REPORT #758

TAX SECTION

New York State Bar Association

Report on Proposed Treasury Regulation § 1.514(c)-2

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TAX SECTION

New York State Bar Association

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April 27, 1993

Michael P. Dolan
Acting Commissioner
Internal Revenue Service
1111 Constitution Ave. NW
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Washington, D.C. 20224

Dear Commissioner Dolan:

Enclosed herewith is a report of the New York State Bar Association Tax Section dealing with proposed Treasury Regulation §1.514(c)-(2), which provides guidance in applying Section 514(c)(9)(E) of the Internal Revenue Code. The Report was prepared by an ad hoc committee of the Tax Section, and its principal author is William B. Brannan.

The subject matter of the Proposed Regulation is the so-called "Fractions Rule," which sets forth conditions under which certain tax-exempt investors may avoid the recognition of unrelated business taxable income when they invest in partnerships holding real property.

The Report commends the Internal Revenue for proposing regulations which go far toward making the Code provision in question workable. It also suggests certain modifications and additions, including the following: (i) modifying both the "reasonable preferred return" and guaranteed payment provisions to encompass situations in which an allocation or guaranteed payment is to take effect prior to an actual distribution or cash payment; (ii) modifications to the "unlikely allocation" exclusion from the restrictions on allocations contained in the Proposed Regulation; (iii) changes in the charge-back rules designed to

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make then less restrictive and easier to apply; (iv) fine-tuning of the much-appreciated provision in the Proposed Regulation dealing with tiered arrangements; and (v) elimination or modification of the anti-abuse rule contained in the Proposed Regulation.

We believe these changes are in furtherance of the spirit of the Proposed Regulation. We would be happy to discuss with you any comments you may have.

Your truly,

Peter C. Canellos

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Tax Report #758

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

Report on Proposed

Treasury Regulation § 1.514(c)-2

April 23,1993

NEW YORK STATE BAR ASSOCIATION TAX SECTION [*]

Report on Proposed Treasury Regulation § 1.514(c)-2

I. Introduction

This report comments upon Proposed Treasury Regulations § 1.514(c)-2 (the "Proposed Regulations"), which were recently promulgated by the Internal Revenue Service to provide guidance regarding the application of Section 514(c)(9)(E). [1] Section 514(c)(9)(E) is an important part of Section 514(c)(9), which provides generally that debt-financed real estate investments by "qualified organizations" ("QOs") will not be treated as giving rise to unrelated business taxable income ("UBTI") under the general acquisition indebtedness rules of Section 514 if the investment satisfies six requirements. One of those requirements, which is set forth in Section 514(c)(9)(B)(vi), is that if the investment is held through a partnership with non-QO partners, then the partnership's tax allocations must either be "qualified allocations" within the meaning of Section 168(h)(6) (i.e., generally pro rata among the partners throughout the life of the partnership) or satisfy the requirements of Section 514(c)(9)(E). Since real estate investments by QOs often are held through partnerships and such partnerships usually have non-QO partners but do not have qualified allocations, Section 514(c)(9)(E) is a critical part of the Section 514(c)(9) exception.

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[*] This report was prepared by an ad hoc committee (the "Committee") comprising members of the Committee on Income from Real Property and members of the Committee on Partnerships, which was chaired by William B. Brannan. The principal authors of the report were Susan B. Arkun, Mark E. Berg, William B. Brannan, Joel Scharfstein and Robert S. Schwartz. Helpful comments were received from William L. Burke, Peter C. Canellos, Arthur A. Feder, Michael Hirschfeld and Michael L. Schler.

[1] Unless otherwise indicated, all Section references herein are to the Internal Revenue Code of 1986, as amended to date (the "Code").

Section 514(c)(9)(E), which is often referred to as the "Fractions Rule", provides generally that a real estate partnership's tax allocations will satisfy Section 514(c)(9)(B)(vi) if (1) the partnership's tax allocations will not result in any QO partner having a share of "overall partnership income" in any year that exceeds its share of "overall partnership loss" for the taxable year for which its share of "overall partnership loss" will be the smallest and (2) the partnership's tax allocations have substantial economic effect under Section 704(b). In June 1990, the Service issued Notice 90-41, [2] which provided preliminary guidance on certain issues regarding the application of Section 514(c)(9)(E). In March 1991, the New York State Bar Association Tax Section submitted a lengthy report providing comments on Notice 90-41 and certain other aspects of Section 514(c)(9)(E) (the "1991 Report"), many of which were reflected in the Proposed Regulations.

In promulgating the Proposed Regulations, the Service has provided important new guidance regarding the application of Section 514(c)(9)(E). The Service is to be commended for providing that guidance in a relatively concise and understandable format, which is especially impressive given the highly technical nature of this area of the law. The Committee generally agrees with the substance of the Proposed Regulations, including the several ways in which they modify the rules contained in Notice 90-41 to allow QOs to make legitimate,

[2] 1990-1 C.B. 350.

non-tax-motivated real estate partnership investments without experiencing catastrophic UBTI consequences.

However, the Committee does have comments on certain aspects of the Proposed Regulations, which comments are set forth below. The Committee's recommendations include the following: (1) the reasonable preferred return rule should be changed to allow income allocations to QO partners before related cash distributions and to clarify certain technical issues; (2) the reasonable guaranteed payment rule should be modified to enable accrual-method partnerships to rely on the rule; (3) the unlikely allocation exclusion should be revised to avoid an emphasis on the foreseeability of the event giving rise to the unlikely allocation; (4) the chargeback provisions should be modified to eliminate the disproportionality concept and to address certain other technical issues; (5) the types of expenses qualifying for the partner-specific allocation exclusion should be broadened; (6) the de minimis allocation and de minimis interest rules should be revised in certain ways; (7) the general anti-abuse rule in Proposed Regulation § 1.514(c)-2(k)(4) should be eliminated; and (8) certain additional issues, such as the effect of the admission of new partners, should be addressed by the final regulations.

II. Reasonable Preferred Returns

A. "Commercially Reasonable" Rate.

Under Proposed Regulation § 1.514(c)-2(d)(4)(i), allocations attributable to a preferred return or a guaranteed payment for the use of capital are disregarded for Fractions Rule purposes only if the preferred return or guaranteed payment is computed by applying a rate of return that is "commercially

reasonable based on the relevant facts and circumstances" to the amount of the partner's unreturned capital. Proposed Regulation § 1.514(c)-2(d)(4)(ii) provides the safe harbor rule that a rate not in excess of the greater of 150% of the applicable Federal rate ("AFR") or the AFR plus four percentage points will be deemed to be "commercially reasonable". These rules significantly liberalize the rules of Notice 90-41, which did not permit reasonable preferred returns or guaranteed payments to be computed at a rate in excess of 120% of the AFR.

While the Committee strongly endorses these rules, it is concerned by the fact that, apart from setting forth the safe harbor rule, the Proposed Regulations do not provide any guidance as to what it means for a rate to be "commercially reasonable". [3/] It could be argued that the preferred return or guaranteed payment rate for any partnership where the partners are dealing with each other at arm's length is commercially reasonable, since by definition the preferred return rate would represent a market rate of return for that transaction. In any event, the regulations as they stand are vague and would give rise to unnecessary controversies on audit in situations where the preferred return rate exceeds the safe harbor rate. Accordingly, the Committee recommends that the test for commercial reasonability be amplified and that the regulations state specifically that the issue of whether a preferred return in excess of the safe harbor rate is commercially reasonable depends upon whether the rate would be reasonable for a comparable transaction that does not involve QO partners or that does not involve any special allocation of income among the partners to

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[3/] Prop. Treas. Reg. § 1.514(c)—(2)(d)(7), Example (1)(iii), illustrates the effect of a preferred return that is not commercially reasonable, but it provides no insight as to what "commercially reasonable" means, as it does not specify the rate of return involved and it simply assumes without explanation that the rate of return is not commercially reasonable.

reflect their entitlement to accrued but unpaid preferred returns.

B. Unreturned Capital.

As suggested above, an integral part of the reasonable preferred return rule is the concept of a QO partner's “unreturned capital”, since that is the base upon which the QO partner may earn a reasonable preferred return. Unreturned capital is defined in Proposed Regulation § 1.514(c)-2(d)(5)(i) as the excess of the amount of capital contributed by the partner over the amount of cash and the net fair market value of property distributed by the partnership to the partner “as a return of capital” Proposed Regulation § 1.514(c)-2(d)(5)(ii), in turn, states that whether a distribution is to be treated as a return of capital should be determined based on all the relevant facts and circumstances, including the partnership agreement. It goes on to state that “generally, a material distribution is treated as a return of capital if it is not attributable to the partnership's cash flow from its business operations”.

The Committee has two comments on Proposed Regulation § 1.514(c)-2(d)(5). First, the Committee believes that the proposed rules regarding what constitutes a return of capital are too vague, since it is unclear whether the result turns on tax accounting principles, GAAP accounting principles, the business arrangement of the partners or something else. The Committee recommends that the regulations state clearly that what constitutes a return of capital depends solely on the business arrangement of the partners, as reflected by the terms of the partnership agreement (as defined in Treasury Regulation § 1.704-1(b)(2)(ii)(h)) and any other relevant facts and circumstances. As long as the partners regard a particular partner's capital as

still being invested in the deal as a business matter, that should be controlling. No other standard would make sense in this context, just as it would not make sense for there to be a special tax rule that the principal amount of a loan may not be repaid out of cash flow from ordinary operations. The approach of looking solely at the business arrangement of the partners also has the virtue of being easily administered, since it usually is quite clear in a partnership agreement when distributions are treated as a return of capital.

The second comment, which is related to the first, is that the second sentence of Proposed Regulation § 1.514(c)-2(d)(5)(ii) (which was quoted above) should be deleted. The reason is that real estate partnerships frequently make distributions out of sources other than "cash flow from business operations" that clearly represent a payment of a return on capital, not a return of capital, as a business matter. Indeed, all such other sources of funds, including proceeds from partnership borrowings, funds released from reserve accounts and proceeds from property sales, may from time to time be applied in whole or in part against the entitlement of partners to their preferred returns. [4/] In addition, there are real estate partnerships that choose as a business matter to apply their cash flow from ordinary operations to a return of the capital of the partners, particularly where the partnership has numerous small assets that it plans to sell fairly quickly (which makes the distinction between ordinary operations and capital transactions somewhat murky) or where the preferred returns of the partners

[4/] The most obvious example of this would be a real estate partnership that made no distributions out of cash flow from ordinary operations because, say, it applied all such cash flow to the payment of "pay through" debt. Thus, the partners' preferred returns would simply accrue for a while and then be paid out of sale or refinancing proceeds. Compare Example (3) in Part IV(D).

are based on an internal rate of return test (which by definition encompasses a return of capital).

C. Current Distribution Requirement.

Proposed Regulation § 1.514(c)-2(d) would retain the requirement from Notice 90-41 that the income allocations intended to give effect to a reasonable preferred return must be made contemporaneously with the related distribution of cash. As explained more fully in the 1991 Report, [5] that requirement severely limits the ability of partnerships to rely on the reasonable preferred return rule, since it creates a risk that the economics of a partnership investment will be distorted by forcing partnership income that is in excess of cash distributions to be allocated to partners that are not entitled to the next cash distributions. [6] Indeed, because it is necessary to specially allocate income to partners that are entitled to accrued but unpaid preferred returns to insure that such preferred returns will be paid, the partnership agreements for transactions not involving QO partners often provide for income allocations to give effect to reasonable preferred returns

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[5] See the 1991 Report at 16-21. See also the letter dated May 23, 1991, from William B. Brannan to Christopher Kehoe, reproduced in Tax Notes, July 1, 1991, at 125-26.

[6] As noted in the 1991 Report, real estate partnerships often realize taxable income in excess of the amount of cash that they distribute to their partners on a current basis for a variety of reasons. The principal cause of income exceeding current cash distributions is the use of cash flow to fund nondeductible expenditures, such as leasehold improvement costs, reserve contributions and amortization of debt. Other causes include the existence of contractual limitations on cash distributions (such as bank loan covenants and partner consent requirements) and the realization of "phantom" income (such as discharge of indebtedness income). If any such income in excess of current cash distributions is not allocated to, and credited to the capital accounts of, the partners that are entitled to the next cash distributions, the business arrangement of the partners may be distorted, since the capital account balances of the partners will not correspond to their entitlements to cash distributions as a business matter. For an example of that result, see the 1991 Report at 18 (Example (1)). See also Example (1) herein, but assume that the property is sold for $200 at the end of year (2).

as they accrue, regardless of whether there is a related cash distribution. [7/] It is also possible that the no-income-before-cash rule may be circumvented by requiring cash contributions from the partners to fund shortfalls in the distribution of reasonable preferred returns. [8/] Consequently, the Committee strongly urges the Service to reconsider its position on this issue and to permit partnerships to allocate income to partners to reflect their entitlements to preferred returns as they accrue.

The Committee understands that the Service's position on this, issue reflects its concern that some type of time value of money abuse might be possible if income allocations could be made as a QO's preferred return accrues, rather than as it is distributed as required by Notice 90-41 and the Proposed Regulations. The Service's original concern in that regard may even have been strengthened by the new approach taken in the Proposed Regulations of permitting reasonable preferred returns to be computed at rates in excess of the AFR test rates if they would be "commercially reasonable", which eliminates the absolute ceiling on income allocations that was present in Notice 90-41.

[7/] For an example of an allocation provision of this nature, see Whitmire, Nelson, McKee and Kuller, Federal Income Taxation of Partnerships and Partners, vol. 3, form 7-22 (1989).

[8/] A partnership could require capital contributions from its partners at the end of each year in an amount equal to the difference, if any, between the amount of the preferred return that accrued during the year and the amount of cash that otherwise would be distributed during the year with respect to that preferred return. The cash that is contributed would then be distributed to the partners that are entitled to the preferred return before the due date of the partnership's tax return for the year. That would seem to validate a current allocation of income to the partners that are entitled to the preferred return, although the Service might be able to argue that the contribution and distribution should be disregarded if they represent a circular flow of cash involving the same partners.

[9] However, the Committee questions whether there would be a significant potential for a time value of money abuse if the Proposed Regulations were modified to permit allocations of income before the related cash distributions, since (1) there is some limit to the income allocations associated with a reasonable preferred return due to the "commercially reasonable" requirement, (2) income allocations have to pass muster under the anti-abuse rule in Proposed Regulation § 1.514(c)-2(k)(4) [10] and (3) income allocations also have to pass muster under the "substantiality" test in Treasury Regulation § 1.704-1(b)(2)(iii). [11] Furthermore, any resulting tax benefit to taxable partners may be limited under Section 704(d), Section 465, Section 469 or other provisions of the Code.

If the Service is concerned that there would be a time value of money abuse potential in spite of the foregoing considerations, the Committee suggests that the Service consider imposing the following two special limitations to minimize such abuse potential in lieu of prohibiting income allocations in respect of accrued but unpaid preferred returns. The first would be to limit the rate at which a reasonable preferred return may be computed to the safe harbor rate in cases where the partnership desires to be able to make income allocations before the related cash distributions, thereby imposing an absolute

[9] As noted earlier, Notice 90-41 contained the bright line rule that preferred returns computed at rates in excess of 120% of the AFR were not reasonable.

[10] In Part VIII(C) of the Report, the Committee recommends that the general anti-abuse rule in Proposed Regulation S 1.514(c)-2(k)(4) be eliminated. If that comment were accepted, a special anti-abuse rule could be included for partnership allocations of income attributable to accrued but unpaid preferred returns.

[11] It should be noted that the risk that the income allocations would fail to satisfy the substantiality test is not only a Section 704(b) hazard for the taxable partners, since a failure to satisfy the substantiality test also would cause the QO partners to violate Section 514(c)(9)(B)(vi), which requires compliance with Section 704(b).

ceiling on the amount of income that may be allocated under the reasonable preferred return mile. The second limitation would be to require in such cases that the preferred return be computed on a compounded basis, i.e., that any preferred return that is paid in a period after the period during which it accrues be paid with an interest factor (computed at the same rate as the preferred return itself) so as to prevent the present value of the preferred return from being diminished by the deferral of payment. That should eliminate any incentive that taxable partners might have to grant QO partners the right to a preferred return that would not be paid on a current basis for the purpose of validating a current income allocation to the QO partners and, therefore, a tax benefit to the taxable partners. That point is illustrated by the following simplified example:

> Example (1). A taxable partner ("TP") and a QO form a partnership, with the QO contributing $100 and TP not making any capital contribution. The partnership borrows $100 from a third party on a nonrecourse basis and acquires an office building for $200 (which for purposes of simplicity is assumed to be nondepreciable). The business deal is that cash flow from ordinary operations is to be distributed first to the QO to pay a 10% cumulative, non-compounded preferred return on its capital (which is commercially reasonable) and then 50% to the QO and 50% to TP; proceeds from the sale of the property are to be distributed first to the QO to return its $100 of capital, then to the QO to pay its 10% preferred return and finally 50% to the QO and 50% to TP. Income and loss generally are allocated 50% to the QO and 50% to TP, except to the extent necessary to give effect to the QO's preferred return. Suppose that the partnership has $10 of taxable income and cash flow from ordinary operations in each of years (1) and (2), that it sells the building at the end of year (2) for $230 and that it makes a single distribution of $150 at the end of year (2). Since the QO's preferred return is not computed on a compounded basis, the $150 would be distributed $135 to the QO (the sum of its $100 of capital, its $20 preferred return and its 50% share of the cash in excess of those amounts) and $15 to TP. Under the Proposed Regulations, the income allocations would be $5 to the QO and $5 to TP in year (1) and $30 to the QO and $10 to TP in year (2). TP obviously would be better off if it could defer the $5

income allocation to it from year (1) to year (2), which would happen if the partnership could allocate all $10 of its income in year (1) to the QO to reflect its accrued preferred return. However, if the price TP must pay to cause all $10 of the income in year (1) to be so allocated to the QO is that it must permit the QO's preferred return to be computed on a compounded basis as per the Committee's suggestion, TP would be worse off on an after-tax basis. The $150 of cash would be distributed $135.50 to the QO (the sum of its $100 of capital, its $21 preferred return and its 50% share of the cash in excess of those amounts) and $14.50 to TP; the income allocations would be $10 to the QO for year (1) and $25.50 to the QO and $14.50 to TP for year (2). The present value of the after-tax cash flow of TP (calculated using a 10% discount rate and using a 31% assumed tax rate) would be $8.27 in this case, versus $8.43 in the first case.

The foregoing two limitations would have the virtue of minimizing any time value of money abuse potential while not interfering with the economics of typical, non-tax motivated real estate partnership transactions.

D. Allocation of Items Versus Overall Income.

Proposed Regulation § 1.514(c)-2(d)(2) states that "items of income (including gross income) and gain" that are allocated to give effect to a reasonable preferred return will be disregarded for Fractions Rule purposes. [12/] That language indicates that allocations of overall income may not be used to give effect to reasonable preferred returns, which would represent a change from Notice 90-41. The Committee suggests that the reasonable preferred return rule allow the use of overall income allocations, since they are no more abusive than item allocations. That change also would help conform the treatment of reasonable preferred returns to the treatment of

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[12/] It should be noted that the parenthetical in the quoted language is redundant.

reasonable guaranteed payments, which are treated as allocations of overall partnership income for Fractions Rule purposes. [13/]

E. Guaranteed Payments.

Proposed Regulation § 1.514(c)-2(d)(6)(ii) provides that a partnership may treat a guaranteed payment payable to a QO for the use of capital as a reasonable guaranteed payment only if the partnership claims a deduction in respect of such guaranteed payment "no earlier than the taxable year it is paid in cash". A payment made within 75 days after the end of a taxable year will be deemed to have been made in the prior taxable year for that purpose.

The Committee has two comments on the reasonable guaranteed payment rule. First, the Committee believes there may be a technical problem with the reasonable guaranteed payment rule as it relates to partnerships that use the accrual method of accounting, which, based on the Committee's experience, represent a large majority of real estate partnerships. [14/] A guaranteed payment for the use of capital is treated as a payment to a third party and, therefore, is deductible by the partnership in the taxable year for which a deduction would be appropriate under its method of accounting. [15/] Accordingly, for an accrual method partnership, a guaranteed payment for the use of capital normally would give rise to a deduction for the taxable year during which it accrues, regardless of when it is

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[13/] See Prop. Treas. Reg. § 1.514(c)-2(c)(1)(ii)

[14/] One reason that the accrual method of accounting is so prevalent is Section 448, which prohibits the use of the cash method of accounting for any partnership that has C corporation partners if the gross receipts of such partnership average over $5 million.

[15/] See Section 707(c) and Treas. Reg. § 1.707-1(c). See generally McKee, Nelson and Whitmire, Federal Income Taxation of partnerships and Partners, vol. 1, H 13.03 (1990).

paid. Proposed Regulation § 1.514(c)-2(d)(6)(ii) would seem to make it impossible for an accrual method partnership to rely on the reasonable guaranteed payment rule, since, as noted above, it seems to mean that a guaranteed payment may not be treated as a reasonable guaranteed payment if the related deduction may be claimed before it is paid.

The Committee recommends that the Service clarify the application of the reasonable guaranteed payment rules to accrual method real estate partnerships. If the no-income-before-cash rule is to be preserved in this context, the only way that the reasonable guaranteed payment rules could be made to work would be for the Fractions Rule regulations to modify the normal rule for deductibility of guaranteed payments by accrual method partnerships under Section 707(c) and to put such partnerships on the cash method of accounting with respect to reasonable guaranteed payments payable to QO partners. [16/] The Committee believes that such a rule would be desirable to make the reasonable guaranteed payment rule work as a technical

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[16/] It is possible that the Service intended to mean what the Committee is recommending, since Prop. Treas. Reg. § 1.514(c)-2(d)(6)(ii) states that "a partnership that avails itself of [the reasonable preferred return rule] is required to deduct a reasonable guaranteed payment to a qualified organization no earlier than the taxable year it is paid in cash" (emphasis added). However, it is unclear whether the word "required" was intended to modify the well- established law regarding the deductibility of guaranteed payments under Section 707(c) or simply to reflect a requirement of the reasonable guaranteed payment rule itself. Since there is no express statement in the preamble or the text of the Proposed Regulations that the Proposed Regulations actually modify the well-established Section 707(c) law in this context, the latter reading presumably was intended.

matter. [17] Moreover, such a rule could be extremely helpful as a policy matter, as it would enable real estate partnerships to avoid the economic risk associated with reasonable preferred returns due to the no-income-before-cash rule as described in (C) above by structuring the preferred returns of their QO partners as guaranteed payments. Unlike a preferred return that is given effect in connection with a liquidation of the partnership by including an appropriate credit balance in the partner's capital account via income allocations (which may not happen due to the Fractions Rule limitations on income allocations), a guaranteed payment is more like a subordinated debt of the partnership that must be paid ahead of ordinary equity distributions to the partners, regardless of the capital account balances of the partners. [18]

Second, the Committee recommends that the 75-day rule for guaranteed payments paid after the close of a taxable year

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[17] Such a rule would raise certain change of accounting method issues in cases where either (i) a partnership interest that is entitled to a guaranteed payment is initially held by a non-QO partner but is later transferred to a QO or (ii) such a partnership interest is initially held by a QO partner but is later transferred to a non-QO. In case (i), the partnership initially would deduct the guaranteed payments as they accrued under the usual Section 704(c) rules, but it would later be required to deduct such payments on a cash basis as a consequence of the admission of the QO partner. Obviously a second deduction should not be permitted at the time of payment for any previously accrued (and deducted) guaranteed payment that was as yet unpaid at the time of the transfer. In case (ii), the partnership initially would deduct the guaranteed payments on a cash basis, but it would later deduct such payments on an accrual basis after the admission of the non-QO partner. To the extent of any accrued but unpaid guaranteed payments at the time of transfer, a deduction should be allowed at the time of payment to prevent a complete disallowance of the deduction.

[18] The Service might also consider whether it is possible to provide for an analogous result in the reasonable preferred return context, i.e., to allow partnerships that pay reasonable preferred returns to their QO partners to make income allocations to the QO partners in respect of their accrued but unpaid preferred returns but then to somehow defer the resulting tax benefit to the taxable partners until such preferred returns are paid. However, such an approach would be substantially more complicated than the proposed treatment of reasonable guaranteed payments due to the Section 704(b) issues it would raise.

be conformed to the rule in Proposed Regulation § 1.514(c)-2(d)(6)(i) for reasonable preferred returns. Under that rule, a preferred return that is distributed after the close of a taxable year but before the due date for the partnership's tax return for that year (without regard to any extension thereof) is deemed to have been made during that year. There does not seem to be any reason to have a more stringent rule for guaranteed payments.

III. The Unlikely Allocation Exclusion

A. "Unlikely" Standard.

Proposed Regulation § 1.514(c)-2(g) provides that a special allocation of items of "unlikely" loss or deduction (other than nonrecourse deductions) to partners that bear the economic cost of those items will be disregarded for Fractions Rule purposes, provided that a principal purpose of the allocation is not tax avoidance. The regulation goes on to provide that a loss or deduction is unlikely only if it results from an "unexpected event", which, in turn, is defined as one that "could not reasonably have been foreseen by the partners". The examples given of unexpected events include labor strikes and significant delays in leasing due to an economic downturn.

The Committee strongly supports the concept of an unlikely allocation exclusion, since the partners in real estate partnerships often seek to have unexpected costs be economically borne only by designated partners (usually the general partner). Any such arrangement necessitates a special allocation of the related loss or deduction for tax purposes that generally would not be permitted under Section 514(c)(9)(E) but for the unlikely allocation exclusion. As long as there is some reasonable

standard insuring that the cost was unlikely to have been incurred (and, therefore, that the partnership was not structured with a view to providing a special allocation of tax benefits to a taxable partner), there is no reason why partnerships that have QO partners should not be able to have such terms.

However, the Committee believes that standard of reasonable foreseeability that is adopted by the Proposed Regulations is too stringent. The reason is that there is usually some chance that many of the events giving rise to the costs that are involved in these special allocations (such as labor strikes or delays in leasing the property) will occur. With the benefit of hindsight on audit, it would be easy for the Service to make a strong case that the event giving rise to the cost was reasonably foreseeable. [19/] Thus, the Committee recommends that the reasonably foreseeable test be deleted and that the unlikely allocation exclusion focus on the question of whether the event giving rise to the cost was unlikely.

In addition, the Committee suggests that the language of the fourth sentence of Proposed Regulation § 1.514(c)-2(g), which enumerates certain events that may give rise to deductions that may be specially allocated under the unlikely allocation exclusion, [20/] be clarified. As a grammatical matter, it is

[19/] The very existence of the special allocation provision in the partnership agreement normally would be evidence that the triggering event was foreseeable, but Prop. Treas. Reg. § 1.514(c)-2(g) provides that no inference should be drawn from the mere inclusion of the special allocation provision in the partnership agreement.

[20/] That sentence reads as follows: "These events include those in the nature of liabilities from tort and other unforeseen third-party litigation; labor strikes; unusual delays in securing required permits or licenses; abnormal weather conditions . . .; significant delays in leasing property due to an economic downturn in the geographic area; and unanticipated cost overruns."

not clear whether the reference to "these events" at the beginning of that sentence was intended to indicate that the enumerated events are per se unlikely to occur or merely that such events may, under appropriate circumstances, be unlikely to occur. Since the general flavor of the enumerated events is that they are unlikely (e.g., "unanticipated cost overruns"), the Service presumably intended that they be regarded as per se unlikely events. [21] The Service should clarify the meaning of this aspect of the Proposed Regulations. The Committee recommends that the Service make clear that the enumerated events are per se unlikely to occur to avoid disputes regarding the likelihood of the enumerated events and generally to illustrate what it means for an event to be unlikely to occur.

Assuming that the foregoing comment is accepted, the Committee also recommends that two specific changes be made to the fourth sentence. First, the reference to "liabilities from tort" should be narrowed to "liabilities from tort in excess of insurance coverage", since it cannot be said as a general rule that tort liabilities are unlikely to be incurred by a real estate partnership given the prevalence of "slip and fall" cases. [22] Second, the Committee suggests that the list of unlikely events be expanded to include the discovery of environmental problems requiring remedial work of which the partners were not previously aware.

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[21] The language of the fourth sentence of Prop. Treas. Reg. § 1.514(c)-2(g) was derived from Part IV of Notice 90-41, which suggested more strongly that the enumerated events were per se unlikely to occur.

[22] Compare Part IV of Notice 90-41, which refers to insurance coverage.

B. Pre-Funding Unlikely Expenses.

As recommended in the 1991 Report, [23] the unlikely allocation exclusion should be available even if the taxable partner is required to pre-fund a reserve for an unexpected partnership expense. That concept could be reflected by adding to the last sentence of Proposed Regulation § 1.514(c)-2(g) the following phrase: "or requires a special partnership reserve funded by the taxable partner for the purpose of discharging expenses associated with unlikely events".

IV. Chargebacks

A. General.

Section 514(c)(9)(E)(ii)(I) provides a special rule for chargebacks, i.e., allocations that reverse prior allocations. That rule (the "Chargeback Exception") is as follows:

> "Except as provided in regulations, a partnership may . . . provide for chargebacks with respect to disproportionate losses previously allocated to qualified organizations 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."

The Proposed Regulations confirm that allocations qualifying under the Chargeback Exception will be disregarded in computing overall partnership income or loss for purposes of the Fraction Rule. [24] In addition, the Proposed Regulations provide (1) limitations on the kind of chargebacks that qualify under the Chargeback Exception, (2) rules for determining when an

[23] See the 1991 Report at 29-30.

[24] Prop. Treas. Reg. § 1.514(c)-2(e)(1).

allocation is disproportionate and (3) guidance as to when an allocation satisfies the requirements of the last sentence of Section 514(c)(9)(E)(ii)(I) (the "ratio requirement").. Special rules are also provided for allocations pursuant to minimum gain chargebacks and qualified Income offsets.

B. Definition of Chargeback.

The Proposed Regulations provide for two basic types of chargebacks that may qualify under the Chargeback Exception. The first type, which is referred to herein as an "overall chargeback", involves (i) allocations of overall partnership income made to reverse prior disproportionately large allocations of overall partnership loss (or a part thereof) to a QO or (ii) allocations of overall partnership loss made to reverse prior disproportionately small allocations of overall partnership income (or a part thereof) to a QO. [25] The second type consists of allocations of items of income or gain made pursuant to a minimum gain chargeback provision or made to reverse certain prior "compensating" allocations of deductions. [26] In general, except for chargebacks of the second type, chargebacks of prior overall allocations (or parts thereof) effected by the use of items will not qualify for the Chargeback Exception.

The Proposed Regulations take the approach of focusing solely on the QO for purposes of deciding whether an overall

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[25] Prop. Treas. Reg. § 1.514(c)-2(e)(1)(i).

[26] The Proposed Regulations also provide that allocations of items of income or gain made to a partner pursuant to a qualified income offset within the meaning of Treas. Reg. § 1.704-1(b)(2)(ii)(d) will be disregarded in computing overall partnership income or loss. Prop. Treas. Reg. § 1.514(c)-2(e)(1)(iv).

allocation is eligible for reversal under the Chargeback Exception. That is, the required inquiry under the Proposed Regulations is whether a prior allocation of overall partnership loss or income was, respectively, disproportionately large or disproportionately small relative to a QO. In the context of a partnership with only one QO partner, that approach should produce the same result as would occur had the proposed Regulations been written in terms of permitting chargebacks of disproportionately large allocations of overall loss to a QO and disproportionately large allocations of income to the taxable partners, although the fact that the two approaches are equivalent is not self-evident. The advantage of the approach of the Proposed Regulation is that it avoids having to define when an allocation to the taxable partners is disproportionately large, which can be problematic in cases where there is more than one QO partner. On the other hand, the Committee's view is that the approach adopted by the Proposed Regulations is somewhat confusing and counterintuitive. In part, that is because the statute is written the other way--the statute permits chargebacks of disproportionate income "previously allocated to the other partners". In addition, disproportionately small overall income allocations to the QO are charged back by making disproportionately small loss allocations to the QO. [27/] That fact is not spelled out in the Proposed Regulations.

Elsewhere in this Report, the Committee recommends that the concept of disproportionality be eliminated from the Regulations, in which case this issue would be moot. However, if the disproportionality concept is retained, the Committee

[27/] The simplest case is a chargeback of a disproportionate 0% income allocation to QO, which requires that a 0% loss allocation be made to the QO to effect the chargeback.

recommends that the regulations with respect to this issue be clarified and that an example of a chargeback of a disproportionately small overall income allocation to a QO be provided.

C. Definition of Disproportionate.

The Proposed Regulations indicate that an allocation to a QO is disproportionately large or disproportionately small if the QO's percentage share of the allocation is greater or smaller, respectively, than its Fractions Rule percentage. [28/] The Proposed Regulations state that a prior allocation is not considered to be disproportionate unless the balance of the overall partnership income or loss for the taxable year of the allocation is allocated in a manner that would independently satisfy the Fractions Rule. [29/]

That definition of disproportionate is conceptually correct. However, there are cases where the definition cannot be applied to identify a disproportionate allocation. Consider the following example:

> Example (2). A taxable partner ("TP") contributes $100 and a QO contributes $900 to a partnership. The partnership agreement allocates overall partnership income first to reverse any 100% overall loss allocations to the QO, then 50% to TP and 50% to the QO until the QO has earned a specified return on its investment and thereafter 70% to TP and 30% to the QO. The partnership agreement allocates overall partnership loss first to reverse any prior 70/30 income allocations, then 50% to TP and 50% to the QO until TP's capital account is reduced to zero (which in part may be a reversal of prior 50/50 overall income allocations) and thereafter 100% to the QO.

[28/] Prop. Treas. Reg. § 1.514(c)-2(e)(2)(i).

[29/] Id.

This partnership's allocations should not be considered to fail the Fractions Rule as a result of its chargeback provisions, since the partnership's allocations that do not represent chargebacks (i.e., the 50/50 and 70/30 income allocations and the 100/0 and at least part of the 50/50 loss allocations) clearly satisfy the Fractions Rule. However, it is unclear how these allocations would fare under the Proposed Regulations. Would the 70/30 residual allocation of overall income be considered to be a disproportionate allocation? If it were not, then the 70/30 loss allocation to reverse that allocation would violate the Fractions Rule. Similarly, under the Proposed Regulations, the 30% income allocation to QO would be disproportionately small only if 30% is less than QO's Fractions Rule percentage (i.e., less than QO's smallest share of overall loss—ignoring disproportionate chargebacks). QO's smallest share of overall loss is 30%, which would be considered to be its Fractions Rule percentage unless the 70/30 loss allocation were to be considered to be disproportionate, in which case QO's Fraction Rule percentage would be 50%. That is a circular question with no answer based on the definition in the Proposed Regulations.

As pointed out in the 1991 Report, [30/] while not self-evident, the concept of disproportionality is irrelevant to the proper application of the Fractions Rule and its chargeback provision. The Fractions Rule should work exactly the same way if the words "disproportionate" were not used in the statute. To illustrate this, consider a partnership whose allocations, without regard to reversals, satisfy the Fractions Rule. Suppose that the partnership agreement provides for a special allocation of overall partnership loss to QO, which allocation is not a reversal of any prior overall partnership income allocation.

Under the Proposed Regulations, that, loss allocation is either disproportionately large or it is not disproportionate at all; it cannot be disproportionately small (since it would then result in the partnership's basic allocations failing the Fractions Rule). In either case, the allocation may be reversed without violating the Fractions Rule. There is no need to know which of the two possible cases it represents. This analysis also applies in the case of an allocation of just a part of overall partnership income for such year. [31] Moreover, a similar analysis applies to an allocation of overall income (or a part thereof) to QO.

Eliminating the concept of disproportionality would greatly simplify the Proposed Regulations and eliminate circularity problems, such as those illustrated by Example (2) above. Accordingly, the Committee recommends that the final regulations be simplified by eliminating the requirement that chargebacks be made to reverse "disproportionate" allocations and simply allowing chargebacks to reverse any prior allocations that were allowable under the basic ratio requirement of the Fractions Rule.

The Proposed Regulations provide that a prior allocation is not considered to be disproportionate unless the balance of the overall partnership income or loss for the

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[30] See the 1991 Report at 32-37.

[31] If a partnership agreement contained an allocation under which a part of overall partnership income for any year was allocated in a disproportionately small percentage to a QO, then the partnership's allocations should be considered to violate the Fractions Rule, since there would at least be a theoretical possibility that such portion could have been realized in isolation (i.e., such portion could have been the entire overall income of a partnership for a taxable year). While arguably this conclusion could be avoided if the partnership had "dependent" partial allocations (e.g., $X of loss is allocated in a disproportionately small percentage to QO only if at least $X is also allocated to QO in the same year in an offsetting disproportionately large percentage) and only one component of the allocation is to be charged back, any concern is addressed by the "remaining balance"

taxable year of the allocation is allocated in a manner that would independently satisfy the Fractions Rule. [32] Accordingly, if the allocation of overall partnership income or loss, exclusive of the prior allocation to be reversed, does not independently satisfy the Fractions Rule, a chargeback of the prior allocation will not be ignored in computing overall partnership income or loss. The goal of this rule is clearly appropriate, since otherwise overall partnership income or loss could be effectively allocated in a manner that violated the Fractions Rule on a multi-year basis. It should be noted, however, that this rule has very little operative effect in view of the "all events" approach of the Fractions Rule. [33] In particular, if the partnership's overall allocations satisfy the Fractions Rule, then, except for "dependent partial allocation cases", [34] any portion of an overall allocation should also satisfy the Fractions Rule.

D. Minimum Gain Chargebacks.

The Proposed Regulations permit minimum gain chargebacks of nonrecourse deductions and partner nonrecourse deductions to be ignored in computing overall partnership income and loss. Unlike the general Chargeback Exception, this rule permits items of income and deduction to be used to effect the

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rule discussed below and by the general anti-abuse provision of Prop. Treas. Reg. § 1.514(ic)-2(k)(4).

[32] Prop. Treas. Reg. § 1.514(c)-2(e)(2)(i).

[33] This rule could be retained if the disproportionate concept were eliminated. It would require, in order for a chargeback to be ignored, that the balance of the overall partnership income or loss for the year of the prior allocation be allocated in a manner that independently satisfies the Fractions Rule.

[34] See footnote 31.

chargeback. [35] That is necessary, since the minimum gain chargeback provisions of the Section 704(b) regulations mandate the use of item allocations to effect chargebacks. [36]

The Proposed Regulations contain seemingly conflicting provisions regarding allocations that charge back minimum gain attributable to the distribution by a partnership of the proceeds of a nonrecourse liability (or a partner nonrecourse debt). On the one hand, Proposed Regulation § 1.514(c)-2(d)(2) indicates that minimum gain chargebacks relating to distributions of the proceeds of a nonrecourse liability (or partner nonrecourse debt) to pay a reasonable preferred return will be disregarded for purposes of applying the Fractions Rule. On the other hand, Proposed Regulation § 1.514(c)-2(e)(4) states that allocations pursuant to a minimum gain chargeback attributable to the distribution of the proceeds of a nonrecourse liability (or a partner nonrecourse debt) will be "taken into account" when the chargeback occurs.

The Committee has two comments on the Proposed Regulations as they relate to chargebacks attributable to distributions of the proceeds of a nonrecourse liability (or a partner nonrecourse debt). First, to the extent that the distribution represents a payment of a reasonable preferred return, it is unclear whether the chargeback would be disregarded at all times under Proposed Regulation § 1.514-2(d)(2) or whether it would be "taken into account" once it occurs under Proposed Regulation § 1.514(c)-2(e)(4). The Committee believes that, like other income allocations associated with a reasonable preferred return,

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[35] Prop, treas. Reg. §§ 1.514(c)-2(e)(1)(ii) and 1.514(c)-2(e)(1)(iii).

[36] See Treas. Reg. §§ 1.704-2(f)(1) and 1.704-2(1)(4).

such chargebacks should be disregarded at all times. [37] Second, the final regulations should clarify what it means for a chargeback to be "taken into account". Presumably that means that the partnership's allocations would be retested at that time under the regulations and one of two results would obtain either the chargeback would not cause a violation of the Fractions Rule or it would cause a violation of the Fractions Rule for that year and all subsequent years (but not prior years). Consider the following example:

> Example (3). A taxable partner ("TP") and a QO form a partnership, with the QO contributing $100 and TP not making any capital contribution. The partnership borrows $100 from a third party on a nonrecourse basis and acquires an office building for $200. Partnership cash distributions are made 100% to the QO until it receives a 10% preferred return (which is commercially reasonable) and a return of its capital, then 50% to the QO and 50% to TP. Partnership losses are allocated 100% to the QO until its capital account is reduced to zero and then 50% to the QO and 50% to TP; partnership income is allocated 100% to the QO to the extent of its 9% preferred return and then 50% to the QO and 50% to TP. Assume that, through the first five years of operations, the partnership's operating income has equaled its operating expenses, $100 of depreciation deductions have been claimed, the $100 of overall loss has been allocated to the QO and no cash distributions have been made. At the end of year 5, the partnership borrows an additional $150 from a third party on a nonrecourse basis and distributes the proceeds to the QO in satisfaction of its accrued but unpaid 10% preferred return and to return its capital. The second borrowing is then repaid over the following ten years, triggering a minimum gain chargeback of $150 to the QO over that period. The first $50 of the chargeback should be disregarded as an income allocation associated with the QO's reasonable preferred return under Proposed Regulation § 1.514(c)-2(d)(2). The remaining $100 of the chargeback, which must be "taken

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[37] The parenthetical language at the end of Prop. Treas. Reg. § 1.514(c)-2(e)(4), which contains a crossreference to Prop. Treas. Reg. § 1.514(c)-2(d)(2), may have been intended to indicate that the chargeback would be "taken into account" when it occurs under Prop. Treas. Reg. § 1.514(c)-2(e)(4) but then immediately disregarded under Prop. Treas. Reg. § 1.514(c)-2(d)(2). However, it is not clear whether that was the Service's intent, and, even if it were, that approach would seem to be unnecessarily convoluted.

into account" when it happens under Proposed Regulation § 1.514(c)-2(e)(4), should be allowable under Proposed Regulation § 1.514(c)-2(e)(2), since it represents a chargeback of the disproportionate allocation of $100 of loss to the QO during the first five years.

The Committee recommends that an example similar to the foregoing be included in the final regulations.

E. Ordering of Chargebacks.

The Proposed Regulations provide that allocations may be reversed in any order but must be reversed in the same ratio as originally made. [38] The provision allowing allocations to be reversed in any order provides appropriate and necessary flexibility without compromising the purposes of the Fractions Rule. Since the Proposed Regulations do not provide a definition of what an "allocation" is, the final regulations should make it clear that a portion of an allocation can also be reversed as long as the ratio requirement is met. [39]

F. Summary of Chargeback Recommendations.

The Committee recommends the following:

1. The final regulations should provide that any prior allocations of overall income (or a part thereof) or overall loss (or a part thereof) that was allowable under the basic ratio requirement of the Fractions Rule may be charged back in

[38] Prop. Treas. Reg. § 1.514(c)-2(e)(2)(i).

[39] For example, consider a partnership between a QO and a taxable partner ("TP") where the QO's Fractions Rule percentage is 50% and under the partnership agreement the partnership's loss of $200 in a given year is allocated 50/50 for the first $100 and then 100% to the QO for the balance. The Regulations should confirm that if $100 of income is realized in the next year, it could be allocated to reverse a part of each allocation; for example, $50 to reverse one-half of the 50/50 allocation (i.e., $25 to the QO

any order. The concept and definition of disproportionality would be eliminated.

2. In the event that the concept of disproportionality is retained, (i) the final regulations should clarify Proposed Treasury Regulation § 1.514(c)-2(e)(1) to indicate specifically that chargebacks of disproportionately small income allocations to a QO are to be effected by disproportionately small loss allocations to the QO, (ii) the final regulations should include an example of a chargeback of a disproportionately small income allocation to a QO and (iii) Proposed Treasury Regulation § 1.514(c)-2(e)(1)(i) should be amended to indicate specifically that a part of an allocation may be reversed.

3. The final regulations should clarify the effect of the occurrence of an allocation pursuant to a minimum gain chargeback provision attributable to a distribution by the partnership of the proceeds of a nonrecourse liability (or a partner nonrecourse debt), including that it would not have any retroactive effect on the partnership for years prior to the year during which the minimum gain chargeback occurs.

V. Tiered Partnerships

Proposed Regulation § 1.514(c)-2(m)(1). provides that if a QO "holds an indirect Interest in real property through one or more tiers of partnerships (a chain)", then the QO will be eligible for the benefits of Section 514(c)(9) only if each of two tests is satisfied. First, the avoidance of tax may not be a principal purpose for investing in the tiered-ownership structure. For this purpose, "investing in separate properties

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and $25 to TP) and $50 to reverse one-half of the 70/30 allocatibn (i.e., $35 to the QO and $15 to TP).

through separate partnerships or chains of partnerships so that section 514(c)(9)(E) is, effectively, applied on a property-by-property basis is not, in and of itself, a tax avoidance purpose". Second, the QO must "demonstrate that the fractions rule is satisfied under any reasonable method".

The Committee commends the Service for adopting this sensible and flexible rule for tiered partnerships, and for illustrating its application with specific examples. These examples make clear that the Fractions Rule may be satisfied in any of the following ways:

1. Using a look-through approach, in which the tiered structure is collapsed and the ultimate allocations to the taxable partners and QOs are tested. [40/]

2. Using a partnership-by-partnership approach, in which each partnership in between the QO and the debt- financed real property is tested with respect to that QO. [41/]

3. In the case of a QO indirectly owning real properties through each of two or more chains, using a property-by-property approach. [42/]

The Committee has the following comments and suggestions with respect to the Proposed Regulations as they relate to tiered partnerships.

[40/] Prop. Treas. Reg. § 1.514(c)-2(m)(2), Example (1). Compare the 1991 Report at 50-51.

[41/] Prop. Treas. Reg. § 1.514(c)-2(m)(2), Example (2). Compare the 1991 Report at 49-50.

[42/] Prop. Treas. Reg. § 1.514(c)-2(m)(2), Example (3). Compare the 1991 Report at 56-58.

First, the Proposed Regulations do not give full effect to Section 514(c)(9)(D), which provides that "[r]ules similar to the rules of [Section 514(c)(9)(B)(vi)] shall also apply ... in the case of tiered partnerships and other entities". As noted earlier, Section 514(c)(9)(B)(vi) provides three alternative means by which a debt-financed real property investment held through a partnership may qualify for the benefits of Section 514(c)(9): meeting the Fractions Rule, meeting the qualified allocations rule and having all the partners of the partnership be QOs. The Proposed Regulations, however, extend the benefits of Section 514(c)(9) to tiered partnerships only where the QO can demonstrate that the Fractions Rule is met. The inference that the two other alternative tests under Section 514(c)(9)(B)(vi) are unavailable to tiered partnerships presumably was not intended, which likely is a function of the fact that the scope of the Proposed Regulations seems to be limited to the Fractions Rule. That omission can be corrected by substituting "section 514(c)(9)(E)" for "section 514(c)(9)" in the introductory language of Proposed Regulation § 1.514(c) 2(m)(1).

More generally, it is hoped that future regulations dealing with the two other alternative tests in Section 514(c)(9)(B)(vi) will provide that a QO's investment in a chain of partnerships is eligible for the benefits of Section 514(c)(9) if the QO can demonstrate either (i) that the qualified allocations rule is satisfied under any reasonable method or (ii) that each partnership in between the QO and the debt-financed real property satisfies one of the three alternative tests in Section 514(c)(9)(B)(vi). [43/]

[43/] See the 1991 Report at 49-50.

Finally, the Proposed Regulations fail to deal with the situation in which a QO invests in a chain of partnerships that has existed for several years and that was not created in anticipation of the QO's investment. The Proposed Regulations properly include an anti-avoidance test, but provide that the QO must satisfy both the anti-avoidance test and the Fractions Rule in order to receive the benefits of Section 514(c)(9). For the reasons (and subject to the exceptions) described in the 1991 Report, [44] the Committee believes that a QO investing in such an existing chain should be entitled to the benefits of Section 514(c)(9) so long as the partnership in which the QO directly invests satisfies the Fractions Rule or the qualified allocations rule, even if some or all of the lower-tier partnerships do not.

VI. Partner-Specific Items of Deduction

Proposed Regulation § 1.514(c)-2(f) excludes special allocations of deductions related to three enumerated types of partner-specific expenditures from the computation of overall partnership income or loss for purposes of the Fractions Rule, provided that the expenditures are allocated to the partners to whom they are economically attributable. The excluded expenditures are (1) expenditures for additional record-keeping and accounting incurred in computing basis adjustments under Section 743(b), (2) additional administrative costs that result from having a foreign partner and (3) state and local taxes or expenditures relating to those taxes.

The Committee agrees that the enumerated exclusions are appropriate and necessary. However, it recommends replacing or supplementing the list of exclusions with a general rule that

[44] Id. at 51-56.

excludes any special allocation of deductions arising as a result of any reasonable type of expense incurred at the partnership level that is directly related to a specific partner or group of partners as a result of a benefit received by, or an obligation incurred by the partnership as a result of the presence of, such partners, provided that such deductions are allocated solely to the partners to whom the expense is attributable and that a principal purpose of the special allocation is not tax avoidance. The Committee believes that a general exclusion would better address the concern that a pro rata allocation of an item of partnership expense should not be required when it clearly can be demonstrated that the expenditure is directly borne by a specific partner or group of partners for legitimate business reasons.

Such a general rule would avoid the drawback of an exclusive list—namely, that it is impossible to envision all the types of expenditures that should be included in the list. The list of partner-specific allocations in the Proposed Regulations clearly is incomplete. For example, additional partner-specific items that the Committee believes should be excluded from application of the Fractions Rule include (1) accounting costs that may be incurred in connection with a transfer of a partnership interest as a result of the partnership making an interim closing of its books to allocate tax items between the transferor and the transferee, (2) expenses incurred to provide a specific partner or group of partners with specialized information that they need for their own unique tax, accounting or other information requirements and (3) interest expense on a loan incurred to fund withholding taxes attributable to foreign partners. There undoubtedly are other examples. The point is that the more flexible approach of stating the general principle (while perhaps including a nonexclusive list of examples) will

allow taxpayers to rely on the partner-specific allocation rule for legitimate expenditures not expressly approved in the final regulations. Needless to say, if the Committee's recommendation that the exclusive list approach be abandoned is not accepted, then the list of expenditures qualifying under Proposed Regulation § 1.514(c)-2(f) should be expanded to include the above-mentioned items.

VII. Partner Nonrecourse Deductions

Proposed Regulation § 1.514(c)-2(j) provides that items of partner nonrecourse deduction that must be specially allocated to a partner pursuant to Treasury Regulation § 1.704(b)-2(i), and any compensating allocations of other items of loss or deduction to other partners, are not taken into account for purposes of the Fractions Rule until the taxable years in which they are allocated. It is not clear, however, what the effect of such allocations will be once they are "taken into account". There are at least three possibilities. The first is that the effect of such partner nonrecourse deduction and related allocations is limited to the taxable year in which they occur, with the consequence that the partnership may satisfy the Fractions Rule in succeeding years, provided that no other violations have occurred. The second is that the partnership will violate the Fractions Rule during the taxable year during which the special allocation occurs and in all future taxable years. The third, and most draconian, is that the partnership will be treated as having violated the Fractions Rule *ab initio*, resulting in loss of the protection of Section 514(c)(9) for all taxable years.

This issue should be clarified. The Committee favors the first approach, which it feels is consistent with the rationale behind the special rule--namely that violations of the Fractions Rule as a result of partner nonrecourse deduction allocations constitute an extraordinary situation mandated by the Section 704(b) regulations, and that partnerships faced with such violations should be treated leniently. In addition, the Committee feels that this part of the Proposed Regulations would benefit from a specific example illustrating the effects of partner nonrecourse deduction allocations for taxable years prior to that allocation, in the taxable year of the allocation and in the taxable year following that allocation.

VIII. Other Comments

A. De Minimis Allocation Rule.

Proposed Regulation § 1.514(c)-2(k)(3) provides that items of loss or deduction (other than deductions attributable to nonrecourse debt) may be specially allocated away from a QO partner without violating the Fractions Rule if (1) the QO's Fraction's Rule percentage of such items is de minimis in amount and (2) the allocation "was neither planned nor motivated by tax avoidance". This test apparently is applied on a partner-by-partner basis. Items of loss or deduction are considered to be de minimis in amount if they do not exceed the lesser of (A) 1% of the partnership's aggregate amount of items of loss and deduction for the year and (B) $20,000.

While the Committee strongly endorses the concept of a de minimis allocation rule, the Committee has two comments on the de minimis rule that has been proposed. First, the Committee objects to the language in the Proposed Regulations that speaks

in terms of whether the allocation was "planned". It could be argued that any special allocation that occurred as a result of an event that was reasonably foreseeable at the outset of the partnership was "planned". It also might be argued that any special allocation by definition was "planned", since the mere inclusion of the special allocation in the partnership agreement represents planning. [45] The Committee believes that the protection of the de minimis rule should be available in any situation where the loss or deduction involved is de minimis in amount and the allocation was not motivated by tax avoidance, regardless of whether the event giving rise to the allocation was reasonably foreseeable or was otherwise "planned". Thus, the "planned" language should be deleted. Otherwise, the de minimis rule will simply function as a specialized version of the unlikely allocation exclusion in Proposed Regulation § 1.514(c)-2(g) and add nothing to the law. The whole point behind having a separate de minimis rule is to avoid questions of likelihood on the ground that the amount involved is de minimis.

Second, the Committee believes that the definition of de minimis amount in the Proposed Regulations is not appropriate. Specifically, the $20,000 ceiling amount is simply too low for large real estate partnerships, which can easily have tens of millions of dollars of deductions each year. [46] The one percent limitation also seems problematic, as it may be too low in cases where the QO holds a very large interest in the

[45] It is curious that Prop. Treas. Reg. § 1.514(c)-2(k)(3) does not have a rule comparable to the rule in Prop. Treas. Reg. § 1.514(c)-2(g) for the unlikely allocation exclusion that the no inference should be drawn from the mere inclusion of the special allocation provision in the partnership agreement.

[46] The $20,000 ceiling amount would apply in any case where the aggregate amount of loss and deduction exceeds $2 million.

partnership but too high where the QO holds a tiny interest. Recognizing the Service's legitimate interest in having a reasonable limitation on the amount of items of loss or deduction that may be specially allocated under the de minimis rule and the need to have a bright line standard for administrability reasons, the Committee recommends that the limitation be equal to the lesser of (i) 10% of the QO's Fractions Rule percentage of the partnership's items of loss and deduction for the year and (ii) $100,000. [47/]

B. De Minimis Interest Rule.

Under Proposed Regulation § 1.514(c)-2(k)(2), the allocation requirements of Section 514(c)(9)(B)(vi) do not apply to a real estate partnership investment if QO partners in the aggregate do not hold over five percent of the capital or profits interest in the partnership and the QO partners "participate on substantially the same terms as all other partners, or as all other similarly situated partners owning substantial interests". The Committee strongly supports the concept of a de minimis interest rule, but it has two comments on the proposed rule.

First, the Committee believes that the five percent limitation is too low, particularly in view of the presence of the second limitation that the QO partners participate on "substantially the same terms" as all other partners or similarly situated taxable partners owning substantial interests

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[47/] While the $100,000 figure could still be problematic for some large real estate partnerships, the Committee believes that the $100,000 figure is sufficiently high that such partnerships could plan their affairs so as to avoid exceeding it.

in the partnership. The Committee recommends that the test be ten percent, as it did in the 1991 Report. [48]

Second, the Committee believes that the second part of the "substantially the same terms" test, which refers to similarly situated taxable partners, is not clear. The language of the regulation actually suggests that there is no limitation (other than the five percent test) where there are no taxable partners owning the same class of interest that the QO partners own. The Committee suggests that the second part of the "substantially the same terms" test be revised to say something like "or there are taxable partners owning substantial interests in the partnership on substantially the same terms".

C. Anti-Abuse Rule.

Proposed Regulation § 1.514(c)-2(k)(4) sets forth an apparently generally applicable anti-abuse rule that the Proposed Regulations "may not be applied in a manner that is inconsistent with the purpose of the fractions rule". The Committee does not understand what that language, which was not included in Notice 90-41, was intended to mean. The general purpose of the Fractions Rule is to prevent the special allocation of tax benefits from QO partners to taxable partners (although there is no clear, concise statement of the purpose of the Fractions Rule in the statute, the legislative history or even the Proposed Regulations). However, the Proposed Regulations expressly sanction various ways that such allocations may occur, such as partner-specific allocations or allocations of unlikely items. As a result, the general anti-abuse provision has the potential to completely negate the benefit of the Proposed Regulations.

[48] See the 1991 Report at 59-61.

Aside from the foregoing problem with the language of the proposed anti-abuse rule, the Committee also believes that it would be bad tax policy for the Service to layer a generally applicable anti-abuse rule on top of the intricate mechanical test of the Fractions Rule. First, such a position would be inconsistent with the legislative evolution of the Fractions Rule. In 1987, Congress specifically choose to abandon the subjective approach in favor of the mechanical approach by replacing the "principal purpose" test that was in effect at the time with the Fractions Rule. [49/] The Proposed Regulations would reverse that decision. Second, the Committee believes that there is not sufficient abuse potential inherent in the Proposed Regulations to justify the inclusion of a general anti-abuse rule. This is not an area where the taxpayer has broad discretion in structuring its transactions, which discretion would warrant the inclusion of a general anti-abuse rule. Rather, it is an area where the taxpayer's position is regulated in extreme detail. In addition, specific anti-abuse rules are already included in the Proposed Regulations for the specific purposes for which such a rule seems appropriate. [50/] Third, the inclusion of a general anti-abuse rule may deter QOs from relying on the Fractions Rule regulations, which would defeat the purpose of the Proposed Regulations. This is an area where certainty of tax consequences (in this case, the absence of UBTI) is of great importance to the affected group of taxpayers. Any type of generally applicable anti-abuse rule (particularly

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[49/] See Section 10214(a) of the Revenue Act of 1987, Pub. L. No. 100-203.

[50/] See Prop. Treas. Reg. § 1.514(c)-2(k)(3) (de minimis allocation rule) and Prop. Treas. Reg. § 1.514(c)-2(m)(1) (tiered partnership rules). See also the recommendations in Part 11(C) and Part VI.

the one that has been proposed) may make it more difficult for such certainty to be obtained.

Thus, the Committee recommends that the anti-abuse rule in Proposed Regulation § 1.514(c)-2(k)(4) be eliminated. If the Service is concerned that clever taxpayers may devise some type of abusive transaction that would pass muster under the detailed mechanical rules of Section 514(c)(9)(E) and other applicable Code provisions, the Service might consider including in the final regulations a specific authorization for it to issue revenue rulings providing that specific types of transactions identified in such rulings will not be permitted under Section 514(c)(9)(E). That "rifle shot" approach would avoid the broad chilling effect that the proposed generally applicable anti-abuse rule might have. The Committee also believes that if there must be a generally applicable anti-abuse rule, it should not be based on the vague and overbroad standard of whether an allocation is "inconsistent" with the purpose of the Fractions Rule. Rather, it should be based on a specific test such as whether the principal purpose of the allocations is tax avoidance.

D. Changes in Partner Interests.

The Committee recommends that the Service give further consideration to, and address more fully in the final regulations, the effects of the transfer of an interest in a partnership from an existing partner (whether taxable or QO) to a QO. Proposed Regulation § 1.514(e)-2(k)(1) provides a starting point in that regard, but it does not specifically address issues such as how to apply the safe harbor reasonable preferred return test for the new QO partner and what effect the transaction has on the availability of the de minimis interest

rule if the transaction causes QOs to hold over 5% of the interests in the partnership. The Committee also recommends that the final regulations specifically address the effects of changes in the interests of partners as a result of the admission of new partners or the reduction in the interests of existing partners. Such transactions are commonplace, but they may raise other technical issues under the Fractions Rule, because they necessarily involve changes in the tax allocations by the partnership. [51/] Some of those issues could be addressed by adopting the principles of Temporary Treasury Regulation § 1.168(j)-1T, Question (22), which applies for purposes of the qualified allocations rule.

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[51/] Prop. Treas. Reg. § 1.514(c)-2(b)(2)(ii) does not help, since it suggests that such allocation changes may automatically be fatal for all subsequent years.