its entitlement to that return. Moreover, it will not be able to increase its capital account balance (and therefore receive such return) in subsequent years unless the partnership realizes sufficient income in such years.

^{11/} Treasury Regulation Section 1.168(j)-1T, Q-25.

^{12/} For purposes of this rule, cash distributions made within 75 days after the end of such taxable year are deemed to have been made during such taxable year.

Notice 90-41, therefore, imposes a very difficult choice on the QO: the QO must either take the economic risk that it will not receive any accrued but unpaid preferred return or accept the consequences of UBTI. Consider the following example:

Example (1): Taxable developer T and a QO form a partnership, with the QO contributing \$100 in cash. The partnership acquires an office building for \$200, using QO's equity contribution and \$100 of proceeds from a nonrecourse bank loan. The partnership's available cash flow is to be distributed first to QO until it has received a 10% per annum preferred return on its equity contribution and then 50% to QO and 50% to T; proceeds from capital transactions are to be distributed to first QO until it has received its 10% preferred return on, and a return of, its equity contribution and then 50% to QO and 50% to T (except in connection with a liquidation of the partnership, in which case such proceeds would be distributed in accordance with the capital account balances of the partners). In accordance with Notice 90-41, the partnership's profits generally are to be allocated to QO to the extent of any current or prior distributions of its 10% preferred return and then 50% to QO and 50% to T. In year 1, the partnership has rental income of \$25, interest and operating expenses of \$10 and depreciation of \$5 (resulting in profits of \$10 and cash flow of \$15). Its \$15 of cash flow is used to fund tenant improvements for the building, so no cash distribution is made. Its \$10 of profits, therefore, are allocated \$5 to QO and \$5 to T. The partnership sells the property at the beginning of year 2 for \$210 (its adjusted tax basis, so no gain or loss is realized) in cash, pays off the bank debt of \$100 and liquidates. The \$110 of net proceeds are distributed in accordance with the capital account balances of the partners, which are \$105 for QO and \$5 for T. As a result, QO receives \$5 less than it is entitled to under the business deal of the partners. This would not have resulted, however, if the partnership had been permitted to allocate all \$10 of its profits in year 1 to QO. ^{13/}

Thus, the income allocation limitation in Notice 90-14 effectively means that there can be no assurance that a reasonable preferred return that is not distributed on a current basis will ever be received. ^{14/}

The Committee strongly urges that the regulations permit partnerships to allocate income to reflect the entitlement

^{13/} It should be noted that QO would have received its full \$10 return if the sale were made at the end of year 1, or would have received a full \$20 return on a sale at the end of year 2 (assuming that the operating results in year 2 were the same as in year 1).

of a QO to a preferred return as it accrues, regardless of whether cash is distributed on a current basis. It is very common for real estate partnerships, especially in development situations, to generate insufficient cash flow in the early years of operations to service the preferred returns of their partners on a current basis. This is caused by the need to fund nondeductible expenditures (including reserves), the accrual of income before the receipt of cash and other factors. Notice 90-41 imposes a real business problem for partnerships that include QOs, and as a result the reasonable preferred return rule described in the Notice is not useful as a practical matter.

Furthermore, the income allocation limitation in Notice 90-41 seems to reflect an excess of caution. The apparent concern is that allocations of income to give effect to a preferred return are somehow illusory and only tax motivated unless the preferred return is actually paid currently. The reasonable preferred return rules already require that the entitlement to a preferred return be set forth in a written partnership agreement; it would be very unusual for a QO to fail to pursue a legally enforceable right to a preferred return. QOs generally act as fiduciaries and their rights to preferred returns are negotiated carefully and, in the experience of Committee members, are enforced. In addition, the preferred return rules already require that the return be computed with respect to the QO's actual investment and (as discussed above) that it yield a debt-like rate of return. There is, therefore, a cap on the amount of income that can be allocated to the QO. Finally, the substantial economic effect requirement of Section 514(c)(9)(E)(i)(II) ensures that accrued but unpaid returns are in fact reflected in capital accounts and have economic effect.

^{14/} For reasonable guaranteed payments, there is an explicit current distribution requirement in Notice 90-41.

Given all of those safeguards, it seems not only unrealistic but also unnecessary to impose the income allocation limitation contained in Notice 90-41. The only type of limitation that might be necessary to prevent income allocations falling outside the purposes of the reasonable preferred return rule would be a requirement that the preferred return rate be either a fixed rate or a floating rate tied to an index that reflects interest rates for lending transactions or to an index that measures the rate of inflation. That should prevent taxpayers from using the reasonable preferred return regulations to validate income allocations that give effect to investment returns tied to partnership profits or some other contingency that does not represent a normal preferred return on equity.

C. Other Technical Issues. There are other technical issues presented by the reasonable preferred return rule. First, Notice 90-41 states that the AFR to be used in determining the maximum acceptable interest rate shall be "appropriately adjusted for the length of the period and the period of compounding". It is unclear what the "length of the period" language means, especially given that Notice 90-41 appears to provide that the taxpayer may select the highest of the short-term, mid-term or long-term AFR as the maximum acceptable interest rate. This language should be clarified or deleted in the regulations.

Second, the regulations should clarify that a preferred return based upon a simple (i.e., noncompounded) rate of return is allowable. That literally is the result under Notice 90-41, since the maximum reasonable preferred return is a dollar amount computed by multiplying the maximum acceptable interest rate by the amount of the investor's unreturned capital plus any accrued but unpaid preferred return from prior periods. That amount by

definition will always exceed a simple preferred return computed at the same interest rate under the same circumstances. However, the aforementioned "period of compounding" language in Notice 90-41 arguably suggests that this was not intended. This is an important clarification, as noncompounded preferred returns are common for real estate partnerships.

Third, the relevant AFR should include the AFR as in effect through the end of the period for which the preferred return is computed, not just the AFR through the "beginning" of such period as indicated in Notice 90-41. Since Notice 90-41 adopts the concept that a reasonable preferred return may be based upon current market interest rates, there is no reason why the relevant AFR should not include the most current AFR possible. ^{15/}

Fourth, the regulations should clarify how the maximum acceptable interest rate is determined where a QO acquires another person's interest in an existing partnership. One approach would be to provide that the maximum acceptable interest rate test be based on the maximum AFR in effect at any time beginning on the date on which the QO enters into a binding contract to acquire the interest; if that test rate is satisfied, and provided the other requirements for a qualified return are met as well, any items of income allocated, and any cash

^{15/} As a practical matter, the approach of allowing a preferred return to qualify based on the AFR at the time the return is calculated generally would be applicable only to partnerships with floating-rate preferred returns tied to the AFR. Presumably QOs would not invest in any partnership with a fixed-rate preferred return (or floating-rate preferred return not tied to the AFR) in excess of the "maximum acceptable interest rate" in effect at the time the investment is made, even if the AFR were expected later to increase, since at least the initial income allocations to the QO would not satisfy the Fractions Rule. It should be noted in this connection that it is not clear whether the Fractions Rule would be deemed to be satisfied in any such case on a prospective basis if the AFR later did increase sufficiently to cause the maximum acceptable interest rate to exceed the preferred return rate.

distributed, to the QO after its acquisition of the interest in respect of its preferred return would be excluded in applying the Fractions Rule. Another approach would be to provide that the purchasing QO steps into the shoes of the original holder of the interest, with the preferred return's status as either qualified or disqualified being determined as if the selling partner were a QO. The theory for such a rule is that the tax allocations of a partnership should not be abusive if they simply give effect to a preferred return that represented a reasonable rate of return at the time the partnership was organized. However, that rule should not apply if there is a material change to the terms of the partnership agreement in connection with the QO's acquisition of its interest. ^{16/} Whatever approach is taken by the regulations, it also should be made clear that the Fractions Rule is not applied to a partnership until it has QO partners. A prior failure of a partnership among taxable persons to satisfy the Fractions Rule should not taint the partnership if it is clear that, from and after the entry of the QO, the Fractions Rule will be satisfied.

D. Guaranteed Payments. Unlike preferred returns, guaranteed payments under Section 707(c) do not involve any corresponding income allocations. Thus, the allocation aspects of the reasonable preferred return rule are not applicable in the case of a guaranteed payment. Indeed, it is not apparent why any special rules are required to enable partnerships qualifying

^{16/} That rule also may require resolving the issue described in the last sentence of note 15 above.

under the Fractions Rule to make guaranteed payments to their QO partners. In any event, the comments in sections A and C above should apply to the reasonable guaranteed payment aspect of the regulations described in Section III of Notice 90-41.

Furthermore, the current distribution requirement should be eliminated for guaranteed payments as well.

III. The Unlikely Allocation Exclusion

A. Background. Section 514(c)(9)(E)(iii) of the Code grants the Treasury Department authority to issue regulations permitting the exclusion or segregation of allocations of items of partnership income or loss in determining whether there has been a violation of the Fractions Rule. The legislative history of Section 514(c)(9)(E)(iii) indicates that Congress intended that the Fractions Rule prohibit special allocations of items of loss and deduction that are designed to shift tax benefits to taxable partners, but that it permit nonabusive special allocations.^{17/} Notice 90-41 indicates that the Treasury Department will exercise its regulatory authority to exclude from the Fractions Rule any items of loss or deduction that are specially allocated to taxable partners if the special allocation satisfies three requirements:

1. The special allocation of items of loss or deduction to a taxable partner will be made only after no QO partner has a positive capital account balance;

2. The partnership has an overall loss for the taxable year, determined taking into account all items of deduction or loss other than nonrecourse deductions and all items of income and gain other than items allocated pursuant to Section 704(b) minimum gain chargebacks, and the amount allocated to a taxable partner does not exceed the amount of the overall loss; and

3. As of the time the special allocation becomes part of the partnership agreement or as of the time of any "extraordinary

^{17/} S. Rep. No. 445, 100th Cong., 2d Sess. 428 (1988).

partnership event" (i.e., a material contribution to the partnership by one or more partners or a material distribution by the partnership to one or more partners), the special allocation is unlikely to occur.

Notice 90-41 refers to this rule as the "Unlikely Allocation Exclusion". The purpose of the Unlikely Allocation Exclusion is to permit certain kinds of special allocations that are not designed for the purpose of shifting tax benefits to taxable partners. An example of a special allocation satisfying the three requirements of the Unlikely Allocation Exclusion is the following:

Example (2): Taxable developer T contributes \$100 and QO contributes \$900 to a partnership. The partnership borrows additional funds and constructs an office building. The partnership agreement allocates losses first 10% to T and 90% to QO until QO's capital account has been reduced to zero, and thereafter 100% to T. Profits are allocated first to reverse prior allocations of loss and then 50% to T and 50% to QO. Bona fide financial projections indicate that the construction and operation of the office building by the partnership are unlikely to result in a partnership loss after QO's capital account has been reduced to zero. After several years of partnership operation, the partnership incurs an unanticipated tort liability in excess of insurance coverage of \$300, during a year in which its overall loss is \$250. T contributes \$300 to the partnership to fund the tort liability. Assuming that following such contribution T's capital account balance equals \$320 and QO's capital account balance equals \$180, the first \$200 of the \$250 loss for the year is allocated \$180 to QO and \$20 to T and the remaining \$50 of loss is allocated to T.

B. Comments on the Unlikely Allocation Exclusion.

The Committee believes that, if an event triggering a special allocation of items of loss or deduction to a taxable partner is truly unlikely to occur, and the taxable partner in fact must bear the economic burden of that loss or expense, the requirements that the QO's capital account first be reduced to zero and that the amount of the special allocation not exceed the amount of overall loss do not further the Congressional intent and are not necessary to prevent the types of abuses at which Section 514(c)(9)(B)(iv) is directed. Moreover, those requirements interfere with partners' legitimate economic

arrangements. Taxable partners in real estate limited partnerships often fund losses relating to cost overruns and other unlikely expenses, and are specially allocated the tax losses corresponding to such expenses, whether or not the QO's capital account has first been reduced to zero. The adverse effect the Unlikely Allocation Exclusion may have on economic arrangements of a partnership is illustrated in example (2) above, where QO was forced to bear \$180 of loss that was intended to be borne by T. In that example, and in many other situations, an unnecessary distortion is caused by the requirement in Notice 90-41 that the QO's capital account must be reduced to zero before a special allocation of losses to a taxable partner is permissible. The Committee therefore believes that regulations should not include a zero capital account requirement.

Similarly, the requirement that the amount of specially allocated losses and deductions not exceed the amount of overall losses also may distort partners' economic arrangements. Again, this can be illustrated by an example.

Example (3): Taxable developer T contributes \$20 and QO contributes \$180 to a partnership. Partnership cash flow generally is distributed 10% to T and 90% to QO until each has received a return of, and a 10% preferred return on, its capital and then 50% to T and 50% to QO. The partnership agreement generally allocates profits 10% to T and 90% to QO to the extent that each has received its preferred return and then 50% to T and 50% to QO? losses generally are allocated first to offset any undistributed profits that have been allocated 50-50 and then 10% to T and 90% to QO. The partnership borrows \$800 and purchases an existing office building for \$1,000. T agrees to bear the cost of any tenant improvements to the building in excess of the partnership's cash flow, although the parties believe that it is unlikely that any such excess costs will be incurred. In each of the first five years, the partnership has net rental income of \$120, interest expense of \$70 and depreciation of \$40, resulting in cash flow of \$50 (which is distributed \$5 to T and \$45 to QO) and profits of \$10 (which are allocated \$1 to T and \$9 to QO). The capital account balances at the end of year 5 are zero for both partners. In year 6, the partnership's operations are the same, except that tenant improvement costs of \$100 are incurred as a result of the unexpected departures of several tenants at the end of that year. T contributes \$50 to the partnership to fund the \$50 of tenant improvement costs in excess of cash flow. Because no overall loss was incurred for the year, T may not be

specially allocated any items of loss or deduction. The capital account balances of the parties at the end of year 6 are \$51 for T and \$9 for QO. The building is sold at the beginning of year 7 for \$860 (resulting in no profit or loss). The debt of \$800 is paid off and the \$60 of net proceeds are distributed in accordance with the capital account balances of the parties, resulting in T receiving \$51 and QO receiving \$9. This is contrary to the business deal of the partners, since the business deal would require that the proceeds be distributed \$6 to T and \$54 to QO.

The foregoing type of business problem is even more likely to occur if the no positive capital account requirement is eliminated, as recommended above. In any event, the limitation of the amount of the special allocation to the amount of the Partnership's overall loss should be eliminated.

The Committee believes that, where the partnership agreement specifically requires a taxable partner to fund a partnership expense that is unlikely to occur, and where the special allocation of related items of deduction and loss to the taxable partner would have substantial economic effect, such special allocation should be excluded from the Fractions Rule. Such an exclusion is appropriate whether such expenses are funded contemporaneously or are paid from a special partnership reserve previously funded by the taxable partner. Furthermore, the rule is appropriate where the taxable partner's "funding" of the expenditure is through loans to the partnership for which the taxable partner (or a related party) bears the economic risk of loss within the meaning of Section 752 of the Code. In all these cases, (i) we are dealing with an unlikely event, (ii) there is a written and enforceable requirement that the taxable partner bear the loss and (iii) the allocation of the loss or deductions has substantial economic effect. Those safeguards are, we believe, sufficient to prevent abuse and render the further requirements imposed under the Notice unnecessary and unrealistic.

With regard to the "unlikely to occur" requirement, Notice 90-41 adopts a rather vague standard that will no doubt cause considerable disputes upon audit. It would be helpful for the regulations to include a nonexclusive list of events that are presumed to be unlikely to occur, such as those indicated in the Notice.

IV. Chargebacks

A. Background. Section 514(c)(9)(E)(ii)(I) provides as follows:

"Except as provided in regulations, a partnership may . . . provide for chargebacks with respect to disproportionate losses previously allocated to [QOs] and disproportionate income previously allocated to other partners. Any chargeback referred to in the preceding sentence shall not be at a ratio in excess of the ratio under which the loss or income (as the case may be) was allocated."

Thus, under Section 514(c)(9)(E)(ii)(I), a chargeback will be a qualifying chargeback only if (i) it is a chargeback of a prior "disproportionate" allocation and (ii) it satisfies the "ratio test" described in the last sentence of Section 514(c)(9)(E)(ii)(I). Notice 90-41 does not specifically address chargebacks, but it does request comments on that topic.

The Committee recommends that regulations be issued defining the types of chargebacks that qualify under the Fractions Rule. In addition, as explained below, the regulations should provide that any qualifying chargeback should be ignored in determining overall income and loss in applying the Fractions Rule. Specifically, any income or loss (or items thereof) allocated pursuant to a qualifying chargeback should be ignored in determining (i) each QO's share of overall partnership income in each year and (ii) each QO's smallest share of overall partnership loss. In addition, the regulations should make clear

that particular items of income, gain, loss or deduction for the year of the chargeback (and not merely overall income or loss for such year) may be used to reverse prior disproportionate overall allocations (as well as prior disproportionate item allocations to which the chargeback rule may be extended). ^{18/} The Committee also recommends that the regulations include a specific rule under which minimum gain chargebacks and partner minimum gain chargebacks will generally be ignored in determining compliance with the Fractions Rule. ^{19/}

B. Identifying "Disproportionate" Allocations.

The starting point for applying these rules is determining when an allocation is "disproportionate". The Code does not indicate what constitutes a disproportionate allocation, and the legislative history provides only a single example involving a relatively simple case. ^{20/} One approach, which is consistent with that example, would be to define a disproportionate allocation as follows: (i) an allocation of overall loss to a QO in a particular year would be disproportionate if the QO's share of overall loss for the year exceeds the QO's smallest share of overall loss for any year; and (ii) an allocation of overall income to a taxable partner for any year would be disproportionate if such taxable partner's share of overall

^{18/} Such regulations could be viewed either as an interpretation of the chargeback provision itself or an exercise of the authority under Section 514(c)(9)(E)(iii) to issue regulations that provide for the exclusion or segregation of items.

^{19/} See section IV(F) below, which summarizes the Committee's recommendations with respect to such chargebacks.

^{20/} The conference report on the 1987 Act describes a partnership that allocates all items of income, gain, loss and deduction 50% to T and 50% to QO, except that the first \$1,000 of loss is allocated 80% to QO and 20% to T. After an overall loss of \$1,000 in 1988, allocated \$800 to QO and \$200 to T, the partnership has overall income of \$500 in 1989. The report states that the \$500 of income in 1989 may be disproportionately allocated to QO to offset the disproportionate allocation of loss to QO in 1988. H.R. Conf. Rep.

income for the year exceeds such partner's smallest share of overall partnership income for any year. This definition is illustrated by the following example.

Example (4): Taxable developer T contributes \$100 and QO contributes \$1,100 to a partnership. Losses are allocated first 50% to T and 50% to QO until T's capital account is reduced to zero and thereafter 100% to QO. Profits are allocated first to charge back any losses allocated 100% to QO and thereafter 50% to T and 50% to QO. Any losses allocated 100% to QO should be considered to be disproportionately allocated (and accordingly eligible for chargeback), since that allocation ratio exceeds QO's smallest share of overall loss for all other years (50%).

The above definition of "disproportionate," however, has an element of circularity in some cases. For example, in cases where the partnership agreement provides for chargebacks of both income and loss allocations, the determination of a QO's smallest share of overall loss (which is necessary to determine whether a loss allocation is disproportionate) requires a determination of whether income allocations to the taxable partners are disproportionately large (i.e., the extent to which losses allocated to taxable partners to reverse prior income allocations are to be ignored in computing a QO's smallest share of overall loss). This assumes that chargebacks of disproportionate income allocations to taxable persons should be ignored in determining overall profit and loss.

Example (5): Taxable developer T contributes \$100 and QO contributes \$1,100 to a partnership. Profits are allocated first to reverse prior 100% loss allocations to QO, then 50% to T and 50% to QO until QO attains a specified return on its investment and finally 70% to T and 30% to QO. Losses are allocated first to reverse prior 70/30 profit allocations, then 50% to T and 50% to QO until T's capital account is reduced to zero (which in part may be a reversal of prior 50/50 profit allocations) and finally 100% to QO. This is essentially the same as example (4) above, except that a provision has been added allocating profits 70% to T and 30% to QO after QO attains its specified return and reversing any such profit allocations if there are subsequent losses. The Fractions Rule is not violated by providing for

the higher profit ratio to T after QO attains its specified return. It seems clear that the reversal of any 100% loss allocations to QO should be considered a chargeback of disproportionate losses; it also seems clear that the Fractions Rule should not be considered to be violated by reason of a provision for a reversal of the 70/30 profit allocation if there are subsequent losses and that such a reversal is within the scope of the chargeback exception. Note that QO's smallest share of overall losses will be 30% (causing the 50/50 allocation of losses to be considered "disproportionate"), unless the reversal of the 70/30 profit allocation is classified as a chargeback and as such is ignored in determining the partners' shares of overall loss.

The regulations would be greatly simplified if it were not necessary to distinguish those allocations that are disproportionate from those that are not. Fortunately, as explained below, there is no reason for the regulations to have to include a mechanism for identifying a disproportionate allocation: under one provision of the statute or another, all chargebacks that meet the ratio test discussed below should be permitted. This conclusion follows because all chargebacks fall within one of the following three categories (using chargebacks of loss to a QO as the illustration): First, chargebacks of disproportionately large losses to the QO; second, chargebacks of loss allocations to the QO that are neither disproportionately large nor disproportionately small; and third, chargebacks of disproportionately small loss allocations to the QO. A loss allocation to the QO within the first category is within the explicit scope of the chargeback exception of Section 514(c)(9)(E)(ii)(I). If a loss allocation is in the second category, then a reversal of that allocation by means of an income allocation to the QO should itself qualify under the Fractions Rule without regard to any special chargeback provision (provided that the regulations adopt the interpretation of the

ratio test described in section D below). ^{21/} If a loss allocation to the QO is in the third category (i.e., it is disproportionately small), then either (i) there would have been a violation of the Fractions Rule at the time of the prior loss allocation, in which case whether the chargeback itself qualifies is irrelevant, or (ii) the chargeback would qualify as a first category chargeback with respect to another QO partner. ^{22/} Thus, in all cases in which the Fractions Rule is satisfied with respect to the initial loss allocation to a QO, such loss allocation should be able to be reversed without violating the Fractions Rule, either by reason of the application of the Fractions Rule itself to such chargeback or pursuant to a regulation permitting chargebacks of disproportionate loss

^{21/} For example, in the case of the partnership in example (4) above, a chargeback of losses that were allocated 50% to QO and 50% to T would not violate the Fractions Rule, since the 50% profit allocation to QO would not exceed its smallest share of losses. In addition, treating an exactly proportionate loss allocation differently, and particularly less favorably, than a slightly disproportionate loss allocation would make no sense. Partnerships wanting to use the rules for disproportionate allocations could use self help by including a savings clause which turns otherwise proportionate allocations into disproportionate allocations by slightly increasing the share of loss allocable to QO or profits allocable to T.

^{22/} Clearly, if a disproportionately small loss allocation to a QO results in a disproportionately large allocation to a taxable partner, the Fractions Rule will be violated; if it results in a disproportionately large loss allocation to some other QO partner, the chargeback would qualify as a first category chargeback with respect to such other QO. In addition, if, as discussed above, a loss allocation to a QO were defined as being disproportionately large whenever it exceeded such QO's smallest share of overall loss (and proportionate whenever it equalled the QO's smallest share of overall loss), it would be impossible by definition for any overall loss allocation to the QO to be disproportionately small. Moreover, under that definition, a disproportionately small loss or deduction item allocation to a QO in any year (other than an allocation that is ignored for purposes of the Fractions Rule) would have to be offset in all events in the same year by other disproportionate item allocations to avoid the potential for the QO having a disproportionately small share of overall loss for the year. Any disproportionately small item allocation that is offset in all events by another item allocation in the same year would generally not be considered to satisfy the substantiality requirement of Treasury Regulation Section 1.704-1(b)(2)(iii).

allocations.^{23/} The same analysis applies to disproportionate income allocations to taxable partners.

C. Chargebacks of Prior Disproportionate Item

Allocations. In some cases, the Section 704(b) regulations require a disproportionate allocation of items of loss or deduction (or items of income) that does not result in a violation of the Fractions Rule in the year of such allocation, and where there is either no overall loss (or overall income) or the overall loss (or overall income) is less than the amount of items of loss and deduction (or income) so allocated. In such cases, while the original disproportionate allocation would not violate the Fractions Rule, the corresponding chargeback may, unless it is ignored in applying the Fractions Rule.

Example (6): QO and taxable developer T contribute \$1,000 and \$0, respectively, to a partnership. Neither partner has an obligation to restore any negative capital account. Cash flow from operations is distributed 50% to QO and 50% to T; proceeds from any capital transaction are distributed first \$1,000 to QO and then 50% to QO and 50% to T. Losses (computed for this purpose by treating gross income allocations as deductible expenses) are allocated 100% to QO. Gross income is allocated to the partners to the extent of and in proportion to cumulative distributions of operating cash flow; any remaining net income is allocated first to reverse prior loss allocations and then 50% to QO and 50% to T. The partnership borrows \$1,000 on a nonrecourse basis and acquires a building for \$2,000. In year 1, the partnership has \$200 of net cash flow from operations (which equals its net income before depreciation) and \$100 of depreciation. The cash flow is distributed equally to QO and T and, accordingly, each is allocated a corresponding amount of gross income. The remaining \$100 of net loss for the year is allocated entirely to QO, leaving QO with a net allocation of \$0 for the year. In year 2, the building is sold for \$2,000, resulting in income of \$100, and this income is allocated entirely to QO to reverse the year 1 loss allocation. The \$100 income allocation to QO should be a qualifying chargeback, notwithstanding that QO was not allocated any "overall loss" for year 1 and that the

^{23/} This assumes that, in the case of allocations that would violate the Fractions Rule but for the Unlikely Allocation Exclusion, reversals of such allocations also would be protected under the Unlikely Allocation Exclusion.

partnership had overall income of \$100 for year. ^{24/}

Neither the statute nor the legislative history specifically limits permitted chargebacks to those that reverse prior allocations of overall income or overall loss. The regulations should provide sufficient flexibility to accommodate chargebacks of item allocations. The Committee recommends that the regulations treat chargebacks of item allocations under a partnership agreement as qualifying chargebacks (subject to the ratio test described below), provided that the partnership's allocations for the year of the item allocation being reversed, determined without regard to such item allocation, would satisfy the Fractions Rule. ^{25/} For instance, in example (6) above, the chargeback in year 2 would be a qualifying chargeback under this rule, since the partnership's \$200 of overall income in year 1, determined without regard to the \$100 of loss disproportionately allocated to QO, is allocated 50/50, which allocation is consistent with the Fractions Rule.

D. The Ratio Test. Under the statute, permitted chargebacks may not be at a ratio in excess of the ratio under which the loss or income (as the case may be) was allocated. ^{26/}

^{24/} Example (6) is similar to the partner nonrecourse debt example in Weitz, Unresolved Issues Remain for Qualified Organizations in Real Estate Partnerships, 73 J. Taxation 332, 336-7 (November 1990), except that in the Weitz example QO guaranteed \$1,000 of additional partnership borrowings instead of making a \$1,000 capital contribution, and the chargeback was "forced" under the partner nonrecourse debt provisions of the Section 704(b) regulations. The result should be the same whether QO contributed \$1,000 (as in example (6) above) or guaranteed \$1,000 of nonrecourse debt (as in the Weitz example). A distinction between the two examples would place an undue emphasis on form rather than substance.

^{25/} The proviso of this rule may be unnecessary, at least in the case of specific (as opposed to automatic pro rata) item allocations under a partnership agreement, in view of the requirement that the Fractions Rule be satisfied in all events and the substantiality requirement of the Section 704(b) regulations. See note 22 above.

^{26/} Section 514(c)(9)(E)(ii)(I).

Thus, chargebacks may be slower, but not faster, than they might otherwise be absent this restriction. ^{27/}

The Fractions Rule imposes limitations on the tax allocations that a partnership may have in order to prevent tax abuse. The statute requires that the Fractions Rule be satisfied for each taxable year that a QO is a member of the partnership, and thus is keyed to the annual tax accounting concept. Chargebacks of a partnership's allocations made in a prior period generally present a much lower potential for tax avoidance than do its primary allocations. Chargebacks, by their fundamental nature and purpose, do no more than reverse prior allocations and are designed to produce the same economic result as if the partnership were able to use multiple-year or cumulative accounting periods. Basic issues of fairness among the partners usually ensure that chargebacks have this limited function, and the regulations would be unjustified in adopting a ratio test that was not sufficiently flexible to permit the typical chargeback.

The regulations should make clear that chargebacks may be tailored so as to reverse the allocations they are intended to offset and, therefore, that the "ratio" is not necessarily computed by reference to the overall income or loss for the year the allocations of which are to be reversed.

Example (7): Assume QO contributes \$1,100, and taxable developer T contributes \$100, to a partnership. Losses are allocated first 50% to QO and 50% to T until T's capital account is reduced to zero and thereafter 100% to QO. Profits are allocated first to QO to charge back any disproportionate allocation of losses and thereafter 50% to QO and 50% to T. The partnership realizes losses of \$400 in year 1 and \$100 in

^{27/} 1987 Act Conference Report at 956. The example described in note 19 above states that the \$500 chargeback in 1989 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 chargebacks, and that thus no more than \$400 of income can be charged back to the QO in 1989.

year 2. In year 3, the partnership realizes \$300 of profits. Under the partnership agreement, the \$400 of losses in year 1 are allocated \$300 to QO and \$100 to T, and the \$100 of losses in year 2 are allocated entirely to QO. The \$300 of profits in year 3 should be permitted to be allocated entirely to QO to reverse the loss allocations to QO. In particular, it should not be necessary to allocate such profits either (i) in the ratio in which aggregate losses for the prior years were allocated (4:1, or \$240 to QO and \$60 to T) or (ii) to reverse the year 2 losses f i.e., \$100 to QO) with the balance allocated pursuant to the overall loss ratio for year 1 (i.e., 3:1, or \$150 to QO and \$50 to T). If in year 4 there were another \$100 of profits, the profits would have to be allocated \$50 to QO and \$50 to T to reverse the loss allocations properly.

It is not clear how a general loss reversal regulation that would address example (7) and other relevant cases should be drafted. The regulation could require that losses be reversed in the amounts and the inverse order of priority in which they were allocated under the partnership agreement. For example, if \$100 of losses were allocated in ratio 1 and thereafter \$200 of losses were allocated in ratio 2, the rule might be that a chargeback would qualify if the first \$200 of income were allocated in ratio 2 and the next \$100 of income were allocated in ratio 1. Such a rule would lead to the right result in example (7). However, that rule would be neither simple (since it requires an analysis of loss allocation priorities under the partnership agreement) nor sufficiently flexible to address all relevant cases. ^{28/}

^{28/} In particular, the rule would not produce the appropriate result where loss allocation ratios vary primarily with time rather than on a time-invariant basis, since the time that a loss is incurred does not necessarily reflect its economic priority under the partnership agreement. For example, consider a partnership to which QO and taxable developer T each contribute \$1,000; losses are allocated 70% to QO and 30% to T for year 1 and thereafter 50% to QO and 50% to T; and profits are allocated 50% to QO and 50% to T in all years after a chargeback of prior losses in the proportion that cumulative losses for prior years were allocated. There is no particular reason for requiring that any losses allocated in the 50/50 ratio should have to be charged back first. In addition, it is not easy to see how to adjust the rule to provide for chargebacks at a slower rate than the maximum permitted under the ratio test.

A better approach would be a simple rule that the statutory ratio test would be satisfied as long as it is satisfied with respect to each separate chargeback under the partnership agreement. This in fact is the typical arrangement for many partnerships. This approach would produce the right result in example (7), i.e., that the chargebacks there would be qualifying chargebacks. However, if under the partnership agreement and the facts of example (7), \$100 of income in year 4 were allocated all to QO, that allocation would not be a qualifying chargeback, since the ratio test applied to the partnership allocation that it purports to reverse (the first \$200 of losses allocated equally to QO and T) would be violated.

The regulations should also make it clear that a chargeback under this rule may reverse any blended combination of prior allocations. For example, if under a partnership agreement \$100 of loss is allocated \$50 to QO and \$50 to T and the next \$100 of loss is allocated \$70 to QO and \$30 to T, it should be possible to allocate \$150 of subsequent income (i) \$50 to QO and \$50 to T to reverse the \$100 50/50 loss allocation, and the balance 35/15 to reverse \$50 of the 70/30 loss allocation, (ii) \$70 to QO and \$30 to T to reverse the \$100 70/30 loss allocation, and the balance \$25 to QO and \$25 to T to reverse \$50 of the \$100 50/50 loss allocation or (iii) on a combination basis (e.g., \$80 of the loss charged back 70/30 and \$70 of the loss charged back 50/50).

E. Using Items to Effect Chargebacks. If there has been a prior disproportionate allocation of loss, there is no reason that items of gross income should not be able to be used to reverse that loss, even where there is no overall net income for the year of the chargeback (subject, of course, to the substantial economic effect regulations). Neither the statute nor

the legislative history specifically requires that overall income or loss be used to effect the chargeback. Similarly, if there has been a prior disproportionate allocation of income, this should be reversible by allocations of items of loss and deduction, even if there is no overall loss for the year (again subject to the substantial economic effect regulations). If any such items were so allocated as chargeback items, they should be ignored in computing overall profit and loss for the year, and overall profit and loss so computed would have to satisfy the Fraction Rule.

The ability to use items to effect chargebacks is needed to enable a partnership agreement to include a minimum gain chargeback without violating the Fractions Rule. For example, consider a partnership to which QO contributes \$1,100 and taxable developer T contributes \$100 and that has allocations similar to those in example (7) and that has a minimum gain chargeback. The partnership borrows \$8,800 from a bank on a nonrecourse basis with no amortization for 5 years, and buys depreciable property for \$10,000. In the first year, the partnership breaks even on net operating income and depreciation is \$1,200. Thus, at the end of year 1, capital accounts are all zero and the basis of the property is \$8,800. Assume at the beginning of year 2 the partnership borrows an additional \$1,000 on a nonrecourse basis secured by the property and distributes the proceeds to QO. This additional borrowing results in a \$1,000 increase in partnership minimum gain, all of which is allocated to QO. ^{29/} Assume that in year 2 the partnership has \$500 of depreciation and \$1,500 of net operating income, all of which is used to repay debt. The net decrease in partnership minimum gain for year 2 is \$1,000, all of which is allocable to QO. Thus, QO

^{29/} Treasury Regulation Section 1.704-1T(b)(4)(iv)(f).

must be allocated \$1,000 of gross income, leaving zero net income to be allocated. ^{30/}

Minimum gain chargebacks and partner minimum gain chargebacks are effected in the manner mandated by the Section 704(b) regulations. Moreover, in a given partnership, it may be difficult if not impossible to confirm that the operation of such chargebacks would not potentially violate the ratio test. These chargebacks generally present little potential for abuse. In view of these considerations, the Committee recommends the regulations include a specific rule under which chargebacks required under the Section 704(b) regulations will generally be ignored in determining compliance with the Fractions Rule.

F. Summary. In summary, the Committee recommends that regulations adopt the following chargeback rules: First, subject to the ratio test, reversals of prior overall income or overall loss allocations should not be taken into account in computing overall income and loss for purposes of determining whether there is compliance with the Fractions Rule. Second, subject to the ratio test, reversals of prior allocations of items of income, gain, loss or deduction should not be taken into account in computing overall income and loss for purposes of determining whether there is compliance with the Fractions Rule, provided that the Fractions Rule would have been satisfied based on overall income and loss computed without regard to the items of income, gain, loss or deduction being reversed. Third, reversals of prior allocations can be effected using item allocations. Fourth, the ratio test will be satisfied if it is satisfied with respect to each separate chargeback under the partnership agreement. Fifth, minimum gain chargebacks and partner minimum

^{30/} Treasury Regulation Section 1.704-1T(b)(4)(iv)(e).

gain chargebacks will generally be ignored in determining whether there is compliance with the Fractions Rule.

V. Tiered Partnerships

A. Background. Section 514(c)(9)(D) provides that "rules similar to the rules of Section 514(c)(9)(B)(vi) shall also apply in the case of any pass-thru [sic] entity other than a partnership and in the case of tiered partnerships and other entities." The legislative history of Section 514(c)(9)(D), which was added by the 1984 Act, does not clarify the meaning of the provision.^{31/} In addition, it should be noted that the Fractions Rule was added to Section 514(c)(9) after the enactment of Section 514(c)(9)(D). Thus, the relationship between the two provisions is unclear. Although Section 514(c)(9)(D) does not appear on its face to require regulations to be operative, it would be extremely helpful if regulations were promulgated to illustrate the application of Section 514(c)(9)(B)(vi) to the various tiered-partnership situations that can arise. Notice 90-41 did not provide any guidance regarding the regulations to be promulgated under Section 514(c)(9)(D).

An investment by a QO in debt-financed real property through a tiered-partnership structure can arise in several different factual situations. First, the QO can invest in the "parent" partnership of an existing chain of partnerships that ultimately hold leveraged real property.

^{31/} This provision is not mentioned at all in the committee reports on the 1984 Act, and it is only mentioned (but not described) in a footnote in the "Bluebook". See Staff of the Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 1152, n.39 (1984); see also Treasury Regulation Section 1.168(j)-IT, Q-20 (describing a similar provision in Section 168(h)(6)(E)).

Example (8): Partnership P, the partners in which are individuals A and B, holds a 99% interest in Partnership S. S holds a 99% interest in Partnership T, which in turn holds debt-financed real property. The chain of partnerships has been in existence with substantially the same ownership for the past five years. QO purchases an interest in P from A. No changes are made in the terms of the partnership agreements for P, S and T.

Second, the QO can invest in a lower-tier partnership (i.e., at a level closer to the real property) of an existing chain of partnerships.

Example (9): Assume the same facts as in example (8), except that QO purchases an interest in S from P.

Third, the QO can invest in a chain of partnerships that has been formed in connection with the investment, such as a chain of partnerships comprising various QO investors in the real property.

Example (10): Five QOs (QO₁ through QO₅), together with T₁, a taxable corporation, form limited partnership LP to invest in certain real property. LP, QO₆ and T₂ then form Partnership R, which makes the investment in debt-financed real property.

Finally, the QO can invest in debt-financed real property through a combination of the above, i.e., two or more partnerships or chains of partnerships.

Example (11): The partners in partnership P are T₁ and QO₁. P's assets consist entirely of interests in Partnership S₁ and Partnership S₂, each of which holds debt-financed real property. The partners in S₁ are P, T₂ and QO₂, and the partners in S₂ are P, T₃ and QO₃.

In any of these situations, there are several significant issues regarding the application of Section 514(c)(9) to the tiered partnership structure. Those issues include (i) whether the chain or chains of partnerships should be looked through in order to apply the Qualified Allocations Rule and the Fractions Rule, and, if so, (ii) whether a partnership that is a

partner in another partnership should be treated as a taxable entity, a QO or something else for this purpose and how the look-through rule applies where some of the partnerships have qualified allocations or satisfy the Fractions Rule while other partnerships do not. ^{32/}

B. General Rule. As a general matter, it is appropriate to apply the Qualified Allocations Rule and the Fractions Rule to the partnership in which the QO directly invests (the "Direct Investment Partnership") and to each of the partnerships in the chain between the Direct Investment Partnership and the debt-financed real property. ^{33/} If each partnership in the chain satisfies either the Qualified Allocations Rule or the Fractions Rule, the Section 514(c)(9) exception should apply. For purposes of determining whether a partnership satisfies either of these rules, any partnership that is a partner in a lower-tier partnership should be treated as QO if it has any direct or indirect partners that are QOs. ^{34/} Thus, in example (10) above, if the tax allocations of both LP and R satisfy the Qualified Allocations Rule or the Fractions Rule, Q01 through Q05 would satisfy the Section 514(c)(9)(B)(vi) requirement. This should be equally true if one of the partnerships satisfies the Qualified Allocations Rule and the other satisfies the Fractions Rule. ^{35/}

Where a chain of partnerships (or a portion thereof) fails to meet the partnership-by-partnership test, the Committee believes that the benefits of Section 514(c)(9) nonetheless

^{32/} See generally Feder and Scharfstein at 77-79.

^{33/} See generally id. at 78-79.

^{34/} Cf. Section 168(h)(6)(F).

should be available if the chain satisfies one of the relevant tests on a combined basis. The combined test would be applied by looking down through the partnerships to the partnership that holds the debt-financed real property, i.e., treating the partners in the various partnerships as partners in a single partnership that holds the debt-financed real property. The partners' percentage interests in the hypothetical partnership would be determined by tracing through each partner's actual direct and indirect interests in the property-owning partnership. For example, suppose in example (10) above that the tax allocations of R do not satisfy either the Qualified Allocations Rule or the Fractions Rule. If, however, the allocations from a hypothetical partnership having as its partners QO₁ through QO₆, T₁, and T₂ would satisfy the Fractions Rule, the QOs would qualify for the Section 514(c)(9) exception. ^{36/}

C. Special Rule for Existing Chains of Partnerships.

The Committee believes that some relief from the above-described general rule is appropriate for QOs that invest in an existing chain of partnerships (an "Existing Chain") that was not created in anticipation of a QO's investment. For example, consider a situation in which, several years ago, an upper tier partnership ("UTP"), a partnership of T₁ and T₂, invested in a lower tier partnership ("LTP"), a partnership that included UTP and numerous other taxable partners. Assume that the allocations of LTP would not pass muster under either the Fractions Rule or the Qualified Allocations Rule if either rule were applicable. UTP now proposes to admit QO as a partner (or T₁ now proposes to sell its partnership interest to QO). In this situation, the tax

^{35/} In any event, QO6 should qualify for the benefits of Section 514(c)(9) so long as the tax allocations of R satisfy either rule.

^{36/} This may enable the partners in the Direct Investment Partnership to cure nonqualifying allocations in the lower-tier partnerships with upper-tier

allocation provisions of the LTP partnership agreement were agreed to among taxable persons at a time when none of them had any reason to consider the potential application of the Section 514(c)(9) rules. Moreover, the LTP tax allocations affect not only the persons that are to become direct partners with QO (T_1 and/or T_2), but also third parties that did not at the formation of LTP and do not now have any direct dealings with a QO.

As discussed above, enormous complexities are presented in applying the Qualified Allocations Rule and the Fractions Rule to many common kinds of real estate partnerships. Furthermore, investments by QOs in Existing Chains where there is no change whatsoever in the terms of the lower-tier partnerships represent a very small risk for potential tax abuse. The Committee believes, therefore, that it would serve no significant tax policy objective, and might indeed inappropriately deny the benefits of Section 514(c)(9), to look through the Direct Investment Partnership and apply the Qualified Allocations Rule and the Fractions Rule to each of the subsidiary members of an Existing Chain.

Instead, we recommend that, in the case of any investment by a QO in an Existing Chain, the regulations should apply the Qualified Allocations Rule and the Fractions Rule only to the Direct Investment Partnership, and should deem the lower-tier members of an Existing Chain to satisfy the Fractions Rule. Thus, in example (8) above, the Committee suggests that the regulations should apply the Qualified Allocations Rule and the Fractions Rule only to P and deem S and T to satisfy the Fractions Rule; in example (9) above, the regulations should

allocations that themselves also do not qualify, but that result, on a combined basis, in allocations that do qualify.

apply the Qualified Allocations Rule and the Fractions Rule only to S and deem T to satisfy the Fractions Rule.

In identifying the Existing Chains to which this grandfather-type relief is applicable, several points should be noted. First, we are not recommending that a QO be permitted to make an investment in a partnership with failed allocations ("NGP") simply by forming a new "clean" partnership ("Newco") to make that investment. In such a case, while NGP might be part of an Existing Chain that included other partnerships above or below it, NGP would not be part of an Existing Chain with Newco. Accordingly, the special rule would not apply to limit testing to the Newco level, but instead would require testing at the NGP level as well. Second, it may be reasonable to provide that an Existing Chain does not include a partnership in which non-grandfathered QOs have a more than de minimis interest if the partnership's allocations do not satisfy Section 514(c)(9)(B)(vi). In that case, the partnership presumably chose the nonqualified allocation route and the concomitant UBIT problems, and there is no particularly compelling reason to provide a grandfather rule that could reverse that choice. Third, it should be clear that an Existing Chain does not include any partnership in which the tax allocations are materially changed in connection with a QO's investment.

Finally, the Committee believes that, while it would be helpful to apply the special rule described herein to all chains of partnerships that qualify as "old and cold", such an approach would present at least some possibility that future real estate investments will be structured with a view to one day taking advantage of the Existing Chain rule. To foreclose that potential for abuse, it would not be unreasonable to limit this special rule to chains of partnerships that are in existence on some

date. One possibility would be to limit the special rule to Existing Chains that were in existence on October 13, 1987, the effective date of the Fractions Rule. The other logical possibility would be to limit the special rule to Existing Chains that were in existence on the date on which the Fractions Rule regulations are promulgated. The rationale for the latter rule is that until such regulations are promulgated, abusive tiered partnership arrangements will not be created in anticipation of favorable treatment under the special rule. ^{37/}

The Committee recognizes that there is some logical inconsistency in proposing a grandfathering approach to lower-tier members of Existing Chains when QO transferees of partnership interests have no ability to grandfather the disqualified allocations of the partnerships in which they directly invest. We believe, however, that a grandfathering approach for lower-tier entities better serves the purposes of Section 514(c)(9) than would a rigid extension of the tests of Section 514(c)(9)(B)(vi), with all their myriad complexities, to all lower-tier partnerships. We also believe that Section 514(c)(9)(D) provides sufficient regulatory authority for the application of a grandfathering type of rule to Existing Chains. Furthermore, the recommended approach is in all cases consistent

^{37/} As a general matter, however, where the regulations provide for grace periods or otherwise permit partnerships to cure formerly defective allocations, those rules also should be taken into account in determining whether a once-failed partnership can be included in an Existing Chain.

with the effective dates of the statutory provisions, for it does require the application of the Section 514(c)(9)(B)(vi) tests to the Direct Investment Partnership. ^{38/}

D. Multiple-Chain Structures. Difficult issues arise when QOs invest in leveraged real property through two or more partnerships or chains. This may arise either where the QO holds investments in a single debt-financed real property interest through two or more chains of Direct Investment Partnerships or, more commonly, where the Direct Investment Partnership in which the QO invests itself owns interests in two or more other partnerships, each of which ultimately owns debt-financed real property (as in the case of QO₁ in example (11) above). Although Section 514(c)(9)(D) offers no clue as to the proper analysis in those cases, certain principles for the application of Section 514(c)(9)(D) to such partnership structures may be gleaned from existing law. Some background may be helpful in demonstrating this point.

As discussed above, an exempt organization's UBTI generally includes an amount equal to a percentage of the total gross income derived from real property held to produce income with respect to which there is an "acquisition indebtedness", which, in general terms, is indebtedness incurred by the exempt organization in connection with the acquisition or improvement of the debt-financed property. When an exempt organization is a

^{38/} In the event that our recommendation as to the treatment of Existing Chains is not adopted, we would urge the adoption of the analysis in section B above for all chains of partnerships.

member of a partnership that carries on a trade or business that is unrelated to the organization's exempt purpose or function, the organization is considered to have incurred its share of the partnership's acquisition indebtedness.^{39/} Thus, the determination of the extent to which a partnership has "debt-financed property" is made on a property-by-property basis.

The requirements of Sections 514(c)(9)(B)(i)-(v) for the Section 514(c)(9) exception also follow a property-by-property approach, for they generally look to the attributes of each property held by the partnership and the indebtedness with respect thereto (e.g., whether there is seller financing as to the particular property). As a consequence, the failure of one property to satisfy those requirements will not affect the eligibility of any other property held by the partnership to satisfy Section 514(c)(9). However, the allocation requirements of Section 514(c)(9)(B)(vi) look to the attributes of the partnership and its partners. Thus, in the single-partnership context, the normal property-by-property analysis is not made--the Section 514(c)(9) exception will not apply to any of the properties of the partnership unless the partnership itself meets one of the Section 514(c)(9)(B)(vi) requirements.

In the tiered partnership context, however, the look-through approach logically requires that one revert to the property-by-property determination under Section 514(c)(9), treating each chain through which the QO owns real property as a separate property. Thus, the result of looking through the tiers of partnerships is consistent with the result where a single

^{39/} See Section 512(c)(1); Treasury Regulation Sections 1.512(c)-1 and 1.514(c)-1(a)(2), example (4); and Rev. Rul. 74-197, 1974-1 C.B. 143.

partnership holds separate real property interests. For example, if, in example (11), P and S₁ have qualified allocations but S₂ neither has qualified allocations nor meets the Fractions Rule, QO₁'s investments in real property through S₁ and S₂ should be treated as separate assets, with the possible result that the property held by S₁ is not "debt-financed property" and does not give rise to UBTI, while the property held by S₂ does give rise to UBTI.

VI. De Minimis Rules

The forthcoming regulations could make a major contribution by providing sensible de minimis rules to simplify the Fractions Rule law. The Committee has two suggestions in this regard.

A. De Minimis Partner Interest. Notice 90-41 indicates that the Treasury Department is considering adopting a de minimis rule pursuant to its authority under Section 514(c)(9)(E)(iii) to issue regulations excluding or segregating items for purposes of the Fractions Rule.

Notice 90-41 suggests that:

"... the regulations could provide that the fractions rule will be deemed to be satisfied for partnerships in which partners other than tax-exempt QOs hold 98 percent of the interests in partnership capital, if the exempt partners participate on substantially the same terms as the taxable partners and if the principal purpose of the allocations is not tax avoidance."

A de minimis rule makes good sense, both from the standpoint of administrative convenience and in order to encourage equity investments in real estate by QOs. However, the Committee believes that the 2% exception suggested in Notice 90-41 is simply not very useful as a practical matter. The de

minimis exception should apply to allow partnership transactions that do not provide any meaningful opportunity for tax avoidance, and it should apply where the aggregate interests of either the QOs or the taxable partners are de minimis. For this purpose, the aggregate interests of QOs should be considered de minimis if their aggregate interests in partnership capital or profits (disregarding any chargebacks of prior loss allocations) are not more than 10%. ^{40/} This rule would be consistent with the 10% de minimis rule for lender-partners in Treasury Regulation Section 1.752-1T(d)(3)(vii). It is appropriate that the Section 752 10% test apply, since Section 752 and Section 514(c)(9)(B)(vi) have the same underlying purpose--to prevent tax avoidance through the transfer of tax benefits between partners.

As compared with partnerships comprising principally taxable investors, where it should not be necessary to invoke the stringent and complex rules of Section 514(c)(9)(B)(vi) unless there is a substantial (i.e., 10%) QO presence, partnerships comprising principally QOs are presumably already attuned to the special rules that apply to their investments. While it would be appropriate to permit QO's to form a partnership with taxable persons that have a small interest in partnership losses (for example, a managing general partner that has a 1% or 2%

^{40/} Some Committee members believe that this de minimis test should be 25% based on the Department of Labor plan asset regulation exemption for pension plan participation that is "not significant". See 29 C.F.R. § 2510.3-101(f).

"carried" interest), once the taxable partners' interest in the partnership losses exceeds the 2% mark suggested in Notice 90-41, it is not particularly troubling that the rules of Section 514(c)(9)(B)(vi) would apply. Accordingly, the Committee suggests that the interests of taxable partners should be considered de minimis, and thus disregarded, if the taxable partners' aggregate interest in partnership losses (disregarding any chargebacks of prior income allocations) is 2% or less.

There is no need for the additional requirement that the de minimis group (whether taxable or QO partners) participate on substantially the same terms as the other group of partners, since there is no material opportunity for abuse where the de minimis group holds a small interest in the partnership (measured by capital or profits interest in the case of QOs and loss interest in the case of taxable partners). Moreover, it would be difficult to satisfy that requirement in the typical case where most of the partners are QOs but there is a taxable general partner that participates in the transaction on very different economic terms than the QOs. If such a requirement is imposed, it should be sufficient that the de minimis group's participation is on substantially the same basis as that of the other partners that own substantially all the interest in the partnership's capital.

B. Insubstantial Allocations. The Committee also recommends that the regulations provide a second de minimis rule that special allocations of insubstantial amounts of overall income or overall loss (or specific items of income, gain, loss, deduction or credit) shall be disregarded in applying the Fractions Rule. The need for such special allocations may arise for a variety of reasons, such as where special allocations to a

general partner are required under the Section 704(b) regulations as a result of the presence of small amounts of recourse debt (e.g., an unpaid plumber's bill). The Fractions Rule should not operate to prohibit such special allocations of partnership expenses to the proper party, or worse yet trigger catastrophic UBTI consequences for QOs, as a result of a small item that may not even be noticed until the partnership's tax return is prepared or may not be avoidable because of general partner liability for partnership debts. In any such case, the opportunity for tax avoidance by definition is minimal. ^{41/}

VII. Miscellaneous Issues

A. Allocations of Partner-Specific Items. The Committee recommends that, pursuant to the authority of Section 514(c)(9)(E)(iii), the regulations provide that disproportionate allocations of partnership items of income, gain, loss, deduction or credit will not be taken into account in applying the Fractions Rule where the allocated item arises from a benefit or detriment directly related to a specific partner or group of partners. Consider the following three illustrations.

Example (12): The partnership agreement for partnership ABC provides that, in the event a transferee of a partnership interest requests that the partnership make an election under Section 754, the additional record-keeping and accounting expenditures incurred by ABC in computing the Section 743 adjustments must be reimbursed by the transferee partner. ABC should be allowed to specially allocate the deductions related to such additional costs to the transferee partner(s) without violating the Fractions Rule.

^{41/} Some of these allocations, as well as those discussed in section VII(A) below, may be allowable under the Unlikely Allocation Exclusion. In many cases, however, it would be difficult to demonstrate that the allocation is truly unlikely.

Example (13): Taxable foreign corporation F and tax-exempt QO are partners in partnership FQ. FQ realizes net income that is effectively connected with the conduct of its business in the United States. As a result, FQ is required by Section 1446 of the Code to pay a withholding tax with respect to the portion of such income that is allocable to F. FQ borrows funds to pay such withholding tax and as a result incurs loan origination fees and interest expense. FQ should be allowed to specially allocate all of the loan fees and interest expense to F without running afoul of the Fractions Rule.

Example (14): Partnership TQ, composed of taxable individual T and tax-exempt QO, sells real property located in State X. State X imposes a partnership-level income tax on the partnership's income and a real property transfer tax on the consideration received on a sale of the property, but in each case an exemption is provided for the portion of income or consideration that is allocable to the tax-exempt entity. A special allocation of such State X taxes to T should not violate the Fractions Rule.

This last example is of special concern for this Committee, given the fact that many of the significant state and local taxes one finds in New York provide (or may provide) for partial exemptions where the partnership includes QOs as partners.

It would be inappropriate for the Fractions Rule to force a pro rata allocation of items of partnership income, gain, loss, deduction or credit that can legitimately be shown to be directly attributable to, and actually borne by, a specific partner or group of partners. We therefore recommend that the regulations include a specific provision stating that an allocation of partnership items of income, gain, loss, deduction or credit will not be taken into account in applying the Fractions Rule if (i) the allocated item corresponds to an expense or benefit directly attributable to the status or activities of a specific partner or group of partners and (ii) the allocation has substantial economic effect.

In the case of specially allocated items that are not attributable to the status of a partner as taxable or tax-exempt, but instead relate to some other partner-specific factors (as with the Section 754 election in example (12) above), some members of the Committee also feel it would be advisable to provide a further requirement that the specially allocated item not be substantial in amount, taking into account the nature of the partnership's activities. Other members are, however, concerned that it may be difficult to identify such status-related items or that in some cases there may be some legitimate but substantial partner-specific items not relating to the status of a partner as taxable or tax-exempt the special allocation of which should be permitted under the Fractions Rule.^{42/} Such members also would suggest that, if a substantiality test is included for nonstatus type items, there also be a mechanism for obtaining the Secretary's consent to other types of special allocations that are shown to be necessary to achieve the fair allocation of such partner-related items.

^{42/} For example in New York there is a 10% "gains tax" on gains from sales of New York real property and sales of "controlling interests" in entities owning New York real property (such as a 50% partnership interest). If a person becomes a minority partner in a partnership owning New York real property, there is no gains tax on that transaction, but there also is no step-up at the partnership level to reflect the excess of the current value of the real property over its original cost to the partnership. In such circumstances, the partnership agreement frequently provides that the "first level" of gains tax incurred by the partnership on a later sale of the real property--that is, the gains tax on the amount of built-in gain inherent in the property at the time the new partner invested--will be borne solely by the other partners (which would necessitate a special allocation of tax items). Where the new partner is a QO, such a special allocation might run afoul of the Fractions Rule, even though it clearly is not an instance of abusive loss shifting.

B. Qualified Allocations. Notice 90-41 suggests that the regulations described therein will be issued under the Fractions Rule. However, certain of those regulations also should apply for purposes of determining whether a partnership has qualified allocations within the meaning of Section 168(h)(6), at least for Section 514(c)(9) purposes, since such regulations would resolve certain nettlesome issues that arise for partnerships attempting to qualify for the Section 514(c)(9) exception under the Qualified Allocations Rule rather than the Fractions Rule. ^{43/} The most important examples of regulations that should have broader application are the Unlikely Allocation Exclusion regulations, the tiered partnership rules, the insubstantial item de minimis rule and the partner-specific expense allocation rule. There is ample authority for such regulations in Sections 168(h)(8) and 514(e) of the Code.

C. Transition Rules. The transition rules described in Section VII of Notice 90-41 need to be clarified. In particular, it is not clear whether the proposed June 25, 1990, effective date will apply in terms of investments made on or after that date, taxable years beginning on or after that date or some other basis. In addition, it is not clear what requirements apply for the period beginning October 13, 1987, and ending June 25, 1990, for transactions that are not grandfathered.

March 26, 1991

^{43/} As a technical matter, a partnership with pro rata tax allocations generally would qualify under the Fractions Rule, even if such regulations do not specifically apply for purposes of the Qualified Allocations Rule.