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Proposed regulations: Fractions rule, partnerships with qualified tax-exempt organization partners

The U.S. Treasury Department and IRS today released for publication in the Federal Register proposed regulations (REG-136978-12) concerning the "fractions rule" for partnerships with qualified tax-exempt organization partners and their partners.

The **proposed regulations** [PDF 245 KB] amend existing regulations under section 514(c)(9)(E)—concerning partnerships that hold debt-financed real property and have one or more (but not all) qualified tax-exempt organization partners—to allow certain allocations resulting from specified common business practices to comply with the rules under section 514(c)(9)(E).

The proposed regulations will appear in the Federal Register on November 23, 2016, and comments and requests for a public hearing must be received within 90 days after that date.

Background

Under the rules of section 511 (relating to tax imposed on the unrelated business taxable income (UBTI) of tax-exempt organizations), there is an exemption from UBTI income derived from debt-financed real property acquired or improved by certain "qualified organizations" (QOs). The exemption from UBTI does not apply if a QO owns an interest in a partnership that holds debt-financed real property (this is the "partnership limitation") unless the partnership satisfies one of the following:

- All of the partners of the partnership are QOs
- Each allocation to a QO is a qualified allocation (within the meaning of section 168(h)(6)), or

- Each partnership allocation has substantial economic effect under section 704(b)(2) and satisfies section 514(c)(9)(E)(i)(I)—the “fractions rule”

The preamble to today’s proposed regulations notes that the IRS and Treasury have received comments requesting “targeted changes” to the fractions rule under existing regulations to allow certain allocations resulting from specified common business practices to comply with the fractions rule. The referenced comments appear to be comments submitted by the American Bar Association (Tax Section) on January 19, 2010 (the “ABA Comments”).

Proposed regulations

The proposed regulations provide guidance in determining a partner’s share of overall partnership income or loss for purposes of the fractions rule—including allowing allocations consistent with common arrangements involving:

- **Preferred returns:** The proposed regulations remove the requirement that cumulative preferred distributions cannot exceed cumulative income allocated with respect to such interests by the due date of the partnership’s tax return (not including extensions). Instead, allocations of items of income and gain with respect to a preferred return may be disregarded under the proposed regulations if the partnership agreement requires that the partnership make distributions first to pay any accrued, cumulative, and compounding unpaid preferred return to the extent that the accrued but unpaid preferred return has not been reversed by an allocation of loss before the distribution, with an exception for distributions to pay taxes.

- **Partner-specific expenditures:** The proposed regulations add management and similar fees to the current list of excluded partner-specific expenditures under the existing regulations, to the extent that these fees do not (in the aggregate) exceed 2% of the partner’s aggregate committed capital. The proposed regulations also include a request for comments concerning whether an imputed deficient underpayment at the partnership level under the new partnership audit rules effective for 2018 should be included among the list of partner-specific expenditures

- **Unlikely losses:** The preamble states that the IRS and Treasury are considering changing the “unlikely loss” standard from “low likelihood of occurring” to “more likely than not,” or some standard in between. Comments are requested concerning what is the appropriate standard.

- **Chargebacks of partner-specific expenditures and unlikely losses:** The proposed regulations modify the chargeback exception to disregard certain additional items in computing overall partnership income or loss for purposes of the fractions rule. Specifically, an allocation of overall partnership income that is made to “chargeback” (reverse) a special allocation of a partner-specific expenditure or a special allocation of an unlikely loss will be ignored in applying the fractions rule. While this exception is helpful in situations where the expense item is directly charged back in a future year by a like amount of income, ignoring the expense item in calculating overall partnership income or loss can lead to complications in applying the more general chargeback rule relating to prior disproportionately large allocations of loss or small allocations of income (the "(i) exception"). Many partnership agreements rely on the (i) exception to satisfy the fractions rule, so proper coordination of the exclusion of unlikely losses and partner-specific expenditures and the operation of the (i) exception is of critical importance. Troublesome situations will most likely arise in the context of disproportionate allocations of management fee expense. Although the disproportionate management fee expense may be disregarded in calculating the original overall partnership income or loss that will be subject to chargeback under this rule as well as the items that comprise the subsequent chargeback allocation, the partnership agreement generally will provide for allocations that economically charge back the total allocations, including the disregarded items. Disregarding management fee expenses will increase the overall partnership income, or decrease the overall partnership loss, that is subject to chargeback in a future year and that comprises the future chargeback allocation. Accordingly, the overall partnership loss that economically charges back a prior disproportionately small allocation of overall partnership income to a QO will involve the charge back of a smaller income amount (i.e., an overall partnership income amount that includes the management fee expense) than was treated as allocated for purposes of the fractions rule. While the chargeback allocation also will exclude the management fee expense, often the disregarded amount in the chargeback year will not match the amount that was disregarded in the original year. In addition, disregarding the management fee expense items could cause hypothetical allocations under different tranches in the allocation waterfall than are actually being made under the partnership agreement. As this discussion illustrates, the original allocation and chargeback amounts often will not be properly coordinated. In recognition of this problem, the IRS and Treasury have requested comments regarding the interaction of disregarded partner-specific expenditures and unlikely losses with chargebacks of such items with overall partnership income.

- **Acquisition of partnership interests after initial formation:** The proposed regulations set forth new provisions that are intended to accommodate staged closings. The provisions, however, are quite limited, and require that the following conditions must be met: (1) the new partner must acquire the partnership interest no later than 18 months following formation of the partnership (the "applicable period"), (2) the partnership agreement and other relevant documents anticipate the new partners acquiring the partnership interests during the applicable period, set forth the time frame in which the new partners will acquire the partnership interests, and provide for the amount of capital the partnership intends to raise, (3) the partnership agreement and any other relevant documents specifically set forth the method of determining any applicable interest factor and for allocating income, loss, or deduction to the partners to adjust partners' capital accounts after the new partner acquires the partnership interest, and (4) the interest rate for any applicable factor is not greater than 150 percent of the highest applicable Federal rate, at the appropriate compounding period or periods, at the time the partnership is formed.

If these conditions are satisfied, the IRS will not closely scrutinize changes in allocations resulting from staged closings for purposes of analyzing allocations applicable prior to the changes and, in computing overall partnership income or loss for purposes of analyzing the fractions rule after the changes, will disregard disproportionate allocations of income, loss, or deduction made to adjust the capital accounts when a new partner acquires its partnership interest after formation. Note, however, that the requirement of an interest rate factor not to exceed 150 percent of the highest applicable Federal rate will mean that very few arrangements will qualify under this provision. The approach taken in the proposed regulations is significantly different than was proposed in the ABA Comments, and it can be expected that the IRS and Treasury will receive comments regarding the staged closing rule.

- **Capital commitment defaults or reductions:** The proposed regulations state that if the partnership agreement provides for changes to allocations due to an unanticipated partner default on a capital contribution commitment or an unanticipated reduction in a partner's capital contribution commitment, and those changes in allocation are not inconsistent with the purpose of the fractions rule, then the changes will not be closely scrutinized for purposes of analyzing allocations applicable prior to the change. In addition, partnership allocations made pursuant to the partnership agreement to adjust partner capital accounts as a result of unanticipated capital contribution defaults or reductions will be disregarded in computing overall partnership income or loss for purposes of the fractions rule. The proposed regulations state that these adjustments may include allocations to adjust partners' capital accounts to be consistent with the partners' adjusted capital account commitments. Despite request in the ABA Comments, the proposed regulations do not appear to accommodate preferred allocations made to QOs as compensation for contributing capital that was otherwise due from a defaulting partner.

- **Tiered partnerships:** Significantly, the proposed regulations amend the third example illustrating application of the tiered partnership rules to eliminate the implication that violation of the fractions rule by a lower-tier partnership can cause the upper-tier partnership to violate the fractions rule unless the upper-tier partnership allocates items from the violating lower-tier partnership separately from other items. Under the proposed regulations, allocations of the violating lower-tier partnership income made by the upper-tier partnership will constitute UBTI by reference to the debt-financed percentage, but the upper-tier partnership itself will not be considered to violate the fractions rule.

- **De minimis rules:** Under the current regulations, certain partnerships in which all QOs own 5% or less of the capital or profits interest in the partnership are exempt from application of the fractions rule. The proposed regulations adopt a rule to address the converse situation. That is, under the proposed regulations, certain partnerships in which all partners (other than QOs) own 5% or less of the capital or profits interest in the partnership will be exempt from application of the fractions rule. The current regulations also include a separate de minimis rule relating to de minimis allocations. Under the current rule, a disproportionate allocation of loss or deduction away from a QO will be treated as made to the QO if (1) the allocation was not tax motivated, and (2) the total amount of those items is less than both – (i) one percent of the partnership's aggregate items of gross loss and deduction for the taxable year, and (ii) $50,000. Under the proposed regulations, the $50,000 amount is increased to $1 million.

- **Effective date and current reliance:** The regulations are proposed to apply to taxable years ending on or after the date that the regulations are published as final regulations. Importantly, however, the preamble states that a partnership and its partners may apply all rules contained in the proposed regulations for taxable years ending on or after November 23, 2016.

For more information, contact a tax professional with KPMG's Washington National Tax:

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