NEW YORK STATE BAR ASSOCIATION

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March 29, 2017

The Honorable Thomas C. West
Acting Ass't Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable John Koskinen
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

The Honorable William M. Paul
Acting Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: **Report No. 1368 on Proposed Regulations Under Section 514(c)(9)(E)**

Dear Messrs. West, Koskinen and Paul:

I am pleased to submit the attached report of the Tax Section of the New York State Bar Association. The report comments on the regulations proposed on November 23, 2016, under the so-called "fractions rule" of section 514(c)(9)(E)(i)(I).

The fractions rule deals with investments in leveraged real estate through partnerships by certain tax-exempt investors. The rule is part of an exception to the general rule that income from debt-financed investments by tax-exempt organizations is subject to federal income tax as unrelated business taxable income. At a high level, the purpose of the fractions rule is to prevent tax-exempt organizations from shifting the benefit of their tax-exempt status to taxable persons, either through disproportionate allocations of loss to the taxable persons or disproportionate allocations of income to the tax-exempt organizations. The existing regulations under the fractions rule are complex and in many respects unclear. It is generally agreed by tax practitioners who work in the area that the regulations are overbroad and, as a consequence, create obstacles for standard commercial transactions on a routine basis.

The proposed regulations represent a welcome attempt to improve the existing fractions rule regulations. The changes in the proposed regulations are generally accommodating of certain common commercial practices of investment funds, the status of which is either unclear under, or not permitted by, the existing fractions rule regulations. Nonetheless, as discussed in detail in the attached report, certain modifications and changes to the proposed regulations would significantly increase their usefulness without undermining the effectiveness of the regulations in achieving the purpose of the fractions rule.

The following is a brief summary of our principal recommendations:

1. The regulations should clarify that the preferred return exception under the proposed regulations imposes a compounding requirement that is separate from the priority distribution requirement.

2. The priority distribution requirement should be subject to an exception for extraordinary distributions, provided that avoidance of the fractions rule is not a principal purpose of the distribution.

3. The tax distribution exemption from the priority distribution requirement should be broadened.

4. The amount of management and similar fees that is eligible for the partner-specific expenditures exception should not be limited to two percent of committed capital.

5. A "significantly more likely than not" standard should be adopted for purposes of the exception for unlikely losses and deductions.

6. The staged closing exception should not limit the interest factor that may be charged to 150% of the applicable federal rate.

7. The staged closing exception should expand the time period during which staged closings may occur to two years from the initial formation of the partnership.

8. The language in the staged closing exception requiring that changes in allocations pursuant to a staged closing arrangement not be inconsistent with the purpose of the fractions rule should be deleted, as there is already a general anti-abuse rule in the regulations; alternatively, if the language is intended to impose restrictions beyond those imposed by the anti-abuse rule, the nature of those restrictions should be clarified.

9. The regulations should clarify that a provision of a partnership agreement authorizing the general partner to vary the economic terms on which new investors are admitted if there have been significant changes in the value of partnership assets prior to their admission does not result in a violation of the staged closing exception.

10. The regulations should clarify that no inference will be drawn from a failure to meet the requirements of the staged closing exception that a violation of the fractions rule has occurred.

11. The language in the exception for defaults on partner capital commitments requiring that changes in allocations pursuant to these defaults not be inconsistent with the purpose of the fractions rule should be deleted, as there is already a general anti-abuse rule in the regulations; alternatively, if the language is intended to impose restrictions beyond those imposed by the anti-abuse rule, the nature of those restrictions should be clarified.

12. The regulations should clarify that no inference will be drawn from a failure to meet the requirements of the exception for defaults on partner capital commitments that a violation of the fractions rule has occurred.

13. Consideration should be given to liberalizing the proposed exception for partnerships in which taxable persons do not own more than five percent of the interests in capital or profits in order to make it more broadly applicable.

14. Imputed underpayments under section 6225 of the new partnership audit rules should be added to the list of eligible partner-specific expenditures.

15. If a partnership seeks to apply both the chargeback exception and the exception for partner-specific expenditures or the exception for unlikely losses and deductions, it should be permitted to satisfy the chargeback exception's requirement that subsequent allocations charge back prior allocations in the same ratio in which the prior allocations were made by demonstrating that, in the absence of the partner-specific expenditures or the unlikely losses and deductions, the partnership would have made the allocations in the same ratios.

We very much appreciate your consideration of these recommendations and would be happy to discuss them with you or provide additional assistance.

Respectfully submitted,

Michael S. Farber, Chair

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