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IRS And Treasury Look To Ease Burden Of Fractions Rule

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Law360, New York (December 14, 2016, 4:10 PM EST) -- On Nov. 22, the Internal Revenue Service and the Treasury Department issued proposed regulations (REG-136978-12) under the "fractions rule" of Section 514(c)(9)(E) of the Internal Revenue Code of 1986, as amended[1]. The proposed regulations attempt to address many of the problems that have dogged the fractions rule, as interpreted in the existing regulations, since its enactment thirty years ago.

While the new rules would become effective only when they are made final, the preamble to the proposed regulations states that taxpayers may rely on them immediately. Therefore, the proposed regulations should immediately provide leveraged real estate partnerships more flexibility to implement various legitimate, non-tax motivated commercial arrangements that were previously subject to much uncertainty.

Although interpretive questions remain, the proposed regulations are a welcome development for real estate fund sponsors and tax-exempt institutional investors.

Background

Section 511 imposes a tax on "unrelated business taxable income," or UBTI, of tax-exempt organizations. UBTI is generally defined as business income that is not connected to the organization's exempt purpose, with important exceptions for various categories of passive income such as dividends, interest, royalties, real estate rents and gain from the sale of property (other than dealer property).

In addition, pursuant to Section 514, UBTI includes a specified percentage of income (including the otherwise exempted categories of passive income) derived from debt-financed property. For a limited category of tax-exempt investors, in particular pension funds and university endowments ("qualified organizations," or QOs), Section 514(c)(9) provides for an exception to the debt-financed property rules that applies to leveraged real property investments.

Where such investments are held by one or more partnerships (or other entities such as limited liability companies that are taxed as partnerships), the Section 514(c)(9) exception is generally only available if the partnership meets the fractions rule, which is intended to ensure that parties do not allocate excessive income to tax-exempt partners and excessive losses to taxable partners.

Under the proposed regulations, the basic fractions rule requirement remains unchanged: a QO's greatest share of income in any year cannot exceed its smallest share of losses. The fractions rule requirements are rigid, technical and unduly complex, and in many cases interfere with the structuring of non-tax motivated real estate joint ventures with tax-exempt investors.

Yet, there are few acceptable alternatives for leveraged real estate partnerships that seek to (or are required to) avoid incurring UBTI for such investors. The other options, including utilizing C corporation "blocker" vehicles or real estate investment trusts, entail a significant amount of administrative expense, compliance costs and (in the case of C corporation blockers) tax leakage.

The problem with the fractions rule, however, is that it sweeps way too broadly and often thwarts legitimate business arrangements. At a high level, the fractions rule is intended to prevent the abusive special allocation of taxable income to QOs (or abusive special allocation of losses to taxable partners) in leveraged real estate partnerships.

But because the existing regulations are not narrowly focused on abusive arrangements, practitioners have had to structure joint ventures in ways that may be contrary to the desired business deal, or rely on tenuous interpretations of the rules or on generic "savings clauses" in partnership agreements.

The common provisions in leveraged real estate partnerships that have historically caused the greatest fractions rule concerns include the following:

Preferred Returns

The fractions rule permits certain otherwise non pro-rata allocations to be ignored in applying the test, including those made in connection with a "reasonable preferred return for capital."[2] Without this rule, any preferred return granted to a QO over other partners would violate the fractions rule, since the allocation of income occasioned by the preference would clearly be higher than the QO's share of losses based on residual equity percentages.[3]

However, such allocations are only ignored to the extent cash distributions in satisfaction of such preferred return have been paid. For most real estate partnerships, this is an exception that swallows the rule, because where QOs (or any other partners) earn a preferred return, the accompanying allocations are done on an accrual basis, irrespective of whether all or a part of the preferred return has been paid.

In leveraged real estate, preferred returns may not be paid on a current basis due to repayment of debt or reinvestment of income.[4] Consequently, where a partnership desires to offer a preferred return to a QO partner, achieving fractions rule compliance requires non-trivial modifications to the business deal, either by paying out the preferred return currently instead of using cash flow in the desired manner, or modifying the allocations in a way that may alter the ultimate economics of the partnership upon an exit, often to the detriment of the QO partner.

Forcing a partnership to resort to one of these alternatives, especially where no tax avoidance is present, does not serve any legitimate tax goal.

Divergent Fees

The current fractions rule regulations also permit certain allocations of "partner specific expenditures" to be disregarded so long as they are allocated to the appropriate partner.[5] This is not a broad exclusion, as the regulations contain a short list of only four categories of expenditures covered.

The purpose of this exception is very clear: namely, that expenses that pertain to a particular partner (taxable or otherwise) are in many respects external to the key partnership economics and allocating such amounts to the "right" partners ought to be permitted. The reason for limiting the exception to only certain enumerated expense items is harder to discern.

Real estate partnerships routinely offer "sliding scale" fee arrangements that allow larger or more influential investors to bear a smaller share of management and similar fees. Whether the resulting fee expenditures are "attributable" to the investors who bear the disproportionately large share of such fees is beside the point — the fact is that these arrangements are the result of bona fide, arm's-length negotiations and are not tax motivated.

Since management fees are not on the list in the current regulations, any "fee breaks" granted to QO partners may violate the fractions rule. As a result, QO investors may be unable to enter into such arrangements or the parties may need to implement unduly complicated allocation schemes that neutralize the impact of disproportionate fee sharing. It is difficult to see whose interests are served when this occurs.

Staged Closings

Many real estate private equity funds allow for the entry of limited partners on a staged basis over a number of closings. Upon a subsequent closing after a QO has already been admitted into the partnership, the interests of the partners will change.

Later-admitted partners are customarily required to compensate the earlier partners with an interest-like payment. The current fractions rule regulations provide that compliance is only tested from the year of the change and then in future (not prior) years, but they also add that shifts will be "closely scrutinized" for abusive intent.[6]

Additionally, early allocations made before the later investors are admitted may need to be reversed through special (i.e., disproportionate) allocations of subsequent income or loss. The lack of IRS guidance in this area, as well as the seemingly technical violations of the fractions rule that may be unavoidable in the case of special allocations, has created reluctance on the part of many QO investors to invest in leveraged real estate partnerships that conduct staged closings.

Tiered Partnership Structures

The current fractions rule regulations deal with tiered partnership structures primarily by setting forth a general rule and providing three examples that illustrate different approaches to satisfying the rule.[7]

One of the examples describes an upper tier partnership (with a taxable and QO partner) that owns an interest in two lower tier partnerships, one of which independently satisfies the fractions rule and one of which does not. The example concludes that the upper tier partnership satisfies the fractions rule with respect to the "compliant" chain only if it separately allocates the tax items from the two chains.[8] This limitation in the rules can create substantial risk for real estate fund partnerships, which commonly invest in many properties through different joint ventures. Given that the economics of these funds are aggregated across investments, it would be exceedingly difficult (if not impossible) for these funds to "ringfence" the allocations from different joint venture entities based on their fractions rule profiles, and funds rarely attempt to do so in practice.

Because of these and other problems, the fractions rule has undoubtedly prevented many real estate joint ventures from being formed and kept many otherwise motivated QO investors from investing in real estate funds.

In a 2002 report, the New York State Bar Association called the fractions rule "deeply flawed," and urged that it be repealed entirely and replaced with an anti-abuse standard that would seek to determine whether a partnership's allocations had a principal purpose of tax avoidance.[9]

More recently, the American Bar Association submitted a letter to the IRS (the ABA Letter) recommending certain "targeted" changes to the fractions rule that would remove some of the uncertainties described above.[10]

Summary of Proposed Regulations

Although the IRS did not go so far as some had advocated and create broad anti-abuse exceptions to the fractions rule, the proposed regulations nevertheless are responsive to the concerns expressed in the ABA Letter, and alleviate many of the challenges described above.

Preferred Returns

The proposed regulations expand the preferred return exception and permit related allocations to be disregarded even if the accompanying distribution is not made currently. Instead, the proposed regulations mandate only that the partnership agreement requires that the first distributions be used to pay any unpaid preferred return to the extent not reversed with interim losses and that any unpaid distribution should compound.

The proposed regulations contain an exception to this new rule, which allows tax distributions to be paid prior to the accrued preference, so long as the tax distributions properly match the tax imposed on a partner in respect of allocated income, and are treated as an advance against future distributions.

The requirements of the new preferred return exception generally correlate to the terms of many real estate partnerships and funds in the market and should make it easier to comply with the fractions rule without introducing unnecessary distortions into the parties' economic deal.

Divergent Fees

The proposed regulations add management (and similar) fees to the list of enumerated expenditures that are disregarded for purposes of the fractions rule, provided that the fees do not, in the aggregate, exceed two percent of the partner's aggregate committed capital.

This new exception should allow real estate partnerships to allocate management fee expenses in accordance with the negotiated deal with their QO partners without concern for fractions rule violations.

Staged Closings

The proposed regulations provide that changes in allocations made in connection with common commercial staged closings should not violate the fractions rule if the following conditions are met:

- The new partner acquires the interest within 18 months of the formation of the partnership;[11]
- The partnership agreement and applicable fund documents contemplate the staged closing process, set forth the fund raising period, state the amount of capital the fund intends to raise, and set forth the method of computing the interest factor as well as the manner in which equalizing allocations will be made to the later partners; and
- The interest factor is not greater than 150 percent of the highest applicable federal rate.

While the first two of these conditions will often be met, compliance with the interest factor limitation may be somewhat difficult in light of the low interest rate environment.

Funds often use an interest factor equal to the preferred return rate, which greatly exceeds 150 percent of the current applicable federal rate. Additionally, in a difficult fund-raising environment, some funds may have difficulty staying within the 18-month limit.

Tiered Partnerships

The proposed regulations eliminate the separate allocation requirement from the problematic example. Therefore, where the allocations of an upper tier partnership satisfy the fractions rule on a stand-alone basis, an arrangement with a lower tier partnership should not cause a fractions rule violation with respect to the other investments of the upper tier partnership, even where no separate allocations are made.

This should be a welcome change to real estate funds that seek fractions rule compliance and that invest in numerous properties through lower tier partnerships and joint ventures.

In addition to the issues described above, the proposed regulations also addressed certain other fractions rule issues, including those associated with capital commitment defaults, allocations of "unlikely losses," income and loss chargebacks and certain de minimis thresholds.

While the new rules would become effective only when they are made final, the preamble to the proposed regulations states that taxpayers may rely on them immediately.

Conclusion

A number of interpretive questions remain under the proposed regulations, including those relating to the preferred return and management fee issues described above. Therefore, sponsors of leveraged real estate partnerships and their QO investors will still need to draft their partnership agreements carefully and consult with counsel to understand and evaluate any fractions rule compliance risks.

Additional guidance is likely to emerge as well. Nevertheless, the proposed regulations are clearly a positive development and should remove some of the uncertainties surrounding common, legitimate business arrangements.

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[1] Unless otherwise indicated, all section references herein are to the Code.

[2] Treas. Reg. section 1.514(c)-2(d).

[3] If, in addition to a preferred return, the QO's capital enjoys a senior position to other partners' capital, then the fractions rule will be violated.

[4] In these situations, it is often the case that the only distributions that are made initially are the "tax distributions" intended to allow partners to pay taxes on the income allocated to them.

[5] Treas. Reg. section 1.514(c)-2(f).

[6] Treas. Reg. section 1.514(c)-2(k)(1).

[7] The general rule is that the partnerships must be able to demonstrate under any reasonable method that the relevant chains of entities satisfy the fractions rule. The regulations also contain an anti-abuse rule stating that use of the tiered-ownership structure must not have a principal purpose of tax avoidance.

[8] Treas. Reg. section 1.514(c)-2(m)(2), Ex. 3.

[9] New York State Bar Association Tax Section, Report No. 1007, Simplification of the Internal Revenue Code, March 18, 2002.

[10] American Bar Association Section of Taxation, Request for Guidance on Partnership Allocations Permitted under Section 514(c)(9)(E), Jan. 19, 2010.

[11] The ABA Letter had recommended a safe harbor period of 24 months.

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