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New York State Bar Association

Tax Section

Proposed Regulations Under Section 514(c)(9)(E)

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Contents

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Report On Proposed Regulations Under Section 514(c)(9)(E)

This report[1] of the Tax Section of the New York State Bar Association provides comments on the regulations proposed on November 23, 2016, under the so-called "fractions rule" of section 514(c)(9)(E)(i)(I) (the "**Proposed Regulations**").[2]

Section 514(c)(9) provides an exception from the general rule that tax-exempt organizations are subject to federal income tax on a portion of their income from leveraged investments. The exception is applicable only to certain tax-exempt organizations ("**qualified organizations,**" sometimes referred to herein as "**QOs**") and only with respect to leveraged investments in real estate.

The fractions rule deals with certain investments in leveraged real estate through partnerships. Adopted in 1994, the existing regulations under the fractions rule (the "**Existing Regulations**") are complex and in many respects unclear, and failure to comply with the regulations can have severely adverse consequences. In addition, it is generally agreed by tax practitioners who work in the area that the Existing Regulations are overbroad and, as a consequence, create obstacles for standard commercial transactions on a routine basis.

The Proposed Regulations represent a welcome attempt by the Internal Revenue Service (the "**Service**") and the Treasury Department ("**Treasury**") to improve the Existing Regulations. Although the proposed changes would not fundamentally overhaul the approach of the Existing Regulations, they would make targeted changes that are generally intended to reduce the overbreadth of the Existing Regulations and thereby permit partnerships to enter into common commercial transactions that do not implicate the purpose behind the fractions rule.

1 The principal author of this report is David Franklin, with substantial assistance from Max Pakaluk. Helpful comments were received from Joe Binder, Kimberly Blanchard, Alan Blecher, Robert Cassanos, Michael Farber, William Funk, Phillip Gall, Michael Hirschfeld, Stephen Land, Eric Lowenstein, Andrew Needham, Richard Nugent, Amanda Nussbaum, Lanre Okunnuga, Avi Reshtick, Michael Schler, David Sicular, Eric Sloan, Karen Sowell, and Richard Upton. This report reflects solely the views of the Tax Section of the New York State Bar Association ("**NYSBA**") and not those of the NYSBA Executive Committee or the House of Delegates.

2 REG-136978-12, 81 Fed. Reg. 84518 (Nov. 23, 2016). Except as otherwise indicated, all "section" references are to the Internal Revenue Code of 1986, as amended (the "**Code**") or the regulations promulgated thereunder.

We believe that the proposed changes are generally positive. However, in some cases, as discussed below, the Proposed Regulations contain certain features that may substantially limit their usefulness. Therefore, we have suggested the additional modifications discussed below.[3] These modifications should permit the Proposed Regulations to better achieve the goal of removing obstacles to standard commercial arrangements, without undermining the effectiveness of the fractions rule regulations in preventing abuse.

This report is divided into three parts. Part I provides a summary of our recommendations. Part II provides a summary of current law and the Proposed Regulations. Part III contains a detailed discussion of our recommendations regarding the Proposed Regulations.

I. SUMMARY OF PRINCIPAL RECOMMENDATIONS

1. For purposes of the preferred return exception, the regulations should clarify that the requirement that there be compounding of any accrued but unpaid preferred return is separate from the requirement that available cash first be distributed in payment of any accrued but unpaid preferred return (sometimes referred to herein as 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 distributions.

3. A tax distribution should be exempt from the application of the Priority Distribution Requirement to the extent it meets the following requirements: (i) the distribution is made pursuant to a provision in the partnership agreement intended, with respect to at least one direct or indirect partner, solely to facilitate that partner's payment of the taxes imposed on its

[3] However, even if our recommendations are accepted, we believe that the fractions rule will still be unduly complex and interfere unnecessarily with nonabusive commercial arrangements. Since the enactment of Section 514(c)(9)(E) in 1987, several Tax Section reports have proposed legislative and/or regulatory changes to ameliorate the harsh results of the fractions rule and facilitate the ability of QOs to make legitimate investments in real estate partnerships without recognizing potentially catastrophic UBTI consequences. *See* NYSBA TAX SEC., *Report on Section 514: Debt-Financed Income Subject to UBIT* (Rep. No. 1217, Aug. 12, 2010); NYSBA TAX SEC., *Report on Simplification of the Internal Revenue Code* (Rep. No. 1007, Mar. 18, 2002); NYSBA TAX SEC., *Report on Section 514(c)(9)(E) Concerning Investments in Leveraged Real Estate Partnerships by Pension Trusts and Other Qualified Organizations* (Rep. No. 894, Feb. 14, 1997) (the "**1997 Report**"); NYSBA TAX SEC., *Proposed Treasury Regulation Section 1.514(c)-2* (Rep. No. 758, Apr. 27, 1993); NYSBA TAX SEC., *Notice 90-41 and Certain Other Issues Arising Under Section 514(c)(9) of the Internal Revenue Code Relating to Debt-Financed Real Estate Investments by Tax-Exempt Organizations* (Rep. No. 687, Mar. 26, 1991).

allocable share of partnership income or gain, (ii) for a distribution made with respect to a common equity interest in the partnership, the distribution is treated as an advance against distributions to which the distributee partner would otherwise be entitled under the partnership agreement, and (iii) the provision was not included in the partnership agreement, or availed of, with a principal purpose of avoiding the fractions rule. However, if this recommendation is not accepted, we recommend in the alternative that the following targeted changes be made to the tax distribution exception to the Priority Distribution Requirement:

a. A partnership should be permitted to make distributions to partners based on a single imputed tax rate, even if that rate exceeds the highest tax rate to which certain partners could in fact be subject for the year in question.

b. The regulations should clarify how to apply the tax distribution exception to the Priority Distribution Requirement where periodic distributions that are made to a permit a partner to satisfy its estimated tax liabilities with respect to its share of partnership income cause that partner's total tax distributions for the year to exceed the product of the partner's allocable share of net partnership income and gain and the sum of the highest statutory federal, state, and local tax rates applicable to such partner.

c. The tax distribution exception to the Priority Distribution Requirement should permit partnerships, in determining partners' shares of partnership income for purposes of calculating tax distributions to the partners, to ignore the impact of Code provisions that have a disproportionate impact on a partner-by-partner basis (such as section 743(b) and section 704(c)).

d. Tax distributions made to a partner to permit that partner to satisfy foreign tax liabilities should qualify for the tax distribution exception to the Priority Distribution Requirement.

e. The regulations should clarify how the tax distribution exception applies to tax distributions to partners that are passthrough entities and to other partners that may not owe tax on their shares of partnership income, such as real estate investment trusts ("**REITs**") or registered investment companies ("**RICs**").

f. The regulations should clarify how the tax distribution exception applies if a partnership has different classes of preferred equity outstanding, with differing levels of seniority.

g. The regulations should permit tax distributions to be made taking into account the character of items allocated to a partner in situations where, because of that character, multiplying the sum of the highest statutory tax rates applicable to the partner by the partner's share of partnership net income would understate the partner's tax liability.

4. The partner-specific expenditure exception for management fees and similar fees should not contain a "two percent" limitation. Instead, if the Service and Treasury believe that a limitation is required, we recommend that the limitation be that the management and similar fees be commercially reasonable based on the relevant facts and circumstances. However, a "two percent" limitation might be included as part of a safe harbor. In that case, the regulations should provide that no inference will be drawn from the fact that a partnership fails to qualify for the safe harbor that the fee arrangement in question does not qualify for the partner-specific expenditure exception.

5. We recommend that a "significantly more likely than not" standard be used for purposes of the exception for unlikely losses and deductions.

6. The exception for changes in partnership allocations due to staged closings should not limit the interest factor charged to 150% of the highest applicable federal rate ("**AFR**"). Instead, the regulations should merely require that any interest factor charged be commercially reasonable under the relevant facts and circumstances.

a. Alternatively, if recommendation #6 is not accepted, we recommend that the limit of 150% of the AFR in the Proposed Regulations be replaced with a standard that is more in keeping with current marketplace practice, such as eight percent.

7. The period during which partnership contributions may occur in connection with a staged closing arrangement should be expanded to two years from the initial formation of the partnership.

8. The regulations should clarify that a partnership should not be treated as violating the requirement in the staged closing exception that the partnership agreement specifically set forth the method for allocating income, loss, or deduction to the partners to adjust partners' capital accounts after a new partner acquires a partnership interest, merely because the partnership agreement grants the general partner (or managing member, or other comparable person or group of persons) the discretion 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.

9. The Service and Treasury should delete from the staged closing exception the language requiring that changes in allocations pursuant to a staged closing arrangement not be inconsistent with the purpose of the fractions rule.

a. Alternatively, if recommendation #9 is not accepted, the regulations should clarify (i) whether the language in question is merely intended to remind partnerships that the application of the exception is subject to the fractions rule regulatory anti-abuse rule,[4] or (ii) whether the language is intended to impose additional requirements beyond those imposed by the anti-abuse rule (and, if so, what those additional requirements are).

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 Service and Treasury should delete from the exception for changes in allocations due to defaults on, or reductions in, partner capital commitments the language requiring that such changes not be inconsistent with the purpose of the fractions rule.

a. Alternatively, if recommendation #11 is not accepted, the regulations should clarify (i) whether the language in question is merely intended to remind partnerships that the application of the exception is subject to the fractions rule regulatory anti-abuse rule, or (ii) whether the language is intended to impose additional requirements beyond those imposed by the anti-abuse rule (and, if so, what those additional requirements are).

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

13. The Service and Treasury should consider liberalizing the proposed exception for partnerships in which non-QOs 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[5] 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, a partnership 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 un-

[4] *See* Treas. Reg. § 1.514(c)-2(k)(4).

[5] *See* section 6225(a)(1), as amended by section 1101 of the Bipartisan Budget Act of 2015 (the "**2015 Budget Act**"), P.L. 114-74, 129 Stat. 584, 625. Throughout this report, citations to section 6225 are to section 6225 as amended by the 2015 Budget Act.

likely losses and deductions, the partnership would have made the allocations in the same ratios. A partnership should be able to meet this burden by using any reasonable method.

II. SUMMARY OF CURRENT LAW AND PROPOSED REGULATIONS

A. Background

A tax-exempt organization is subject to federal income tax on its unrelated business taxable income ("**UBTI**") under section 511. Income from debt-financed property ("**UDFI**") is treated as UBTI to the extent provided under section 514. Debt-financed property is property with respect to which there is acquisition indebtedness.[6]

Section 514(c)(9) excludes certain indebtedness of a QO from the meaning of "acquisition indebtedness." A QO is a school described in section 170(b)(1)(A)(ii) or its affiliated support organization described in section 509(a)(3), a qualified trust under section 401, a title-holding company exempt from tax under section 501(c)(25), or a retirement income account described in section 403(b)(9).[7] The indebtedness excluded by section 514(c)(9) is indebtedness incurred in acquiring or improving real property.[8]

Various qualifications apply to the exclusion contained in section 514(c)(9). One set of qualifications relates to investments by QOs in real property held through partnerships, which are eligible for the exclusion only if (1) all partners of the partnership are QOs, (2) the partnership allocates to each QO an unvarying share of each item of income, gain, loss, deduction, and credit (such an allocation, a "**qualified allocation**"), or (3) the partnership complies with the requirements of section 514(c)(9)(E).[9] Because QOs often hold real estate investments through partnerships that have non-QO partners and lack qualified allocations, section 514(c)(9)(E) is frequently critical to qualifying for the section 514(c)(9) exception.

[6] Section 514(b)(1).

[7] Section 514(c)(9)(C).

[8] Section 514(c)(9)(A).

[9] Section 514(c)(9)(B)(vi).

Section 514(c)(9)(E) imposes two requirements: first, the allocations to a QO must comply with a special restriction on allocations of income and loss (*i.e.*, the fractions rule);[10] and, second, each allocation of the partnership must have substantial economic effect ("**SEE**") under section 704(b)(2).[11] The fractions rule is satisfied if:

> the allocation of items to any partner which is a qualified organization cannot result in such partner having a share of the overall partnership income for any taxable year greater than such partner's share of the overall partnership loss for the taxable year for which such partner's loss share will be the smallest.[12]

The motivating concern behind the fractions rule is that a leveraged real estate partnership could otherwise "transfer the benefit of [a QO's] tax-exempt status to taxable organizations" by disproportionately allocating taxable income to the QO and/or taxable loss to the taxable partners.[13] For instance, if, in year 1, a QO were allocated 10% of overall partnership loss and, in year 5, the QO were allocated 40% of overall partnership income, the disproportionate allocations would generally trigger a fractions rule violation.

If that were all there were to applying the Fractions Rule, it would be relatively straightforward. However, the complexity of the Fractions Rule is magnified by the requirement that a partnership satisfy the rule not only based on the allocations the partnership has *actually* made, but also prospectively, based on allocations the partnership *might* make in the current year or future years.[14] The complexity is further compounded by an array of exceptions in the Existing Regulations that are designed to create carve-outs for nonabusive fact patterns or common com-

[10] Section 514(c)(9)(E)(i)(I).

[11] Section 514(c)(9)(E)(i)(II). This report does not focus on the SEE requirement. However, the SEE requirement can also create significant obstacles to common commercial arrangements. For example, as noted in the 1997 Report (as defined in footnote 3 above), clawback provisions commonly used in the fund context raise an issue as to whether the SEE requirement is satisfied. In addition, so-called "target allocations," which have become widespread in the partnership world, raise questions under both the SEE requirement and the fractions rule. In our 2010 report on target allocations, the Tax Section recommended that Treasury and the IRS issue guidance providing that target allocations that will almost invariably produce the same allocation of income or loss to each partner as would have been produced under Treas. Reg. 1.704-1(b)(2)(ii)(b) or (d) will be deemed to have economic effect for purposes of section 514(c)(9). *See* NYSBA TAX SEC., *Report on Partnership Target Allocations* (Rep. No. 1219, Sept. 23, 2010).

[12] Section 514(c)(9)(E)(i)(I). The regulations refer to a QO's percentage share of the overall partnership loss for the taxable year for which the QO's percentage share of the loss will be the smallest as the QO's "fractions rule percentage." *See* Treas. Reg. § 1.514(c)-2(c)(2).

[13] H.R. Rep. No. 100-391(1), at 1076 (1987).

[14] Treas. Reg. § 1.514(c)-2(b)(2)(i). This requirement applies starting with the first taxable year of the partnership in which the partnership holds debt-financed real property and has a QO partner. *Id.*

mercial transactions, but that do not always achieve that goal (or achieve it with only very limited success). For example, there are exceptions for certain preferred returns and guaranteed payments;[15] certain chargebacks of prior disproportionate allocations;[16] certain partner-specific expenditures;[17] certain unlikely losses or deductions;[18] and certain allocations that are not taken into account until they actually occur.[19] Because of concerns over potential abuses, the exceptions are generally narrowly tailored and subject to significant qualifications. The prospective nature of the general rule, combined with the multitude of exceptions and special rules, result in a framework that is extremely complicated and difficult to apply. This problem is magnified by the cliff effect of non-compliance with section 514(c)(9)(E), so that even a minor deviation from the requirements of the fractions rule has the potential to cause the income and gain of a QO to become taxable under the UDFI rules.[20]

B. Summary of the Proposed Regulations

The Proposed Regulations would make a number of changes to the Existing Regulations, generally to accommodate common commercial practices among investment funds.

1. Preferred Returns

In determining overall partnership income or loss, the Existing Regulations disregard items of income and gain (or overall partnership net income) allocated with respect to a current or cumulative reasonable preferred return.[21] However, this exclusion applies only to the extent that those allocations are accompanied by corresponding (or prior) distributions of cash in respect of the preferred return (the "**Current Distribution Requirement**"). The Proposed Regulations replace the Current Distribution Requirement with the condition that the allocations in respect of a reasonable preferred return are excluded only if the partnership agreement re-

[15] Treas. Reg. § 1.514(c)-2(d).

[16] Treas. Reg. § 1.514(c)-2(e).

[17] Treas. Reg. § 1.514(c)-2(f).

[18] Treas. Reg. § 1.514(c)-2(g).

[19] Treas. Reg. § 1.514(c)-2(h) and (j).

[20] In 2011, the Obama administration proposed to replace the fractions rule with an exception that would apply if (i) all partnership allocations have SEE and (ii) no partnership allocation has a principal purpose of tax avoidance, and to grant regulatory authority to eliminate the "cliff effect" in the case of a violation of the rule. *See* Dep't of the Treasury, *General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals*, at 89-90 (2011). Congress did not adopt the proposal.

[21] Treas. Reg. § 1.514(c)-2(d). This is pursuant to a grant of regulatory authority in the Code. *See* section 514(c)(9)(E)(ii)(II).

quires the partnership to distribute any accrued, cumulative, and compounding unpaid preferred return prior to making other distributions (*i.e.*, the Priority Distribution Requirement).[22]

The Proposed Regulations include an exception to the Priority Distribution Requirement for distributions made pursuant to a provision of the partnership agreement intended to facilitate the partners' payment of taxes imposed on their allocable share of partnership income or gain.[23] The tax distributions must be treated as advances against other distributions the partners are entitled to, and the distribution cannot exceed a partner's allocable share of net partnership income and gain multiplied by the highest statutory federal, state, and local tax rates applicable to the partner.

2. Management and Similar Fees

In determining overall partnership income or loss, the Existing Regulations exclude certain enumerated partner-specific items of deduction or loss, such as administrative costs that result from having a foreign partner or costs for record-keeping and accounting incurred as a result of a transfer of a partnership interest.[24] The Proposed Regulations add a new category of excluded partner-specific expenditures for management and similar fees.[25] The aggregate amount of these fees is subject to an annual limitation of two percent of the partner's capital commitments to the partnership.

3. Chargebacks of Prior Special Allocations of Partner-Specific Expenditures and Unlikely Losses and Deductions

In determining overall partnership income or loss, the Existing Regulations exclude certain chargebacks and offsets.[26] In general, a partnership can allocate disproportionately large amounts of overall partnership loss and disproportionately small amounts of overall partnership income to a QO consistent with the fractions rule, as the rule does not prohibit a QO from being allocated "too much" loss or "too little" income. However, absent an exception, an allocation made to reverse such a disproportionate allocation would not be consistent with the fractions rule, as it would entail a disproportionately large allocation of income, or disproportionately small allocation of loss, to a QO.

[22] Prop. Treas. Reg. § 1.514(c)-2(d)(2)(ii).

[23] Prop. Treas. Reg. § 1.514(c)-2(d)(2)(iii).

[24] Treas. Reg. § 1.514(c)-2(f).

[25] Prop. Treas. Reg. § 1.514(c)-2(f)(4).

[26] Treas. Reg. § 1.514(c)-2(e).

For example, a partnership might allocate profit 50% to a taxable partner and 50% to a QO until there have been 100*x* of net profits, and then subsequently allocate the income 90% to the taxable partner and 10% to the QO. If the partnership has net profits of 105*x*, and then in a subsequent year has net losses of 3*x*, the partnership may allocate the 3*x* of losses among the partners so as to reverse out the last 3*x* of profits, which were allocated in a 90:10 ratio. The 90:10 allocation of net profits (a disproportionately small allocation of profit to the QO) does not raise an issue under the fractions rule, but the subsequent reversal (a disproportionately small allocation of loss to the QO) would present an issue in the absence of an exception.

The Code provides for an exclusion[27]—fleshed out in the Existing Regulations—for chargebacks with respect to disproportionate losses previously allocated to qualified organizations and disproportionate income previously allocated to other partners. The Existing Regulations also include a number of other exclusions for chargebacks and offsets, such as for allocations with respect to a minimum gain chargeback or a qualified income offset. The Proposed Regulations add an exclusion for allocations of income made to charge back prior allocations of partner-specific expenditures that were excluded in computing overall partnership income or loss for purposes of the fractions rule; under this exception, these chargeback allocations would also be excluded in computing overall partnership income or loss for purposes of the fractions rule.[28]

In determining overall partnership income or loss, the Existing Regulations also exclude unlikely losses or deductions (other than items of nonrecourse deductions) that are specially allocated to a partner, so long as a principal purpose of the allocation is not tax avoidance.[29] Unlikely losses must have a low likelihood of occurring, taking into account all relevant facts, circumstances, and information available to the partners. The Proposed Regulations add an exclusion for allocations of income made to charge back prior allocations of unlikely losses and deductions that were excluded in computing overall partnership income or loss; under this exception, these chargeback allocations would also be excluded in computing overall partnership income or loss for purposes of the fractions rule.[30]

27 Section 514(c)(9)(E)(ii)(I).

28 Prop. Treas. Reg. § 1.514(c)-2(e)(1)(vi).

29 Treas. Reg. § 1.514(c)-2(g).

30 Prop. Treas. Reg. § 1.514(c)-2(e)(1)(vii).

4. Request for Comments on the Proper Standard for Determining Unlikely Losses and Deductions

The Proposed Regulations also request comments on the proper standard to use in applying the unlikely losses and deductions exception—whether it be the existing "low likelihood of occurring" standard, a "more likely than not" standard, or some standard in between those two.

5. Changes in Partnership Interests

If a QO in a fractions rule partnership were to transfer its partnership interest (or if there were otherwise a shift in its partnership interest—for instance, because of a newly admitted partner), the QO's share of overall partnership income and loss would be correspondingly reduced. In the absence of an exception, that could present a problem under the fractions rule. The Existing Regulations provide that, in the case of a transfer or shift of a partnership interest, the resulting changes in partnership allocations will be closely scrutinized but generally will be taken into account only on a prospective basis.[31] The close scrutiny is directed toward whether the transfer or shift "stems from a prior agreement, understanding, or plan or could otherwise be expected given the structure of the transaction."[32]

It is common for investment funds to raise capital through multiple closings over a period of time (commonly referred to as "**staged closings**"). Each subsequent closing potentially results in a transfer or shift of a partnership interest for purposes of Treasury regulations section 1.514(c)-2(k)(1). In addition, the multiple closings are frequently accompanied by special allocations intended to true up the partners' capital accounts. As a result, staged closings raise significant questions under the fractions rule.

The Proposed Regulations provide an exception for changes in partnership allocations due to certain staged closing arrangements.[33] Application of the exception is subject to the following specific conditions:

- the new partner must acquire the interest within 18 months following the formation of the partnership;
- the partnership agreement must anticipate the admission of new partners during that period, set forth the time frame for admitting new partners, and provide for the total capital the partnership intends to raise;

[31] Treas. Reg. § 1.514(c)-2(k)(1).

[32] *Id*.

[33] Prop. Treas. Reg. § 1.514(c)-2(k)(1)(ii).

- the partnership agreement must specifically set forth the method for determining any applicable interest factor and allocations of income, loss, or deduction to account for the new partner; and

- the applicable interest rate must not be greater than 150% of the AFR at the time the partnership was formed.

Moreover, the exception states that the changes in allocations must not be inconsistent with the purpose of the fractions rule (as expressed in the anti-abuse rule of Treasury regulations section 1.514(c)-2(k)(4)).

If the exception applies, (1) changes in partnership allocations due to an acquisition of a partnership interest by a partner after the initial formation of the partnership will not be closely scrutinized, but will be taken into account only in determining whether the partnership satisfies the fractions rule in the taxable year of the change and subsequent taxable years, and (2) disproportionate allocations of income, loss, or deduction as a result of, or to reflect, the acquisition will be disregarded in computing overall partnership income or loss.

It is also common for investment funds to have provisions in their partnership agreements dealing with defaults on capital commitments by investors, which often would result in a transfer or shift of a partnership interest. These changes in allocations raise questions under the fractions rule similar to those raised by staged closings.

The Proposed Regulations provide an exception for changes in partnership allocations due to unanticipated partner defaults on, or reductions in, a partner's capital commitment.[34] The exception applies to changes in partnership allocations:

- that result from an unanticipated partner default on a capital contribution commitment or an unanticipated reduction in a partner's capital contribution commitment,

- that are effected pursuant to provisions prescribing the treatment of such events in the partnership agreement, and

- that are not inconsistent with the purpose of the fractions rule under Treasury regulations section 1.514(c)-2(k)(4).

If the exception applies, the changes in partnership allocations will not be closely scrutinized, but will be taken into account only in determining whether the partnership satisfies the fractions rule in the taxable year of the change and subsequent taxable years. Moreover, if the exception applies, allocations of income, gain, loss, or deduction made pursuant to the partner-

[34] Prop. Treas. Reg. § 1.514(c)-2(k)(1)(iii).

ship agreement to adjust partners' capital accounts as a result of such a default or reduction will be disregarded in computing overall partnership income or loss for purposes of the fractions rule.

6. Tiered partnerships

The Existing Regulations provide that, with respect to a QO that holds an indirect interest in real property through tiers of partnerships, the fractions rule is satisfied only if (1) the avoidance of tax is not a principal purpose for using the tiered-ownership structure, and (2) the partnerships can demonstrate under any reasonable method that the chains satisfy the requirements of the Existing Regulations.[35] The Existing Regulations contain three examples illustrating three different approaches to satisfying condition (2) above.[36] One example illustrates the "independent chain approach."[37] The example deals with an upper-tier partnership (P2) with a QO partner. P2 invests in two lower-tier partnerships (P1A and P1B). The P1B allocations do not satisfy the fractions rule. However, the example assumes that, if P2's interest in P1B were completely disregarded, the P2/P1A chain would satisfy the fractions rule. The example concludes that P2 satisfies the fractions rule with respect the P2/P1A chain, but only if the P2 partnership agreement allocates those items allocated to P2 by P1A separately from those items allocated to P2 by P1B.

The Proposed Regulations remove the "separate allocation" requirement from the example. The preamble to the Proposed Regulations (the "**Preamble**")[38] explains the change by noting that a typical real estate partnership will not make separate allocations to its partners of lower-tier partnership items, and that the requirement under the partnership provisions in the regulations under subchapter K that partnership items such as items that would give rise to UBTI be separately stated[39] should suffice to separate the tiers of partnerships.[40]

7. *De Minimis* Exceptions

The Existing Regulations contain a couple of *de minimis* rules.

First, the Existing Regulations exclude partnerships from the application of section 514(c)(9)(B)(vi) (which, by reference, excludes application of the fractions rule) if two conditions are met: (1) QOs, in the aggregate, do not hold interests of greater than five percent of

[35] Treas. Reg. § 1.514(c)-2(m)(1).

[36] Treas. Reg. § 1.514(c)-2(m)(2).

[37] Treas. Reg. § 1.514(c)-2(m)(2), Ex. 3.

[38] 81 Fed. Reg. 84518 (Nov. 23, 2016).

[39] *See* Treas. Reg. § 1.702-1(a)(8)(ii).

[40] Preamble, at 84521–22.

partnership capital or profits, and (2) taxable partners own substantial interests in the partnership, through which they participate on substantially the same terms as the QOs.[41]

Second, the Existing Regulations contain another *de minimis* exception that provides that an allocation of loss or deduction (other than nonrecourse or partner nonrecourse deductions) away from a QO to other partners will be treated as having been allocated to the QO if:

(i) The allocation was neither planned nor motivated by tax avoidance; and

(ii) The total amount of those items of partnership loss or deduction is less than both:

(A) One percent of the partnership's aggregate items of gross loss and deduction for the taxable year; and

(B) $50,000.[42]

The Proposed Regulations make the following changes to the *de minimis* rules:

First, the Proposed Regulations add a new *de minimis* exception for partnerships that meet the following two conditions: (1) all non-QO partners, in the aggregate, do not hold (directly or indirectly through a partnership) interests of greater than five percent of partnership capital or profits and (2) the partnership complies with a modified version of the SEE rules under Treasury regulations section 1.704-1(b)(2). The SEE rules would be modified by disregarding the following two special rules in Treasury regulations section 1.704-1(b)(2)(iii)(c): (A) the presumption that an allocation has a reasonable possibility of substantially affecting the dollar amount a partner will ultimately receive if there is a strong likelihood that offsetting allocations will not be made within five years and (B) the presumption that the fair market value of a property is equal to its adjusted tax basis (or section 704(b) value, if different).[43]

Second, the Proposed Regulations replace “$50,000” in Treasury regulations section 1.514(c)-2(k)(ii)(B) with “$1 million.”

Finally, the Proposed Regulations add language that limits the exception currently in Treas. Reg. § 1.514(c)-2(k)(2) of the Existing Regulations to partnerships in which QOs do not hold interests of greater than five percent of partnership capital or profits either directly *or* indirectly through a partnership.[44]

41 Treas. Reg. § 1.514(c)-2(k)(2).

42 Treas. Reg. § 1.514(c)-2(k)(3).

43 Prop. Treas. Reg. § 1.514(c)-2(k)(2)(ii).

44 Prop. Treas. Reg. § 1.514(c)-2(k)(2)(i)(A).

8. Partner-Specific Expenditures and Imputed Underpayments

Effective for partnership taxable years beginning after December 31, 2017, new partnership audit rules would permit the Service to collect an amount referred to as an "imputed underpayment" directly from a partnership.[45] The Preamble requests comments on whether such an imputed underpayment that is collected from the partnership should be included among the list of partner-specific expenditures.[46]

9. Interaction of Disregarded Partner-Specific Expenditures and Unlikely Losses with the Chargeback Exception

In the Preamble, the Service and Treasury request comments on another aspect of the exceptions for partner-specific expenditures and unlikely losses and deductions as follows:

> Notwithstanding the rule in the proposed regulations, an allocation of an unlikely loss or a partner-specific expenditure that is disregarded when allocated, but is taken into account for purposes of determining the partners' economic entitlement to a chargeback of such loss or expense may, in certain circumstances, give rise to complexities in determining applicable percentages for purposes of fractions rule compliance.[47]

III. Discussion of Recommendations

A. Introduction

The proposed changes are generally positive. However, they contain certain features that may substantially limit their usefulness. With appropriate modifications that are recommended below, we believe that the Proposed Regulations would significantly improve the fractions rule regulations by removing obstacles to standard commercial transactions and exempting other arrangements that do not materially implicate the purpose of the fractions rule, without undermining the effectiveness of the fractions rule regulations in preventing abuse.

B. Preferred Returns

In order to qualify for the preferred return exception in the Existing Regulations, a partnership generally may not allocate the preferred return to a partner to the extent the preferred

[45] *See* section 6225(a)(1).

[46] Preamble, at 84519–20.

[47] Preamble, at 84520.

return has not yet been distributed (*i.e.*, the Current Distribution Requirement).[48] We agree with the observation in the Preamble that the Current Distribution Requirement is not consistent with standard market practice and interferes unnecessarily in common business transactions. As we stated in the 1997 Report:

> This requirement [*i.e.*, the Current Distribution Requirement] is inconsistent with the normal practice of allocating profits first to preferred capital partners to the extent of their accrued preferred return, whether or not paid—an allocation approach that is consistent with the economic arrangement of the parties. Deferring until payment the corresponding allocation of income to a preferred capital partner creates a risk that the partner will not achieve its preferred economics due to a shortfall in its capital account (caused by insufficient income in the year of payment and subsequent years). This in turn severely limits the usefulness of the regulatory safe harbor for reasonable preferred returns.[49]

As noted above, the Proposed Regulations would replace the Current Distribution Requirement with the Priority Distribution Requirement—*i.e.*, a requirement that the partnership first distribute any available cash to pay the preferred return before making other distributions.[50] We agree that replacing the Current Distribution Requirement with a requirement along the lines of the Priority Distribution Requirement would be a significant improvement. However, the Priority Distribution Requirement, as currently drafted, is in certain respects overly broad and so would also interfere with common commercial transactions. In order to avoid this result, we believe that a number of modifications should be made to the Priority Distribution Requirement.

1. Clarify That the Tax Distribution Exception Imposes a Compounding Requirement That Is Separate from the Priority Distribution Requirement

We note that certain language in the Preamble and in the text of the Proposed Regulations contain an apparent inconsistency that may not have been intended. The Preamble says at one point: "The Treasury Department and the IRS have reconsidered the necessity of the current distribution requirement to prevent abuses of the fractions rule. So long as the preferred return is required to be distributed prior to other distributions (with an exception for certain distributions intended to facilitate the payment of taxes) and any undistributed amount compounds, the likelihood of abuse is minimized."[51] This statement implies the existence of two separate and

[48] Treas. Reg. § 1.514(c)-2(d)(6)(i).

[49] 1997 Report, at 17-18.

[50] Prop. Treas. Reg. § 1.514(c)-2(d)(2)(ii).

[51] Preamble, at 84519.

independent requirements: first, the Priority Distribution Requirement, and, second, a compounding requirement. However, the text of the Proposed Regulations, as well as other language in the Preamble, do not so clearly distinguish between the compounding requirement and the Priority Distribution Requirement.[52] Notwithstanding the potential ambiguity in the Proposed Regulations, we assume that, consistent with the above-quoted language, the drafters intended the compounding requirement to be separate from the Priority Distribution Requirement. We agree that the preferred return exception should impose a compounding requirement that is separate from the Priority Distribution Requirement. However, we note that the preamble to the Existing Regulations expressed concerns regarding the impact of compounding in the context of a preferred return owed to a QO partner. In explaining the reason for including the Current Distribution Requirement, the preamble to the Existing Regulations stated as follows: "A suggestion that partnerships be required to compound allocated but unpaid amounts could exacerbate the problem. Compounding would increase the amount of undistributed income or gain allocated to the tax-exempt partners."[53]

For the following reasons, we believe that including a compounding requirement as part of the preferred return exception, should, on balance, discourage abuse. Compounding an accrued but unpaid preferred return makes it more difficult for a partnership to deprive a QO of all or part of the economic benefit associated with an allocation of preferred return merely by defer-

[52] Specifically, the text of the Proposed Regulations states:

> Except as otherwise provided in paragraph (d)(2)(iii) of this section, items of income and gain (or part of what would otherwise be overall partnership income) that may be allocated to a partner in a taxable year with respect to a reasonable preferred return for capital are disregarded under paragraph (d)(2)(i) of this section for purposes of the fractions rule only if the *partnership agreement requires the partnership to make distributions first to pay any accrued, cumulative, and compounding unpaid preferred return* to the extent such accrued but unpaid preferred return has not otherwise been reversed by an allocation of loss prior to such distribution.

Prop. Treas. Reg. § 1.514(c)-2(d)(2)(ii) (emphasis added). Similarly, the Preamble states:

> Therefore, the proposed regulations remove the current distribution requirement and instead disregard allocations of items of income and gain with respect to a preferred return for purposes of the fractions rule, but *only if the partnership agreement requires that the partnership make distributions first to pay any accrued, cumulative, and compounding unpaid preferred return* to the extent such accrued but unpaid preferred return has not otherwise been reversed by an allocation of loss prior to such distribution (preferred return distribution requirement).

Preamble, at 84519. Read literally, this language appears not to impose an independent compounding requirement at all; furthermore, while it does appear to impose the Priority Distribution Requirement, it appears to impose it only where there is compounding (so that the Priority Distribution Requirement would not apply to the extent that the return did not compound).

[53] T.D. 8539, 1994-1 C.B. 157.

ring the distribution of the preferred return. We believe that the issue raised in the preamble to the Existing Regulations—that compounding could "exacerbate the problem [by] increas[ing] the amount of undistributed income or gain allocated to the tax-exempt partners"—should be a concern only in situations where it is probable that a preferred return that compounds will *never* be distributed. In that case, the compounding would increase the total income allocated to a preferred QO partner, without increasing the ultimate economic benefit to the preferred QO partner. However, given that preferred equity usually has a priority right to receive distributions, we believe that it will not typically be the case that a partnership could make allocations of a preferred return to a preferred QO partner that are respected under section 704(b), if the preferred return is unlikely to ever be distributed.[54] Accordingly, we believe that that is likely to be an issue only in unusual fact patterns that can be adequately addressed by anti-abuse rules (specifically, the existing fractions rule anti-abuse rule in Treasury regulations section 1.514(c)-2(k)(4), and the anti-abuse rule included as part of our recommended exception from the Priority Distribution Requirement for certain extraordinary distributions, as discussed below in Part III.B.2).

Therefore, we recommend that the language be clarified so that it is clear that the regulations impose two separate requirements: the Priority Distribution Requirement and a compounding requirement. Furthermore, in order to conform to standard market practice and limit the potential for abuse, we recommend that the compounding requirement provide that any accrued but unpaid preferred return compound at least annually.

2. Add an Exception for Extraordinary Distributions

We recommend that an exception be added to the Priority Distribution Requirement for extraordinary distributions. A partnership may have a pressing business need to make a distribution to one of its common partners, even though the partnership may not be fully caught up on distributions of the preferred return. We believe that it is critical that an exception be added to permit a partnership in such a position to make a distribution to a common partner without violating the terms of the Priority Distribution Requirement.

[54] In theory, such a situation might arise if the aggregate fair market value of the partnership's assets was significantly less than the aggregate section 704(b) value of those assets, but the partnership made section 704(b) allocations based on the section 704(b) book value of the assets under the "value equals basis" presumption of Treasury regulations section 1.704-1(b)(2)(iii)(3)(C). However, the excess of the aggregate section 704(b) value of the partnership's assets over the aggregate fair market value of the partnership's assets would ordinarily represent a real economic loss or detriment, and it seems unlikely that a partnership would, under normal circumstances, intentionally plan itself into a fact pattern where it suffers a real economic loss or detriment. Accordingly, we believe that fact patterns of this type can be adequately addressed by anti-abuse rules (as discussed in the text above).

For example, a common partner, who has been actively involved in managing the partnership's business, may have an unforeseen but permanent falling out with the other partners, or may have committed some act of serious misconduct. If, due to the falling out or the misconduct, the partnership has a pressing business need to redeem the common partner immediately, we believe that it should be permitted to do so without violating the terms of the Priority Distribution Requirement. However, if the partnership is not fully caught up on the distribution of its preferred return, such a distribution to a common partner would appear to violate the Priority Distribution Requirement. As a result, the Priority Distribution Requirement would in effect force the partnership to choose between either allowing the common partner to remain in the partnership or violating the fractions rule, both of which could have disastrous consequences for the partnership and its partners.[55] This type of distribution does not appear to be contrary to the purposes of the fractions rule. For example, assuming that the common partner in question is a taxable person, its redemption from the partnership could result in its having a significant taxable gain under section 731(a), which might otherwise have been deferred. In addition, even if the partner has a loss on the redemption, because the loss is being recognized in connection with the partner's redemption from the partnership, the loss should generally represent a real economic loss incurred by the partner, and therefore the recognition of that loss would not be contrary to the purpose of the fractions rule.[56]

As another example, the partnership may wish to acquire a property as a contribution from an incoming partner under section 721(a), and the parties may further desire that the partnership make a distribution to the incoming partner in reimbursement of preformation capital expenditures under Treasury regulations section 1.707-4(d). It does not appear that such a distribution would generally be contrary to the purpose of the fractions rule, assuming that it occurs as part of a legitimate and extraordinary transaction that materially alters the economic positions of the participants and is entered into for *bona fide*, non-tax business reasons.[57] However, if the

[55] In some circumstances, it may be possible to remove the partner in question without violating the Priority Distribution Requirement by having another partner or a non-partner (other than the partnership itself) buy the partner out. However, that may not be possible or practical in all situations.

[56] In addition, changes in allocations resulting from a redemption of the type discussed in the example would generally be subject to close scrutiny under Treasury regulations section 1.514(c)-2(k)(1), which should also help to foreclose the potential for fractions rule avoidance in connection with this type of transaction. See the discussion in Part III.F below regarding changes in partners' interests in the partnership, specifically in connection with the proposed exceptions for staged closings and partner defaults on contribution obligations.

[57] On the other hand, if the transaction were merely "window dressing" and the real motivation behind the distribution were to prevent the partnership from distributing the preferred return to the QO partner, the distribution might violate the purpose of the fractions rule. However, we believe that this type of fact pattern could be adequately addressed by anti-abuse rules.

partnership is not fully caught up on distributions of the preferred return, it appears that such a redemption would violate the Priority Distribution Requirement in the Proposed Regulations.

Therefore, in order to afford partnerships the flexibility they may need in order to adapt to unforeseen changes in circumstances and in order to facilitate non-abusive commercial transactions, we recommend that the Service and Treasury modify the Priority Distribution Requirement by adding an exception for extraordinary distributions, provided that avoidance of the fractions rule is not a principal purpose of any such distributions. We believe that whether a distribution is extraordinary should be determined from the partnership's perspective and not that of any particular partner (for example, in the case of a partnership redemption, the redeemed partner).

3. Broaden the Proposed Exception for Tax Distributions

a. Primary Recommendation—Permit Flexibility in Tax Distribution Provisions, Subject to Anti-Abuse Rule

Under the Proposed Regulations, the Priority Distribution Requirement would be subject to an exception for tax distributions. A distribution would not qualify for the exception unless each of the following requirements is met:

- The distribution is made pursuant to a provision in the partnership agreement intended to facilitate the partners' payment of taxes imposed on their allocable shares of partnership income or gain;
- The distribution is treated as an advance against distributions to which the distributee partner would otherwise be entitled under the partnership agreement; and
- The distribution does not exceed the distributee partner's allocable share of net partnership income and gain multiplied by the sum of the highest statutory federal, state, and local tax rates applicable to such partner.[58]

The inclusion of the third prong of the tax distribution exception (the "**Third Prong**") was presumably motivated by a concern that, in the absence of such a limitation, a partnership might make distributions to taxable partners owning common equity that are in excess of their tax liabilities with respect to their partnership income, thereby resulting in the deferral of the distribution of the preferred return to a QO partner.

We agree with the Service and Treasury that a tax distribution exception should be included if the Priority Distribution Requirement is retained. However, we believe that the Third

[58] Prop. Treas. Reg. § 1.514(c)-2(d)(2)(iii).

Prong is inconsistent with how many (if not most) tax distribution provisions in existing partnership agreements operate.

In our experience, the tax distribution provisions of partnership agreements very frequently provide for tax distributions based on a single imputed rate, even in situations in which not all partners are actually subject to that rate. For example, the partnership agreement may provide for tax distributions to be made to all partners based on the highest federal, state, and local tax rate applicable to residents of a particular locality—such as New York City or Washington, D.C.—even though certain partners may be resident elsewhere or even be tax-exempt organizations. There are two principal reasons for this. First, given the complexity of the tax law, the many different kinds of taxes to which a partner may be subject (federal, state, local, and foreign), and the fact that different partners may be subject to tax in different jurisdictions, it is often not practical for the partnership to attempt to make tax distributions based on the specific tax rates to which each partner is actually subject. Second, even though partners may pay taxes based on differing effective rates, they frequently view it as more equitable for the partnership to make tax distributions to *all* partners based on a single imputed rate, even though some of those partners may be subject to a lower tax rate, or in some cases may even be tax-exempt.

For similar reasons—*i.e.*, both simplicity and perceived fairness—tax distribution provisions frequently disregard the impact of partnership provisions that apply in a disparate manner to different partners, with the principal examples being section 704(c) and section 743(b). As a result of this type of provision, the tax distribution to a partner may sometimes exceed the partner's maximum potential tax liability with respect to its actual share of partnership income.

Accordingly, if the Third Prong is retained in its current form, we believe the tax distribution exception will be of limited benefit. In order for the tax distribution exception to apply broadly, we believe that it should be extended significantly. However, it is important to consider that tax distributions are often among the most heavily negotiated provisions in partnership agreements. They are frequently tailored to fit the particular circumstances and needs of specific partners and partnerships, and so there are wide variations in how they are drafted. Because of this, we believe that it would be extremely difficult to adequately expand the tax distribution exception by adding targeted rules.

Therefore, our primary recommendation is that a tax distribution should satisfy the third prong in the tax distribution exception to the extent (i) the distribution is made pursuant to a provision in the partnership agreement intended, with respect to at least one direct or indirect partner,[59] solely to facilitate that partner's payment of the taxes imposed on its allocable share of

[59] With respect to (i) above, it should be clarified that an "indirect partner" includes a taxable person who owns a partnership interest indirectly through a REIT or a RIC.

partnership income or gain,[60] (ii) for a distribution made with respect to a common equity interest in the partnership, the distribution is treated as an advance against distributions to which the distributee partner would otherwise be entitled under the partnership agreement,[61] and (iii) the provision was not included in the partnership agreement, or availed of, with a principal purpose of avoiding the fractions rule. It would be possible either to add this as an alternative method of satisfying the requirements of the tax distribution exception (*i.e.*, alongside the exception as currently drafted) or to substitute it for the exception as currently drafted. We believe that such a rule would be sufficiently flexible to permit partners to negotiate tax distribution provisions that fit their needs on a case-by-case basis, while still preventing avoidance of the fraction rule.[62]

[60] This requirement is intended to ensure that a partnership determines tax distributions, including tax distributions generally applicable to all partners, in a manner consistent with the tax rates that are reasonably expected to apply to one or more of the partners receiving those distributions (as opposed to determining tax distributions by reference to some hypothetical tax rate that bears no relation to the tax rates to which any partner in the partnership could reasonably be expected to be subject). It is not intended to require that the drafters of a partnership agreement be able to identify a particular partner that they had in mind when they selected an imputed tax rate to use for the tax distribution provision in the partnership agreement. A requirement that the drafters be able to identify a particular partner that they had in mind at the time of drafting would be impractical because in many cases the identities of the particular partners (for example, the future recipients of profits interests) will not be known when the partnership agreement is drafted.

[61] In our recommendation, we have limited the requirement that the distribution be treated as an advance to distributions with respect to common equity interests. It is not unusual for a preferred partner to negotiate to receive tax distributions that are not treated as advances against future distributions from the partnership. We do not see anything abusive about this practice—in effect, the partner has simply negotiated to receive a tax gross-up from the partnership. Tax gross-up payments are commonplace in other areas, and we do not believe that they should be viewed differently in the partnership world. Accordingly, when a tax distribution is made with respect to a preferred interest, we believe that the tax distribution exception should be available even if the distribution that is not treated as an advance against future distributions from the partnership.

[62] The Service and Treasury could also consider including, as an additional requirement, a restriction that the combined tax rate used to determine the amount of a tax distribution to partners not be significantly greater than the combined rate, based on reasonable expectations and assumptions, actually applicable to the highest-taxed partner (*e.g.*, the partner subject to the highest combined tax rate) entitled to receive a share of such distribution under the partnership agreement. If the Service and Treasury do so, they should consider how best to balance the goal of preventing abuse with the flexibility that partnerships require in order to structure their tax distributions. In addition, if a requirement like the one described above is included in the regulations, the requirement should take into account indirect partners as well as direct partners. (See Part III.B.3.b below for a discussion of determining partners' applicable tax rates where there are indirect partners through partnerships or other entities.) It should also take into account the fact (alluded to in footnote 60 above) that, at the time the partnership agreement is drafted, the drafters may not know exactly what the tax profiles of the partners will be. For example, the partnership may wish to make tax distribu-

In addition, the regulations could also include an example illustrating the "principal purpose" prong of the exception. The example could involve a partnership that makes tax distributions to its taxable partners at a rate that is substantially in excess of the tax rate that is actually applicable to those partners, with the rate having been chosen with a principal purpose of deferring the distribution of the preferred return to a QO partner.

b. Alternative Recommendation—Targeted Changes

Alternatively, if our primary recommendation is not accepted, we believe that several different modifications would need to be made to the tax distribution exception from the Priority Distribution Requirement in order for the exception to be broadly useful:

- A partnership should be permitted to make distributions to all, or a subset[63] of, its partners based on a single imputed rate, even if that rate exceeds the maximum tax rate to which certain partners are or may be subject for the year in question. In our experience, this is how many, if not most, partnership agreements are drafted. If tax distributions are made to a subset of the partners, the regulations might require that the subset not have been chosen with a principal purpose of avoiding the fractions rule. If the Service and Treasury are concerned that such a rule could open the door to abuse, we recommend, as a less preferred alternative, that the final regulations permit the use of the maximum combined federal, state, local, and/or foreign income tax rate applicable to individuals or entities resident in a particular jurisdiction specified in the partnership agreement, provided that that jurisdiction not have been selected with a principal purpose of avoiding the fractions rule.[64]

tions to holders of profits interests, but the identities of the profits interest recipients may not yet have been determined. Under these circumstances, the drafters of the partnership agreement should be permitted to draft the tax distribution provision based on reasonable expectations and assumptions as to the tax profiles of the future partners.

[63] Many partnerships make tax distributions only to subsets of their partners. An obvious situation is where certain of the partners are exempt from taxes (although it should be noted that many partnerships make tax distributions at a single imputed rate to all partners, even though some of those partners may be tax-exempt). Additionally, in a situation in which only certain partners are expected to be allocated phantom income, *i.e.*, taxable income without a current distribution of cash, the partnership agreement may require tax distributions to be made only to those particular partners. Partnerships may have many different reasons for choosing to make tax distributions only to subsets of their partners, and we do not believe that such arrangements should be presumed to be abusive.

[64] Alternatively, in order to prevent abuse, an additional requirement along the lines of that discussed in footnote 62 above might be included.

- Partners may make tax distributions periodically throughout the year to permit partners to pay their estimated taxes with respect to their shares of partnership income. However, because the distributions are typically made in part based on projections and estimates, the total tax distributions for the year may ultimately exceed a partner's actual income tax liability with respect to its partnership income for the year in question. In that situation, the tax distributions could violate the third prong of the tax distribution carve-out, unless perhaps the partnership were to "claw back" the excess tax distributions from the partner, which is frequently not done and often not practical. We further note that the tax distribution exception, as currently drafted, could impose a particular hardship in the tiered partnership context, where an upper-tier partnership may wish to make periodic tax distributions to its partners, but may have very limited information as to its allocable share of income from lower-tier partnerships in which it invests until it receives the schedules K-1 from those partnerships for the year in question. Accordingly, if the prong is retained in its current form, the regulations should clarify how partnerships, in applying the tax distribution exception, should take into account tax distributions made to permit partners to make estimated tax payments. We recommend that the regulations permit partnerships to make distributions intended to permit the payment of estimated taxes, provided that the amounts of the distributions are not determined with a principal purpose of avoiding the fractions rule. Alternatively, if this recommendation is not accepted, we recommend that a partnership be permitted to make distributions to fund estimated tax payments to all partners (or a subset of its partners) based on a single imputed rate, even though that may result in total tax distributions to a partner that are in excess of the product of the partner's allocable share of net partnership income and gain and the sum of the highest statutory federal, state, and local tax rates applicable to such partner.

- A partnership should be permitted to disregard the partner-specific impact of certain Code provisions (for example, section 743(b) and section 704(c)) in determining tax distributions. As noted above, this type of provision is found in many partnership agreements today.

- The Third Prong takes into account only federal, state, and local tax liabilities. We recommend also including foreign tax liabilities, as we do not believe that it would be contrary to the purpose of the tax distribution exception (or to the purpose of the fractions rule more broadly) for a partnership to make a distribution to permit a partner to pay a foreign tax liability.

- The regulations should explain how the tax distribution exception applies to tax distributions to partners that are themselves partnerships for tax purposes. In general, a partnership does not itself pay federal income taxes,[65] however, if the partnership has partners who are taxpayers, the partnership may negotiate to receive tax distributions from a lower-tier partnership in which it is a partner. In providing guidance on this point, we believe that the Service and Treasury should also consider that the partners of the upper-tier partnership, and their shares of the upper-tier partnership's tax items, may change from year to year, and that it may not be possible or practical for a lower-tier partnership to make tax distributions to an upper-tier partnership that accurately reflect the tax liabilities of the upper-tier partnership's partners with respect to their indirect shares of the lower-tier partnership's tax items. Similar guidance should be provided in the case of other passthrough partners, such as S corporations, and other types of partners that may not owe tax on their shares of partnership income, such as REITs or RICs.

- The regulations should clarify how the tax distribution exception applies if a partnership has different classes of preferred equity outstanding, with differing levels of seniority.

- The regulations should permit tax distributions to be made taking into account the character of items allocated to a partner in situations where, because of that character, multiplying the sum of the highest statutory tax rates applicable to the partner by the partner's share of partnership net income would understate the partner's tax liability. For example, a partnership may allocate $1 million of ordinary income and $1 million of capital losses to a partner. Because of the limitations on capital losses, the partner may owe a substantial tax bill with respect to its share of partnership income for the year in question. However, the tax distribution exception limits tax distributions to "the distributee partner's allocable share of *net partnership income and gain* multiplied by the sum of the highest statutory federal, state, and local tax rates applicable to such partner." (Emphasis added.) Accordingly, it is not clear that a partnership that makes a tax distribution to a partner under these circumstances (*i.e.*, where the overall net income allocated to the partner for the year is $0) would be able to comply with the requirements of the tax distribution exception. We do not believe that it would be contrary to the purpose of the fractions rule to permit a partnership, in making tax distributions, to take into account the character of items allocated to partners. Therefore,

[65] However, under the partnership audit rules enacted by Congress in 2015 and applicable to partnership taxable years beginning after December 31, 2017, the Service may be able to collect an imputed underpayment from a partnership. *See* section 6225(a)(1). *See* Part III.I below for a discussion of imputed underpayments and the exception for partner-specific expenditures.

we believe that the regulations should permit tax distributions under these circumstances.[66]

C. Management and Similar Fees

In the 1997 Report, we raised the issue that, under the Existing Regulations, a partnership is unable to specially allocate different amounts of management fees among its partners in the very common fact pattern where not all partners pay management fees at the same rate. We believe that the absence of management fees from the list of partner-specific expenditures in the Existing Regulations interferes with common marketplace practices in a manner that does not promote the purposes of the fractions rule. Accordingly, we agree with the proposal to add to the list of enumerated partner-specific expenditures management and similar fees.

However, we have comments regarding the proposal to limit the amount of eligible fees to two percent of a partner's capital commitments on an annual basis.[67] We suspect that the "two percent" limit was chosen due to the fact that many funds charge a management fee of two percent of each partner's capital commitments (or some similar measure) each year. However, for the reasons set forth below, we do not believe that this type of limitation should be included in the operative rule in the regulations (although, as discussed below, it may be appropriate for a safe harbor).

First, while two percent would be sufficient today to cover many of the management fee arrangements of which we are aware, the exception is intended to apply to other, similar fees as

[66] In our experience, partnerships take different approaches in determining tax distributions where net losses have been allocated to partners in prior years. Some partnerships determine tax distributions on a cumulative basis, *i.e.*, by reference to cumulative prior distributions and cumulative partnership net income. That can reduce the amount of tax distributions that are made, because a partnership net loss from a prior year may be taken into account in determining the tax distributions to which partners are entitled in subsequent years. By contrast, other partnerships take a "year by year" approach. The Service and Treasury may wish to consider whether some version of a cumulative approach should be required for purposes of the tax distribution exception. However, in doing so, the Service and Treasury should consider how to balance the potentially competing goals of, on the one hand, preventing avoidance of the fractions rule and, on the other hand, affording partners and partnerships sufficient flexibility to structure tax distributions in a manner that meets their practical and economic needs (including an appropriate degree of administrative convenience). In addition, if a cumulative approach were to be adopted, we believe that it should take into account the fact that certain prior losses may not be available to offset certain types of future income (for example, in the case of capital losses, due to the limitations on the use of such losses).

[67] Prop. Treas. Reg. § 1.514(c)-2(f)(4).

well.[68] Once these additional, similar fees are included, the total amount for a year might very well exceed two percent of the partner's capital commitments. Second, while committed capital is often used as a measure, it is not always used. In a typical private equity fund, committed capital is used during the investment period, but after the investment period the fee is typically calculated based on invested capital (or a similar measure). In addition, some partnerships use other metrics, such as net asset value, fair market value, or even the amount of rental income generated by the partnership's assets. Accordingly, limiting the fee to a certain percentage of capital commitments seems unduly restrictive. Finally, even though two percent of capital commitments/invested capital is a commonly used standard today, the standard may change over time. Consequently, the use of a fixed standard like "two percent of capital commitments" as the operative rule in the regulations would tend to either (i) distort the economics of the marketplace or (ii) limit the usefulness of the rule in achieving its intended purpose. In this connection, we note that none of the other items on the list of partner-specific expenditures contains a limitation like that proposed for management or similar fees, even though some of them—for example, "[a]dditional administrative costs that result from having a foreign partner"—arguably could raise similar concerns. If not necessary in the case of any of the other items, we do not believe that a limitation to a specific percentage amount should be necessary in this case.

For all of those reasons, we recommend that the final regulations not impose a limit of two percent of capital commitments on the management or similar fees that qualify for the exception. Instead, if the Service and Treasury believe that a limitation is required, we recommend that the management and similar fees be required to be commercially reasonable based on the relevant facts and circumstances.[69] However, we do believe that it would be reasonable to include such a limitation as part of a safe harbor.[70] In that case, the regulations should provide that

[68] The Preamble states: "These fees . . . may include fees paid in connection with the acquisition, disposition, or refinancing of an investment." Preamble, at 84519.

[69] This would be similar to the rule for preferred returns. *See* Treas. Reg. § 1.514(c)-2(d)(4)(i) ("A preferred return or guaranteed payment for capital is reasonable only to the extent it is computed, with respect to unreturned capital, at a rate that is commercially reasonable based on the relevant facts and circumstances.").

[70] We note that some have proposed an interpretation of the two percent limitation that we believe was not intended. The exception for partner-specific expenditures, as it would be modified by the Proposed Regulations, would read in relevant part as follows:

> Provided that the expenditures are allocated to the partners to whom they are attributable, the following partner-specific expenditures are disregarded in computing overall partnership income or loss for purposes of the fractions rule . . . (4) [e]xpenditures for management and similar fees, if such fees *in the aggregate* for the taxable year are not more than 2 percent of the partner's capital commitments.

Treas. Reg. § 1.514(c)-2(f), *as proposed to be modified by* Prop. Reg. § 1.514(c)-2(f)(4) (emphasis added). Under the interpretation in question, the two percent limitation would apply not to the aggregate managethe fact that no inference will be drawn from a partnership's failure to qualify for the safe harbor that the fee arrangement in question does not qualify for the partner-specific expenditure exception.

D. Chargebacks of Prior Special Allocations of Partner-Specific Expenditures and Unlikely Losses and Deductions

The Proposed Regulations would include an exception pursuant to which allocations of income made to charge back prior special allocations of deduction or loss would not be taken into account for tax purposes in determining overall taxable income or loss under the fractions rule, if the prior allocation of deduction or loss was disregarded under the exception for partner-specific allocations or the exception for unlikely losses and deductions. We agree with this change.

ment (or similar) fee deductions allocable to a particular partner for the year, but only to the difference between the greater amount of fee deductions allocable to a particular partner, as compared to the lower amount of fee deductions allocable to all partners. The interpretation can be illustrated by the following example: Assume that a partnership has two investor partners, each owning a 50% capital interest. One partner (a QO) agrees to pay management fees at a two percent rate, and the other partner (a non-QO) agrees to pay management fees at a 2.25% rate. Arguably, in such a case, the partnership's management fees up to two percent can be allocated *pro rata*—and thus would not need to qualify under the exception for partner-specific expenditures—and only the excess .25% would need to be specially allocated to the non-QO partner and would therefore require the protection of the exception. Thus, under this reading of the language of the Proposed Regulations, only .25% of the management fees would be specially allocated, and since .25% is less than two percent, the two percent limitation would not be exceeded in this particular case. Under this reading of the regulations, the language "in the aggregate" also would refer only to the .25%, because the language "in the aggregate" refers back to the language "such fees," and "such fees" would refer back to the portion of the fees that is specially allocated, *i.e.*, only .25% of the fees.

We believe that this reading of the language of the Proposed Regulations is not what the drafters intended. As noted above, two percent is commonly used by many funds to determine the amount of management fees owed each year. Accordingly, the use of the number "two percent" suggests to us that the drafters likely intended the two percent limitation to apply to the total management fees charged to a partner for the year in question. Accordingly, if the two percent limitation is retained—whether (contrary to our recommendation) as the operative rule, or as part of a safe harbor—the Service and Treasury may wish to consider clarifying whether the two percent limitation is intended to apply to the total management (or similar) fees allocated to a partner for the year in question or only to the difference between the fees allocated to that partner and the lower amount of fees allocated to all partners.

E. The Proper Standard for the Unlikely Losses and Deductions Exception

In the Preamble, the Service and Treasury requested:

> comments explaining why "more likely than not" is a more appropriate standard than the standard contained in the existing regulations, or whether another standard turning upon a level of risk that is between "more likely than not" and "low likelihood of occurring" might be more appropriate and what such other standard could be.[71]

We agree that additional guidance should be provided on this point. The current "low likelihood of occurring" language is too vague to be of much use in determining how unlikely an occurrence must be in order to qualify for the exception. The list of examples in the regulations is also of limited helpfulness in clarifying the standard. The relevant sentence reads as follows:

> The types of events that may give rise to unlikely losses or deductions, depending on the facts and circumstances, include tort and other third-party litigation that give rise to unforeseen liabilities in excess of reasonable insurance coverage; unanticipated labor strikes; unusual delays in securing required permits or licenses; abnormal weather conditions (considering the season and the job site); significant delays in leasing property due to an unanticipated severe economic downturn in the geographic area; unanticipated cost overruns; and the discovery of environmental conditions that require remediation.[72]

Certain of these events are presumably highly unlikely, such as "tort and other third-party litigation that give rise to unforeseen liabilities in excess of reasonable insurance coverage." The Existing Regulations, thus, can be read as applying only to events that have no more than a remote possibility of occurring. However, other language in the regulations can be read to suggest the contrary. For example, "unanticipated cost overruns," while not likely to occur, presumably may have more than merely a remote possibility of occurring. The use of the word "may" introduces a further lack of clarity. The word "may" can be read to suggest that even, for example, some unforeseen litigation liabilities in excess of reasonable insurance coverage may have too high a likelihood of occurring to qualify under the "unlikely loss" exception. The word "may" thus can be read as further evidence that the regulations in effect impose a "remote likelihood" standard. Thus, the list of exceptions is in the end not very helpful in fleshing out the exception. The current uncertainty regarding the standard detracts significantly from the usefulness of the exception.

[71] Preamble, at 84520.

[72] Treas. Reg. § 1.514(c)-2(g).

A "more likely than not" standard—*i.e.*, a standard that requires that it be more likely than not that the loss or deduction in question will *not* be incurred—would have the virtue of being both more precise and more widely used in the tax world than the standard in the Existing Regulations. For that reason, we believe that the adoption of a "more likely than not" standard would be an improvement by comparison to the standard in the Existing Regulations. However, because a "more likely than not" standard would apply to allocations that have close to a 50% likelihood of occurring, there is some risk that it could lead to results that are contrary to the purpose of the fractions rule.[73]

A possible alternative to a "more likely than not" standard would be a "significantly more likely than not" standard, which would require that it be significantly more likely than not that the loss or deduction in question will not be incurred. The "significantly more likely than not" standard is used in the "original issue discount" regulations for purposes of determining the payment schedule for a debt instrument that provides for alternative payment schedules based

[73] For example, if a partnership agreed to specially allocate to a non-QO partner a loss that had a 49% chance of being incurred and then, if the loss was incurred, to charge it back by subsequently allocating to the non-QO partner income that the partnership was highly likely to earn, the partnership could potentially confer a timing benefit on the non-QO partner without imposing a detriment on any QO partners. To qualify under the exception for unlikely losses and deductions, the allocations could not be made with a principal purpose of avoiding taxes, but it would be possible for a partnership to enter into such an arrangement without having tax avoidance as a principal purpose. The arrangement would also have to pass muster under the substantiality rules, but given the presumptions that apply for purposes of those rules, the allocations might conceivably be structured so that they have substantiality. *See* Treas. Reg. § 1.704-1(b)(2)(iii)(3)(c).

We note that, when the more-likely-than-not standard was proposed in Notice 90-41, 1990-1 C.B. 350, there were two additional requirements under the exception. The three requirements read in full as follows:

(1) Under the partnership agreement, the allocation will be made only after no partner that is a qualified organization has a positive capital account balance (as determined and maintained in accordance with section 1.704-1(b)(2)(iv));

(2) The partnership has a partnership net taxable loss for the year, and the allocation will not exceed the amount of that loss; and

(3) At the time that the provision requiring the allocation becomes part of the partnership agreement, it is unlikely that such an allocation will be made.

See Notice 90-41, section IV. The inclusion of requirements (1) and (2) would have significantly limited the circumstances in which the exception could have applied. Accordingly, replacing the existing standard in the "unlikely losses and deductions" exception with a "more likely than not standard," without making any further changes, would result in an exception that is arguably broader than the one proposed in Notice 90-41.

upon the occurrence of contingencies.[74] As compared to the "more likely than not" standard, the "significantly more likely than not" standard would have the advantage of being less susceptible to abuse; however, it would have the disadvantages of being less precise and more likely to interfere with non-abusive arrangements. While we believe that either standard would be an improvement over the standard in the Existing Regulations, on balance we recommend the adoption of the "significantly more likely than not" standard.[75]

F. Changes in Partnership Interests

1. Staged Closings

In the 1997 Report, we raised the issue that the Existing Regulations create uncertainty as to the proper treatment of partnerships that have staged closings (referred to as "multiple closings" in that report). The Existing Regulations provide that changes in partnership allocations that result from transfers or shifts of partnership interests (other than transfers from a QO to another QO) will be closely scrutinized (to determine whether the transfer or shift stems from a prior agreement, understanding, or plan or could otherwise be expected given the structure of the transaction), but generally will be taken into account only in determining whether the partnership satisfies the fractions rule in the taxable year of the change and subsequent taxable years.[76] In the common fact pattern where the partnership intends from the beginning to have staged closings, the language of the Existing Regulations creates uncertainty as to whether there could be deemed to be a "prior agreement, understanding, or plan" that could give rise to a fractions rule violation.

The Proposed Regulations would add an exception for changes in partners' interests and allocations made in connection with staged closings. In a staged closing, additional investors join a fund over an extended period of time after the initial formation of the fund, usually not exceeding two years. When the subsequent investors join, they typically have to pay an interest factor that is distributed to the partners who joined before them. In addition, some or all of the cash contributed by the subsequent partners may be distributed to the partners who joined before. It is generally intended that the subsequent investors participate in the economics of the fund as if they had joined at the initial closing; accordingly, allocations are frequently made to bring the partners' capital accounts into alignment. However, the general partner or manager is frequently

[74] *See* Treas. Reg. § 1.1272-1(c)(2).

[75] The Service and Treasury might also wish to consider providing guidance on whether, and under what circumstances, the exception should be applied on a combined basis (rather than a separate basis) to multiple partnership allocations that are made on the occurrence of multiple different contingencies.

[76] Treas. Reg. § 1.514(c)-2(k)(1).

given discretion to deviate from this practice if the values of the fund's assets have changed significantly between their acquisition by the fund and the subsequent closing.

The proposed exception would apply if the resulting changes in allocations and disproportionate allocations "are not inconsistent with the purpose of the fractions rule under § 1.514(c)-2(k)(4)" and each of the following conditions is satisfied:

(A) the new partner acquires the partnership interest no later than 18 months following the formation of the partnership (the "**applicable period**");

(B) the partnership agreement and other relevant documents anticipate the new partners acquiring the partnership interests during the applicable period, set forth the time frame in which the new partners will acquire the partnership interests, and provide for the amount of capital the partnership intends to raise;

(C) the partnership agreement and any other relevant documents specifically set forth the method of determining any applicable interest factor and allocating income, loss, or deduction to the partners to adjust partners' capital accounts after the new partner acquires the partnership interest; and

(D) the interest rate for any applicable interest factor is not greater than 150% of the highest applicable federal rate, at the appropriate compounding period or periods, at the time the partnership was formed.[77]

We support the inclusion of an exception for staged closings, which are common commercial transactions motivated by valid non-tax business reasons. However, for the reasons set forth below, the exception included in the Proposed Regulations would likely need to be significantly modified in order to be of use in the vast majority of cases.

[77] Prop. Treas. Reg. § 1.514(c)-2(k)(1)(ii). The proposed safe harbor rate of 150% of the highest AFR is similar to the safe harbor rate used in the exception for preferred returns and guaranteed payments for capital in the Existing Regulations, which is based in part on 150% of the highest long-term AFR. *See* Treas. Reg. § 1.514(c)-2(d)(4)(ii). It is also similar to the safe harbor rate used in the exception from the partnership disguised sale rules for preferred returns and guaranteed payments for capital under Treasury regulations section 1.707-4(a). *See* Treas. Reg. § 1.707-4(a)(3)(ii).

We note that the Service has issued a private letter ruling on a staged closing arrangement, but it was silent as to the interest factor. PLR 200351032 (Sept. 26, 2003) concluded, under the particular facts at issue in the ruling, that a staged closing arrangement would not result in a fractions rule violation. However, the ruling does not state whether an interest factor was charged. Accordingly, it is not possible to determine whether no interest factor was charged or whether an interest factor was charged but the drafter of the ruling did not consider it relevant to the analysis.

The most significant issue with the proposed exception is the limitation of the interest factor to 150% of the highest AFR. The highest AFR in effect for March 2017 is 2.78%,[78] 150% of which is 4.17%. By contrast, in our experience, many funds currently use an interest factor in the range of eight percent, almost double the amount permitted by the proposed exception. Accordingly, limiting the interest factor to 150% of the highest AFR will likely render the staged closing exception of limited usefulness. We are concerned that, if the limitation in the Proposed Regulations is retained, very few partnerships will qualify for the staged closing exception. Further, if the marketplace has determined that an interest factor in the range of eight percent is appropriate for this type of transaction, it is not clear why the Service or Treasury would seek to impose a lower rate. Accordingly, we recommend that, rather than setting a specific rate, the exception simply provide that the rate must be commercially reasonable under the relevant facts and circumstances. Alternatively, if this recommendation is not accepted, we recommend that the limitation of 150% of the AFR be replaced with a standard that is more in keeping with current marketplace practice, such as eight percent.[79]

The exception would not apply to contributions occurring more than 18 months after the initial formation of the partnership. We understand the Service's and Treasury's concern with having a period that is completely open-ended. However, in our experience, many funds conduct staged closings over a two-year period after the initial formation of the fund. It would not appear that the use of a two-year period (as opposed to an 18-month period) would open the door to significant abuse. Accordingly, we recommend that the period during which partnership contributions pursuant to staged closings may occur be expanded to two years from the initial formation of the partnership.

In addition, although subsequent investors are generally admitted on the same terms as the initial investors, the general partner is typically given discretion to vary the economic terms on which new investors are admitted, if there have been significant changes in the value of part-

[78] *See* Rev. Rul. 2017-7, 2017-10 I.R.B. 1007 (Feb. 17, 2017). 2.78% is the AFR for a long-term instrument with an annual compounding period. The AFRs for instruments with different terms and different compounding periods are all lower than 2.78%.

[79] Building a specific percentage into the exception would create the risk – similar to that mentioned above in the discussion of the proposed "two percent" limitation on management and similar fees – that the rule may become obsolete if the marketplace were to change and the eight percent limitation fall out of use in commercial transactions. However, because the proposed "staged closing" exception is in effect only a safe harbor, the potential downside of including a specific percentage limitation in the exception would be that commercial transactions would no longer qualify for the safe harbor and would be closely scrutinized under the general rule of Treasury regulations section 1.514(c)-2(k)(1). In that case, provided that "no inference" language is included as part of the staged closing exception (as discussed below), partnerships should still be able to qualify under the fractions rule in appropriate fact patterns.

nership assets prior to their admission. We recommend that the regulations clarify that the flexibility afforded to a general partner (or managing member, or other comparable person or group of persons) by this type of provision will not violate the requirement that the partnership agreement "specifically set forth the method . . . for allocating income, loss, or deduction to the partners to adjust partners' capital accounts after the new partner acquires the partnership interest." The grant of authority to the general partner to take into account changes in the value of partnership assets in setting the terms on which new investors enter the partnership is driven by economic concerns and should not be viewed as contrary to the purposes of the fractions rule.

As drafted, the proposed exception would apply only if (i) four specific conditions are met[80] *and* also (ii) the changes in allocations and disproportionate allocations "are not inconsistent with the purpose of the fractions rule under § 1.514(c)-2(k)(4) [the "**Anti-Abuse Rule**"]."[81] Requirement (ii) in the preceding sentence creates confusion, because it is not clear (1) whether it is intended merely as a reminder that the application of the staged closing exception is subject to the Anti-Abuse Rule (which is presumably the case for all of the exceptions in the fractions rule regulations) or (2) whether, on the contrary, it is intended to impose some additional limitation(s) on the scope of the staged closing exception, and if so, what those limitation(s) are. Consequently, we believe that if the staged closing exception were finalized in its current form, it would likely be of little comfort to partnerships, because they will have no way of knowing whether their staged closing arrangements satisfy requirement (ii), as it may be interpreted by the Service.

Therefore, we recommend that requirement (ii) be deleted. We believe that the four specific requirements set forth in the Proposed Regulations (as modified in accordance with our above recommendations), along with the Anti-Abuse Rule, should be sufficient to prevent abuse of the staged closing exception. Alternatively, if requirement (ii) is retained, the regulations should clarify whether the language in question is merely intended to remind taxpayers that the application of the exception is subject to the Anti-Abuse Rule, or whether it is instead intended to impose an additional limitation (or limitations) beyond those imposed by the Anti-Abuse Rule. Moreover, if the language in question is intended to impose an additional limitation (or limitations), the final regulations should contain an example or examples illustrating the limitation(s).

[80] *See* Prop. Treas. Reg. § 1.514(c)-2(k)(1)(ii)(A)-(D), the text of which is set forth in the text accompanying footnote 77 above.

[81] The Anti-Abuse Rule provides as follows:

> The purpose of the fractions rule is to prevent tax avoidance by limiting the permanent or temporary transfer of tax benefits from tax-exempt partners to taxable partners, whether by directing income or gain to tax-exempt partners, by directing losses, deductions, or credits to taxable partners, or by some other similar manner. This section may not be applied in a manner that is inconsistent with the purpose of the fractions rule.

Finally, for the sake of clarity, we recommend adding language to the regulations stating that no inference will be drawn that a fractions rule violation has occurred from the mere fact that changes in allocations pursuant to a staged closing arrangement fail to satisfy the requirements of the staged closing exception. The arrangement would be "closely scrutinized" as provided in proposed Treasury regulations section 1.514(c)-2(k)(1)(i). However, the mere failure to satisfy the safe harbor should not itself be viewed as a factor tending to indicate that an arrangement violates the fractions rule.

2. Defaults on, or Reductions in, Partner Capital Commitments

Changes in partners' interests in a partnership and in partnership allocations may result if a partner defaults on its capital commitment or the partner's capital commitment is reduced. Partnership agreements commonly contain provisions addressing how the partners' interests are to be adjusted in the event of such a default or reduction. In the 1997 Report, we pointed out that the language in the Existing Regulations regarding changes in partnership allocations that result from transfers or shifts of partnership interests creates uncertainty as to whether a change in allocations due to partner defaults on, or reductions in, capital commitments could give rise to a fractions rule violation. As in the case of the proposed exception for staged closings discussed above, the Proposed Regulations provide an exception from the "close scrutiny" otherwise mandated by Treasury regulations section 1.514(c)-2(k)(1) in these situations. The exception provides in relevant part:

> Changes in partnership allocations that result from an unanticipated partner default on a capital contribution commitment or an unanticipated reduction in a partner's capital contribution commitment, that are effected pursuant to provisions prescribing the treatment of such events in the partnership agreement, and that are not inconsistent with the purpose of the fractions rule under [Treasury regulations section 1.514(c)-2](k)(4)], will not be closely scrutinized under [Treasury regulations section 1.514(c)-2](k)(1)(i)], but will be taken into account only in determining whether the partnership satisfies the fractions rule in the taxable year of the change and subsequent taxable years.[82]

In addition, if the exception applies, allocations of income, gain, loss, or deduction made pursuant to the partnership agreement to adjust partners' capital accounts as a result of such a default or reduction will be disregarded in computing overall partnership income or loss for purposes of the fractions rule.

[82] Prop. Treas. Reg. § 1.514(c)-2(k)(1)(iii).

We agree that an exception for defaults on, or reductions in, partner capital commitments should be included in the final regulations. However, as in the case of similar language in the exception for staged closings (discussed above), the language "that are not inconsistent with the purpose of the fractions rule under paragraph (k)(4) of this section" creates confusion. Specifically, it is not clear (i) whether this language is intended merely as a reminder that the exception is subject to the Anti-Abuse Rule or (ii) whether it is intended that the language impose some additional limitation(s). Consequently, we believe that, if the exception for partner defaults or reductions in partner capital commitments were finalized in its current form, it would likely be of little comfort to partnerships, because they will have no way of knowing whether their changes in allocations are consistent with the purposes of the fractions rule, as that requirement may be interpreted by the Service.

Accordingly, we recommend that the language in question be deleted. We believe that the other requirements set forth in the Proposed Regulations, along with the Anti-Abuse Rule, should be sufficient to prevent abuse of the exception. In this connection we note that, in order for the exception to apply, it must be the case that the default or reduction was unanticipated.[83] Therefore, it appears that the potential for abuse should be quite limited. We also note that our recommendation appears to be consistent with the rationale for the change as described in the Preamble, which states that, "[t]he Treasury Department and the IRS have determined that changes in allocations resulting from unanticipated defaults or reductions do not run afoul of the purpose of the fractions rule if such changes are provided for in the partnership agreement." That language suggests that changes in allocations resulting from partner defaults or reductions in capital commitments are consistent with the purpose of the fractions rule, provided that (i) the defaults or reductions are unanticipated and (ii) the changes are provided for in the partnership agreement. In that case, an additional regulatory requirement that the changes in allocations be consistent with the purpose of the fractions rule is unnecessary and only leads to confusion.

Alternatively, if the language is retained, the regulations should clarify whether it is merely intended to remind taxpayers that the application of the exception is subject to the Anti-Abuse Rule, or whether the language in question is instead intended to impose an additional limitation (or limitations) beyond those imposed by other requirements of the exception and the Anti-Abuse Rule. Moreover, if the language in question is intended to impose an additional limitation (or limitations), the final regulations should contain an example or examples illustrating the limitation(s).

[83] *Id*. ("Changes in partnership allocations that result from an *unanticipated* partner default on a capital contribution commitment or an *unanticipated* reduction in a partner's capital contribution commitment…" (emphasis added)).

Finally, for the sake of clarity, we recommend adding language to the regulations stating that no inference will be drawn that a fractions rule violation has occurred from the mere fact that changes in allocations due to defaults on, or reductions in, partner capital commitments do not meet the requirements of the exception for defaults on, or reductions in, partner capital commitments. The arrangement would be "closely scrutinized" as provided in proposed Treasury regulations section 1.514(c)-2(k)(1)(i). However, the mere failure to satisfy the safe harbor should not itself be viewed as a factor tending to indicate that an arrangement violates the fractions rule.

G. Tiered Partnerships

In the case of tiered partnerships, the Existing Regulations require that (i) the avoidance of tax not be a principal purpose for using the tiered ownership structure and (ii) that the relevant partnerships demonstrate under any reasonable method that the relevant chains satisfy the requirements of the fractions rule.[84] The regulations contain three examples illustrating three different reasonable methods of demonstrating that allocations with respect to tiered partnerships satisfy the fractions rule.[85] Example 3 illustrates the so-called independent chain approach, in which an upper-tier partnership (P1) owns interests in two lower-tier partnerships, one of which (P1A) is fractions rule compliant, the other of which (P1B) is not. The example concludes that P2 satisfies the fractions rule with respect to the P2/P1A chain, but "only if the P2 partnership agreement allocates those items allocated to P2 by P1A separately from those items allocated to P2 by P1B." The example further states that P2 does not satisfy the fractions rule with respect to the P2/P1B chain.

The Proposed Regulations would eliminate the "separate allocation" language from the example.[86] We agree with the proposed change. Many (if not most) funds do not make allocations with respect to one investment completely independently from allocations with respect to other investments. For example, carried interest distributions are frequently subject to limitations that apply on an aggregate basis across all investments in a fund. Accordingly, the example in the Existing Regulations is inconsistent with standard, non-tax-motivated commercial arrangements. The problem caused by this example would be ameliorated by the deletion of the "separate allocation" language from the example.

[84] Treas. Reg. § 1.514(c)-2(m)(1).

[85] Treas. Reg. § 1.514(c)-2(m)(2), Exs. 1–3.

[86] In this connection, the Preamble points out that the Treasury Regulations require a partnership to state separately partnership items, such as items giving rise to UBTI, that would give rise to an income tax liability for a partner different from that which would arise if the item were not stated separately. *See* Treas. Reg. § 1.702-1(a)(8)(ii).

H. *De Minimis* Exceptions

The Proposed Regulations would make three changes to the *de minimis* exceptions in Treasury regulations section 1.514(c)-2(k)(2) and (3). First, the Proposed Regulations would add an exception that would be similar to the existing exception for partnerships not more than five percent of the capital or profits of which is owned by QOs.[87] The new exception would apply to partnerships not more than five percent of the capital or profits of which is owned by persons *other than* QOs. However, the exception would apply only if the partnership's allocations satisfy a modified version of the SEE safe harbor. The modification to the SEE safe harbor would consist of applying it without the following special rules in Treas. Reg. § 1.704-1(b)(2)(iii)(c): the presumption that there is a reasonable possibility that allocations will affect substantially the dollar amounts to be received by the partners from the partnership if there is a strong likelihood that offsetting allocations will not be made within five years, and the presumption that the adjusted tax basis (or book value, if different) of partnership property is equal to the fair market value of such property.

We believe that the inclusion of an exception along the lines of what is proposed would be helpful. However, as currently drafted, it will be of very limited use, because it will apply only if persons other than QOs do not own more than five percent of the capital or profits of the partnership. It is common in the fund context for a profits interest to be issued to the general partner of the fund. The profits interest often is entitled to twenty percent of the partnership's profits, after the investors have received a return of their capital and a preferred return. The new *de minimis* exception would be significantly more useful if it were broadened to apply to an investment fund in which the only non-QO were the general partner. That would require expanding the exception so that it would apply if non-QOs owned, for example, not more than five percent of the capital or twenty-five percent of the profits of the partnership. Limiting the profit share to twenty-five percent would generally permit a non-QO general partner to receive profits attributable to a twenty-percent carried interest plus an additional share of profits attributable to a small share of contributed partnership capital.[88] However, in order for the exception to apply to a typical non-QO general partner, the profit share would have to be measured over the life of the partnership, so that catch-up allocations of profits to the general partner (i.e., after the limited partners have been fully allocated their preferred returns) would not cause the general partner's profit share to exceed the limitation (e.g., twenty-five percent).[89] We believe that the application

[87] See Treasury regulations section 1.514(c)-2(k)(2) for the existing exception.

[88] The general partner typically contributes at least some portion of the fund's initial capital, *e.g.*, one percent.

[89] Similarly, in a fund where the general partner has a twenty percent carried interest, as the general partner is allocated profits in respect of its profits interest, the general partner's section 704(b) capital account will

of the modified SEE safe harbor, as set out in the current proposed exception, would sufficiently limit the potential for abuse.

The Proposed Regulations would change $50,000 to $1 million in Treas. Reg. § 1.514(c)-2(k)(3)(ii)(B). We agree with this change.

The Proposed Regulations would also make a change to the existing five percent *de minimis* exception. That exception applies if:

(A) Qualified organizations do not hold, in the aggregate, interests of greater than five percent in the capital or profits of the partnership; and

(B) Taxable partners own substantial interests in the partnership through which they participate in the partnership on substantially the same terms as the qualified organization partners.[90]

The Proposed Regulations would add a parenthetical to prong (A) so that it reads as follows: "Qualified organizations do not hold (*directly or indirectly through a partnership*), in the aggregate, interests of greater than five percent in the capital or profits of the partnership." (Emphasis added.) We do not have an objection to the proposed change.

I. Partner-Specific Expenditures and Imputed Underpayments

In the Preamble, the Service and Treasury request comments on whether an imputed underpayment under the new partnership audit rules[91] should be included among the list of partner-specific expenditures. For the following reasons, we believe that it should.

Effective for partnership taxable years beginning after December 31, 2017, the new partnership audit rules would permit the Service to collect an amount referred to as an "imputed underpayment" directly from a partnership.[92] While official administrative guidance on this issue is not yet issued, the imputed underpayment, if paid by the partnership, would presumably be a

generally come to represent more than five percent of the partnership's total section 704(b) capital. That issue is magnified by the fact that initial distributions, apart from tax distributions, are typically made on a priority basis to limited partners (until they have received a return of their contributed capital plus their preferred return). Therefore, if the profits interest limitation is increased to, for example, twenty-five percent, the Service and Treasury should clarify that a non-QO's interest in partnership capital is determined based on its share of invested capital.

90 *Id*.

91 Sections 6221 through 6241, enacted pursuant to section 1101 of the 2015 Budget Act, 129 Stat. 584, 625.

92 *See* section 6225(a)(1).

noncapitalizable, nondeductible expenditure under section 705(a)(2)(B).[93] The fractions rule regulations provide that noncapitalizable, nondeductible expenditures are included for purposes of determining overall partnership income or loss: "Except as otherwise provided in this section, the partnership items that are included in computing overall partnership income or loss are those items of income, gain, loss, and deduction (including expenditures described in section 705(a)(2)(B)) that increase or decrease the partners' capital accounts under § 1.704-1(b)(2)(iv)."[94]

At a high level, an imputed underpayment is generally determined by netting all adjustments of partnership items of income, gain, loss, or deduction and multiplying the net amount by the highest rate of tax in effect for the reviewed year under section 1 or 11.[95] However, the Code provides that, "[t]he Secretary shall establish procedures under which the imputed underpayment amount may be modified consistent with the requirements of [section 6225(c)(1)]."[96] In addition, the Code further provides that "[s]uch procedures shall provide for determining the imputed underpayment without regard to the portion thereof that the partnership demonstrates is allocable to a partner that would not owe tax by reason of its status as a tax-exempt entity (as defined in section 168(h)(2))."[97] Accordingly, while detailed administrative guidance has not been officially released on how to apply the substantive provisions of section 6225(c)(1), a partnership may under some circumstances be able to reduce the amount of an imputed underpayment to the extent that its taxable income was allocable (or should have been allocated) to a QO partner.[98] In that

93 Section 6241(4) provides that, "[n]o deduction shall be allowed under subtitle A for any payment required to be made by a partnership under this subchapter." This is reflected in the "blue book" that accompanied the legislation. *See* STAFF OF THE JOINT COMM. ON TAX'N, GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 2015, JCS-1-16, at 79 (Mar. 2016) (indicating that a partnership's payment of an imputed underpayment will reduce the outside basis of the partners under section 705(a)(2)(B)).

In January 2017, Treasury initially released proposed regulations under the new partnership audit rules. *See* NPRM REG-136118-15 (Jan. 18, 2017). However, due to a regulatory freeze established by the Trump administration, the proposed regulations have been withdrawn, and their ultimate fate remains unclear. *See* Matthew Madara, *Partnership Audit Rules Pulled After Regulatory Freeze*, 2017 TNT 15-2 (Jan. 25, 2017). The proposed regulations would provide that a payment by a partnership of an imputed underpayment is a noncapitalizable, nondeductible expenditure under section 705(a)(2)(B). *See* Prop. Treas. Reg. § 301.6241-4(a).

94 Treas. Reg. § 1.514(c)-2(c)(1)(i).

95 Section 6225(b)(1)(A). The "reviewed year" is the partnership taxable year to which the item being adjusted relates. *See* section 6225(d)(1).

96 Section 6225(c)(1).

97 Section 6225(c)(3).

98 The proposed regulations initially released in January 2017 and then withdrawn would permit a partnership to request that the amount of an imputed underpayment be adjusted with respect to the portion of the

case, it would appear generally to make sense for the partnership to allocate the nondeductible, noncapitalizable expenditure attributable to the imputed underpayment to the non-QO partners.

If the nondeductible, noncapitalizable expenditure attributable to the imputed underpayment were taken into account in determining the partners' shares of overall partnership income or loss for purposes of the fractions rule, the special allocation of that expenditure to the non-QO partners would increase the QO's share of overall partnership income for the year in which the imputed underpayment was taken into account. That in turn could lead to a fractions rule violation, because the QO's share of overall partnership income for the year in which the imputed underpayment was taken into account could be higher than the QO's lowest share of partnership loss. Accordingly, we recommend that imputed underpayments be added to the list of eligible partner-specific expenditures.[99]

J. Interaction of Disregarded Partner-Specific Expenditures and Unlikely Losses or Deductions with the Chargeback Exception

In the Preamble, the Service and Treasury request comments on another aspect of the exceptions for partner-specific expenditures and unlikely losses and deductions as follows:

> Notwithstanding the rule in the proposed regulations, an allocation of an unlikely loss or a partner-specific expenditure that is disregarded when allocated, but is taken into account for purposes of determining the partners' economic entitlement to a chargeback of such loss or expense may, in certain circumstances, give rise to complexities in determining applicable percentages for purposes of fractions rule compliance.[100]

We are aware of issues that may arise if a partnership attempts to rely on both (i) the exception for partnership-specific expenditures or the exception for unlikely-losses and deductions and (ii)

imputed underpayment that is allocable to a tax-exempt partner. *See* Prop. Treas. Reg. § 301.6225-2(d)(3)(i).

99 In some cases, an imputed underpayment may result in a section 705(a)(2)(B) amount that the partnership cannot allocate to the partner to whom the amount was attributable (for example, if the partner in question is no longer a partner in the partnership). Accordingly, adding imputed underpayments to the list of eligible partner-specific expenditures will not be sufficient to avoid fractions rule problems in all cases. Therefore, Treasury and the Service may wish to consider adding a broader exception for the allocation of section 705(a)(2)(B) amounts attributable to imputed underpayments. In addition, in appropriate circumstances, it would appear that the allocation of a section 705(a)(2)(B) amount attributable to an imputed underpayment could qualify under the exception for unlikely losses or deductions. However, it would be helpful for regulations to confirm that point.

100 Preamble, at 84520.

the chargeback exception in Treasury regulations section 1.514(c)-2(e)(i). For example, assume that a fund has two investors: QO1, a qualified organization, and, TP1, a taxable investor. The third partner is the GP (also a taxable person). Each of QO1 and TP1 contributed 50% of the fund's capital at the fund's inception and is entitled to be allocated a preferred return (determined at the same rate for each investor) before net income is allocated to the GP. In making allocations, the fund initially apportions all of its net income ratably between the investors (*i.e.*, one half to each). The amount apportioned to an investor is initially allocated 100% to that investor until the investor has been allocated an amount equal to its accrued preferred return. After an investor has been allocated its accrued preferred return, the investor's share of the fund's net income is allocated 80% to the investor and 20% to the GP as carried interest. Net losses are generally allocated first to reverse prior allocations of net income, in the same ratio and in the reverse of the order in which the allocations of net income were made. However, in each year of the partnership, TP1 is specially allocated a partner-specific expenditure that is equal to one percent of its contributed capital.

The fund will need to rely on the partner-specific expenditure exception to satisfy the fractions rule. That is because, in each year of the partnership, the special allocation of the partner-specific expenditure to TP1 will decrease TP1's share of the partnership's net income or increase its share of the partnership's net loss. Therefore, if the partner-specific expenditure were taken into account for purposes of the fractions rule, QO1's fractions rule percentage would be below 50%, but in years in which the fund has positive net income, QO1 could be allocated more than 50% of that net income. Accordingly, in order to satisfy the fractions rule, the fund will need to ignore the partner-specific expenditure in determining the partners' shares of overall partnership income and loss.

However, the fund will also need to rely on the chargeback exception in order to satisfy the fractions rule. That is because, in a year in which the fund allocates net loss to offset prior allocations of net income that included allocations of carried interest to the GP, the GP will receive 20% of such allocations, and so QO1 may be allocated only 40% (*i.e.*, 50% * 80%) of the fund's net loss for the year in question.[101] If 40% were QO1's fractions rule percentage, the fund would not be fractions-rule compliant, because QO1 may be allocated more than 40% of the fund's net income for years in which the fund has net income.

Under the chargeback exception, the following allocations are disregarded in computing overall partnership income or loss for purposes of the fractions rule:

[101] For simplicity, these numbers ignore the special allocation of the partner-specific expenditure to TP1. The question of how that special allocation should be taken into account in applying the chargeback exception is discussed below.

- allocations of what would otherwise be overall partnership income that may be made to chargeback (*i.e.*, reverse) prior disproportionately large allocations of overall partnership loss (or part of the overall partnership loss) to a QO, and

- allocations of what would otherwise be overall partnership loss that may be made to chargeback prior disproportionately small allocations of overall partnership income (or part of the overall partnership income) to a QO.[102]

A prior allocation is disproportionately large if the QO's percentage share of that allocation exceeds its fractions rule percentage; a prior allocation is disproportionately small if the QO's percentage share of that allocation is less than its fractions rule percentage.[103] For example, in the case of the fund, if in a year the fund is in carry and allocates net income 40% to QO1, 40% to TP1, and 20% to the GP, the allocation of 40% of the fund's net income to QO1 is disproportionately small because 40% is less than QO1's fractions rule percentage (50%).[104] Accordingly, if in a later year the fund allocates net loss in the same ratio to reverse the prior net income allocation, the allocation of 40% of the fund's net loss to QO1 should be disregarded under the chargeback exception, provided that the other requirements of that exception are satisfied.

In order for the chargeback rule to apply, the following additional requirements must be satisfied:

- Prior disproportionate allocations may be reversed in full or in part, and in any order, but must be reversed in the same ratio as originally made (the "**Same Ratio Requirement**").[105]

- A prior allocation (or allocations) is not considered 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.[106]

[102] Treas. Reg. § 1.514(c)-2(e)(1)(i) and (ii).

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

[104] Again, for simplicity, this ignores the special allocation of the partner-specific expenditure.

[105] *Id*. The Same Ratio Requirement has its basis in the statute. *See* section 514(c)(9)(E)(ii)(I) ("Except as provided in regulations, a partnership may without violating the requirements of this subparagraph [*i.e.*, section 514(c)(9)(E)] 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.").

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

- Generally, the exception applies to a chargeback of an allocation of part of the overall partnership income or loss only if that part consists of a *pro rata* portion of each item of partnership income, gain, loss, and deduction (other than nonrecourse deductions, as well as partner nonrecourse deductions and compensating allocations) that is included in computing overall partnership income or loss.[107]

It is unclear how the Same Ratio Requirement is to be applied when the partnership also qualifies for the exception for partner-specific expenditures. Presumably the allocation of the partner-specific expenditure should not be taken into account in determining whether the Same Ratio Requirement is satisfied. Otherwise—in our example—because the partner-specific expenditure is allocated solely to TP1 in each year of the partnership, QO1 may be allocated a higher share of overall partnership income in a year in which the partnership has positive net income than the share of overall partnership loss that QO1 would be allocated in a subsequent year in which the prior allocation of net income is charged back, and the Same Ratio Requirement would not be satisfied.

Accordingly, it appears that the allocation of the partner-specific expenditures should not be taken into account in determining whether the Same Ratio Requirement is satisfied.[108] However, it is not entirely clear how the partner-specific expenditures should be backed out of the partnership's actual allocations for purposes of applying the Same Ratio Requirement. There appear to be at least two possible ways of applying the Same Ratio Requirement in this type of fact pattern.

The simplest method would be to increase the allocation of net income (or decrease the allocation of net loss) to the partner to whom the partner-specific expenditure was allocated, by the amount of the partner-specific expenditure in question. This method has intuitive appeal and in addition would be relatively mechanical and simple to apply. However, the problem with this method is that, in many fact patterns, it would result in allocations that differ not only from the allocations that the partnership actually made, but also from any allocations that the partnership could ever have made under the partnership agreement.

In our fund example, assume that the fund has positive net income for the taxable year in question. Assume also that, taking into account the partner-specific expenditure allocated to TP1

[107] Treas. Reg. § 1.514(c)-2(e)(2)(ii). There is an exception for minimum gain chargebacks attributable to the distribution of nonrecourse debt proceeds. In addition, the limitation does not apply to the extent the Service provides otherwise by revenue ruling or revenue procedure or, on a case-by-case basis, by letter ruling. *Id*.

[108] That conclusion also seems consistent with the fact that, under Treasury regulations section 1.514(c)-2(f), the partner-specific expenditure is ignored in determining overall partnership income and loss for purposes of the fractions rule.

for the current year, the cumulative net income allocated to TP1 is below TP1's cumulative preferred return. Accordingly, for the year in question, the fund does not actually allocate any share of the net income apportioned to TP1 to the GP. Assume further, however, that if the partner-specific expenditure had not been allocated to TP1 for the current year, the cumulative net income allocated to TP1 would have exceeded the preferred return, thereby resulting in an allocation of income to the GP with respect to its carried interest. In that case, backing out the partner-specific expenditure by merely increasing the allocation of fund net income to TP1 would fail to accurately reflect the parties' economic arrangement, because it would result in allocations of net income that the fund would never have made. For that reason, we believe it is likely that use of this particular method would result in an anomalies in applying the Same Ratio Requirement, and therefore we do not recommend the adoption of this method.

A second possible method would be to look to the allocations that the partnership hypothetically would have made to all of its partners, if there had been no partner-specific expenditures to which the partner-specific expenditure exception applied (the "**Hypothetical Allocations Method**"). For example, in the case of the fund, net losses are generally made first to reverse out prior allocations of net income, in the same ratio and in the reverse of the order in which the allocations of net income were made. Furthermore, both investors in the fund have the same carry structure, joined the partnership at the same time, and generally share proportionately in all partnership allocations (other than with respect to the partner-specific expenditure). Accordingly, were it not for the partner-specific expenditures, the fund generally should allocate net losses that reverse out prior net income allocations in the same ratio in which those net income allocations were made, and the fund therefore should satisfy the Same Ratio Requirement under the Hypothetical Allocations Method.

We recommend that the final regulations clarify that a partnership should be able to satisfy the Same Ratio Requirement by applying the Hypothetical Allocations Method. If a partnership *would have* made its initial allocations and its subsequent chargeback allocations in the same ratios in the absence of any partner-specific expenditures, then it appears to be consistent with the purpose of the fractions rule generally, and the purposes of the partner-specific expenditure and the chargeback exceptions in particular, to treat the Same Ratio Requirement as satisfied. However, we are open to the possibility that there might be other reasonable methods of satisfying the Same Ratio Requirement.

The question remains, however, as to how a partnership would demonstrate that it satisfies the Same Ratio Requirement using the Hypothetical Allocations Method. For many partnerships, it would be extremely burdensome to have to re-calculate all partnership allocations assuming hypothetically that the partnership had never made, and will never make, any special allocations of partner-specific expenditures. Therefore, we recommend that the final regulations permit a partnership to use any reasonable method of satisfying the Hypothetical Allocations

Method. We believe that, in the majority of cases, a partnership will be able to meet this burden by referring to the allocation provisions of the partnership agreement, assuming that the net income and net loss allocation provisions are drafted so that, if a partnership makes prior allocations of net income (or loss) in various ratios, subsequent allocations of net loss (or income) will reverse the prior allocations in the same ratios.[109] In the case of a fund that first apportions profits among all of its investors and then allocates part of an investor's share of the profits to the general partner once the investor has been allocated a specific preferred return, the fund may also need to produce such information as is necessary to demonstrate that, absent the disregarded allocations of partner-specific expenditures, the investors would always be at the same allocation tier of the partnership's waterfall at the same time.

Similar issues may arise if a partnership seeks to qualify under the exception for unlikely losses and deductions and the chargeback exception. Accordingly, our comments regarding the partner-specific expenditures exception apply to the exception for unlikely losses and deductions as well.

[109] The partnership would need to satisfy the other requirements of the chargeback exception as well. For example, the allocations to be charged back would generally need to consist of allocations of overall partnership income or loss (disregarding any allocations of partner-specific expenditures or other special allocations that are disregarded for purposes of determining overall partnership net income or loss under the fractions rule).