REPORT #894

TAX SECTION

New York State Bar Association

REPORT ON SECTION 514(c)(9)(E) CONCERNING
INVESTMENTS IN LEVERAGED REAL ESTATE PARTNERSHIPS
BY PENSION TRUSTS AND OTHER QUALIFIED ORGANIZATIONS

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TAX SECTION
New York State Bar Association

February 14, 1997

Hon. Donald C. Lubick
Acting Assistant Secretary
(Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Re: <u>Report on Section 514(c)(9)(E) Concerning Investments in Leveraged Real Estate Partnerships by Pension Trusts and Other Qualified Organizations</u>

Dear Secretary Lubick:

I am pleased to enclose our report on Section 514(c)(9)(F) and the regulations there-under, concerning the taxation of pension funds and certain other exempt organizations ("QOs") that invest in leveraged real estate investment partnerships. The principal drafter of the report was Patrick C. Gallagher, Co-Chair of our Corporations Committee.

The report concludes that, despite helpful regulations issued in 1994, Section 514(c)(9)(E) remains conceptually and mechanically flawed and a significant impediment to non-abusive transactions typical in the industry. Even the slightest violation of the statutory requirements (such as an immaterial departure from "substantial economic effect" or a prohibited hypothetical future allocation that never in fact is made) generally taints the entire investment and converts to unincorporated business taxable income all debt-financed income earned by all partners from the investment. We believe the cliff effect of taxing all QO partners on all debt-financed income for even a minor, non-abusive infraction of the allocation requirements is unduly harsh.

The report concludes that legislative amendments are necessary to address these problems appropriately. As an alternative to the current statutory scheme, the report strongly recommends replacing Section 514(c)(9)(E) with a two-part test that requires (1) each partnership allocation to have substantial economic effect (as under current law) and (2) no allocation to a QO partner to have a principal purpose of tax avoidance. The report discusses how regulatory authority might be exercised under the revised statute, including to strenghten the substantial economic effect test for Section 514(c)(9)(E) purposes.

As a second statutory recommendation, the report urges replacing the cliff effect of current law with a rule that taxes <u>both</u> the QO and the taxable partners, but only to the extent partnership allocations fail to comply with the revised statutory test described above. Taxing both parties in this manner is intended to create a negative sum situation that will discourage taxpayers from taking an aggressive approach to allocations, while at the same time creating a more equitable penalty whose severity is proportional to the magnitude of the violation.

As a much less desirable alternative to new legislation, the report suggests possible amendments to the current regulations that would address some, but not all, of the problems under current law. However, the report concludes that any attempted regulatory solution would at best be a patchwork approach that would fail to address the structural difficulties in the statute.

We would be pleased to work with you and members of your staff to develop further any of the above proposals. Please do not hesitate to contact us if we can be of any further assistance.

Substantially identical letters have been sent to Chairman Archer and Chairman Roth.

Respectfully submitted,

Richard L. Reinhold

[Enclosure]

cc: Hon. Margaret M. Richardson

NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON SECTION 514(c)(9)(E) CONCERNING INVESTMENTS IN LEVERAGED REAL ESTATE PARTNERSHIPS BY PENSION TRUSTS AND OTHER QUALIFIED ORGANIZATIONS

This report[1] concerns section 514(c)(9)(E) and the regulations thereunder.[2] Those provisions specify requirements that must be satisfied to enable pension trusts and certain other organizations generally exempt from federal income tax to make equity investments in leveraged real estate partnerships without incurring “unincorporated business taxable income” (“UBTI”) by reason of such leverage. The report concludes that section 514(c)(9)(E) is conceptually and mechanically flawed and a significant impediment to non-abusive transactions typical in the industry (see II.B below). The report further concludes that legislative amendments are necessary to address this problem appropriately, and it suggests possible legislative amendments (see II.C.1 below). As a much less desirable alternative to new legislation, the report also suggests possible amendments to the current regulations that would address some, but not all of the problems under current law (see II.C.2 below).

[1] This report was prepared by an ad hoc committee including members of the Committees on Partnerships and Tax-Exempt Entities The principal drafter of the report was Patrick C. Gallagher, with significant contributions by William B. Brannan. Peter C. Canellos. Richard L. Reinhold. Margaret L. Riess and Ann I Thomas Helpful comments were received from Andrew V Berg. Peter H. Blessing. Michael Hirschfeld. Richard O. Loengard. Steven C. Todrys. and Thomas M. Zollo

[2] Unless otherwise indicated, “section” references herein are to the Internal Revenue Code of 1986, as amended (the “Code”), and references to “Reg. §__” are to the Treasury Regulations promulgated there-under.

I. BACKGROUND

Pension trusts and other tax-exempt organizations ("EOs") generally are taxable on UBTI under sections 511 through 513. UBTI includes income derived by an EO from any trade or business regularly carried on by the EO that is unrelated to the EO's exempt purpose. Section 514 expands the definition of UBTI to treat as UBTI the debt-financed portion of any income (including passive investment income) derived by an EO from any leveraged investment ("unrelated debt-financed income"). Section 514(c)(9) in turn excludes from unrelated debt- financed income — and hence potentially exempts from federal income tax -- income earned by any "qualified organization*' from a leveraged real estate investment if numerous requirements are met (the "Real Estate Exception") A "qualified organization" ("QO") is defined to include a qualified trust under section 401, a school meeting certain requirements and its affiliated support organizations, and a title-holding company exempt from tax under section 501(c)(25).[3]

Satisfying the Real Estate Exception is of paramount concern to any QO investing in leveraged real estate, as well as to non-QO sponsors and other participants in such investments that seek to raise capital from QOs. The importance of the Real Estate Exception is magnified by the substantial role of QO capital in such investments.

The requirements imposed by section 514(c)(9) fall into two categories. First, sections 514(c)(9)(A) and 514(c)(9)(B)(i)-(v) apply to any equity investment by a QO in leveraged real estate, whether the property is held by the QO directly or by a

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

partnership in which the QO is a partner These provisions (i) require that the debt be incurred to “acquire or improve” the real property.(ii) require a fixed purchase price. (iii) prohibit certain contingencies in the debt payment terms, and (iv) prohibit certain relationships among the purchaser, the seller, the lender, any lessee(s) and the QO.

Second, sections 514(c)(9)(B)(vi) and 514(c)(9)(E) impose further requirements if the QO invests through a partnership. Section 514(c)(9)(B)(vi) provides that, if real property is held by a partnership, the Real Estate Exception will not apply unless one of three tests is met. First, all partners of the partnership can be QOs. However, since real estate partnerships typically are sponsored by a taxable partner and may have other taxable investors, this test is almost never met. Second, each allocation to a QO partner of the partnership can be a “qualified allocation” within the meaning of section 168(h)(6). This generally requires that the QO maintain a fixed share of each item of income, gain, Loss, deduction, credit and basis throughout the life of the partnership. The requirement is incompatible with the economic terms of virtually all real estate partnerships (including the “carried interest” often earned by the sponsoring partner) and therefore can rarely be met. Third, the partnership can meet the onerous allocation requirements of section 514(c)(9)(E) and the regulations there-under. It is these requirements that QOs (and other investment participants) typically must grapple with in leveraged real estate partnership investments.

II. SECTION 514(c)(9)(E)

A. Summary of Provision

Section 514(c)(9)(E) was enacted in substantially its current form by the Revenue Act of 1987, as retroactively amended by the Technical Corrections Act of 1988.[4] Regulations under section 514(c)(9)(E) were proposed in 1992[5] and finalized in May 1994.[6]

Section 514(c)(9)(E) imposes a two-part test:

- Fractions Rule. Under the "Fractions Rule." the allocation of items to any QO partner cannot result in the QO having a share of overall partnership income for any taxable year greater than the QO's share of overall partnership loss for the year for which the QO's loss share will be the smallest (such smallest loss

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[4] The short-lived predecessor to section 514(c)(9)(E) was enacted by Tax Reform Act of 1986 §1878(c)(3) as a technical correction to the original 1984 Act version of section 514(c)(9)(B)(vi). In lieu of the complex allocation requirements of current section 514(c)(9)(E). under the prior provision a real estate partnership would satisfy the Real Estate Exception if the requirements of section 514(c)(9)(B)(i)-(v) were met (as under current law), unless "the principal purpose of any allocation to any partner of the partnership which is a qualified organization which is not a qualified allocation (within the meaning of section 168(h)(6)) is the avoidance of income tax."

[5] 57 FR 62266 (12/30/92). The proposed regulations were preceded by Notice 90-41, 1990-1 C.B. 350. The proposed regulations and Notice 90-41 were the subject of two prior Tax Section reports: NYSBA Tax Section. Report on Proposed Treasury Regulation Section 1.514(c)-2(42793) (the "1993 NYSBA Report"), and NYSBA lax Section. Report on 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 (3/26/91) (the " 1991 NYSBA Report").

[6] Reg. §1.514(c)-2. T.D. 8539.

share is the QO's "Fractions Rule Percentage"). Reg. §1.514(c)-2(b)(2)(i) generally requires the Fractions Rule to be satisfied on a "prospective basis" as well as on an actual basis for each year, so that the potential occurrence in the future of an allocation prohibited under the Fractions Rule generally will cause the partnership to fail to qualify for the Real Estate Exception for all taxable years, including those preceding the year of the prohibited allocation.[7] In determining overall partnership income or loss for purposes of applying the Fractions Rule, certain chargebacks of prior allocations, preferred return allocations, and other specified allocations are disregarded.[8]

- Substantial economic effect test. Each partnership allocation must have substantial economic effect within the meaning of section 704(b)(2).

Section 514(c)(9)(E) is intended to deprive a QO of the benefit of the Real Estate Exception where a leveraged real estate partnership in which the QO is a partner is "designed to transfer the benefit of [the QOs] tax-exempt status to taxable organizations" by over-allocating taxable income to the QO or

[7] This harsh prospective disqualification rule is alleviated only slightly by the "unlikely loss" rule of Reg. § 1.514(c)-2(g) and other regulatory exceptions. Moreover, even if a partnership satisfies one of these narrow regulatory exceptions to the prospective disqualification rule, the partnership will fail to qualify for the Real Estate Exception for the year in which the prohibited allocation actually occurs and all future years

[8] See section 5l4(c)(9)(E)(ii) and Reg. §1.5l4(c)-2.

over-allocating taxable loss to taxable partners.[9]

B. Flaws in Section 514(c)(9)(E)

There is a broad consensus among practitioners familiar with this area that no provision of the tax law is more conceptually and technically flawed, more difficult and vexing to deal with, and more wasteful of taxpayer and government resources than section 514(c)(9)(E). As noted in the 1991 NYSBA Report on Notice 90-41, “the current statutory provisions are in many respects simply unworkable.”

The 1993 NYSBA Report on the 1992 proposed regulations commended the Service “for providing ... guidance in a relatively concise and understandable format” and stated that it generally agrees with the substance of the Proposed Regulations.” including the ways in which they modified the prior rules to allow QOs to make “legitimate, non-tax-motivated real estate partnership investments without experiencing catastrophic UBTI consequences.” The 1994 final regulations further improved the rules in that respect, including by reflecting comments made in our 1993 report on the proposed regulations.

Despite these regulator) improvements, however, it has become clear since the issuance of the proposed and final regulations, as practitioners have continued to struggle with the requirements laid down, that the rules in this area — particularly the statute itself -- remain an enormous stumbling block in structuring and negotiating straightforward, non-abusive real estate transactions.

[9] H.R. Rep. No. 100-391(1), 100th Cong., 1st Sess. 1076(1987).

1. In general. There are three basic problems with section 514(c)(9)(E). First, it is overreaching and rigidly mechanical, making it difficult or impossible to accomplish customary, non-abusive business objectives Examples of such objectives are described in II.B.2-3 below. As a result, frequently it is impossible to satisfy section 514(c)(9)(E) without modifying the proposed economics in a manner that disadvantages the QO and/or taxable investors in the transaction. By relying on complex mechanical rules rather than sound tax principles, the fractions Rule in particular creates problems of administration and fairness for the government and taxpayers alike. Second, though deceptively simple at first blush, section 514(c)(9)(E) is extremely complicated and difficult to apply. Section 514(c)(9)(E) and its regulations can rarely be applied with complete confidence, even in the simplest circumstances. This is due in part to the requirement that the Fractions Rule generally must be satisfied on a “prospective basis” as well as on an actual basis from year to year, so that a hypothetical future violation of the Fractions Rule can disqualify the investment from the Real Estate Exception from inception even if that prohibited allocation is unintended or never occurs at all. As a result, the Fractions Rule requires anticipating every conceivable allocation that may occur in the future. Third, the cliff effect of section 514(c)(9)(E) is draconian. Even the slightest violation of section 514(c)(9)(E) (such as an immaterial departure from substantial economic effect or a

prohibited hypothetical future allocation that never in fact is made) taints the entire investment and converts to taxable UBTI all debt financed income earned by all QO partners from the investment."[10]

In combination, the above problems invariably make section 514(c)(9)(E) a perilous and enormously time-consuming experience for practitioners and investors alike. It also significantly increases transaction costs.

2. Fractions Rule. The Fractions Rule impedes or thwarts the following common, non-abusive business objectives

- Multiple properties. Investment partnerships that own multiple properties often make "carried interest" and other allocation determinations at least in part on a property-by-property basis rather than on a portfolio basis. Because the Fractions Rule applies based on "overall" partnership income or loss, such property-by-property allocations are virtually impossible under the Fractions

[10] The de minimis rules of Reg. §1.5.14(c)(2) and (3) are so narrow that they can almost never be used. For example, the 5°oQO participation threshold of Reg. §1.514(c)-2(k)(2) seems unreasonably low given the companion requirement that substantial taxable partners participate on the same terms as the QOs.

Rule.[11] An inconvenient alternative is to have each

[11] Surprisingly, the Fractions Rule can encourage taxpayers who wish to approximate the economics of a property-by-property approach to create allocations that have the effect of deferring carried interest income allocations to a taxable partner. For example, assume GP (a taxable entity) and QO form a partnership, investing capital in a 1:99 ratio, and that the partnership purchases multiple properties. With respect to each property, GP is entitled to 20% of cumulative net profits, and cumulative net losses are borne in relation to capital (1% to GP and 99% to QO). In the absence of the Fractions Rule, normally:

(1) income from each property would be allocated (i) first. 1% to GP and 99% to QO to the extent losses from that property were previously allocated under clause (2)(ii) below, and (ii) thereafter. 20% to GP and 80% to QO: and

(2) losses from each property would be allocated (i) first. 20% to GP and 80% to QO to the extent income from that property was previously allocated under clause (1)(ii) above, and (ii) thereafter. 1% to GP and 99°o to QO.

This simple, non-abusive scheme will not work under the Fractions Rule, however, because QO's share of overall partnership income could be as high as 99% (for a year in which allocations are made only under clause (I Mil above), which exceeds QO's Fractions Rule Percentage of 80% (determined by clause (2)(i) above). (Allocations under clause (I)(i) will not be disregarded for Fractions Rule purposes under the chargeback rule of Reg. § 1.514(c)-2(e). because the clause (1)(i) allocations as well as the clause (2)(ii) allocations they reverse are allocations with respect to a particular property rather than allocations of "overall" partnership income or loss. Allocations under clause (2 Mi I will not be disregarded under a similar analysis.)

To address this problem while preserving their original economics as much as possible, the parties may instead postpone allocating income with respect to GP's 20% carried interest on a property until such mutually agreed time as GP is irrevocably entitled to retain the carried interest (such as when the property is sold, and eliminate the carried interest chargeback I allocation under clause (2)(i) above. Under this alternative arrangement, QO's Fractions Rule Percentage is 99% (rather than 80%). since QO will always be allocated at least 99% of overall partnership loss. The revised allocations satisfy the Fractions Rule, because QO is never allocated income in excess of its 99% Fractions Rule Percentage. In addition, the allocations should have substantial economic effect, because GP will be obligated to return prior carried interest distributions to the extent of any capital account deficit it has on liquidation (which would result if the deferred carried interest income allocations to GP are less than the amount of GP's carried interest distributions). Unfortunately, while the parties have solved their Fractions Rule problem, the Fractions Rule has encouraged an unintended result that is undesirable both tor them (because, in contrast to their original, preferred transaction. GP must assume some risk that ii will be required to return upon liquidation carried interest distributions previously received by it) and for the government (because of the deferral of income allocations to GP and hence the deferral of taxes).

property owned by a separate partnership. Even then, however, there is a risk that, due to the common ownership of the entities, either (i) the allocations would be integrated for purposes of (and thereby fail) the Fractions Rule.[12] or (ii) if the arrangement involves any tiering of partnerships (e.g., a holding partnership with multiple operating subsidiary partnerships), the allocations would fail to satisfy the tiered partnership requirements of Reg. §1.5l4(c)-2(m). Moreover, holding each property in a stand-alone partnership generally would preclude any element of pooling in the allocations (e.g., reducing the carried interest on one property due to an earlier loss on a different property). In these respects, the Fractions Rule significantly disrupts customary, non-abusive transactions in a manner that probably could not be addressed by regulation.

- Disproportionate allocations of different types of income. A related problem is that many real estate partnerships allocate differently different types of income (e.g., operating income versus disposition gain) generated by a particular property. As in the case of multiple property allocations, the ability to make legitimate, non-abusive allocations of different income types is significantly hampered by the Fractions Rule given its rigid measurement of "overall" partnership income and loss.

- Disproportionate sharing of expenses. In an investment partnership involving multiple limited partners, larger investors (including QOs) may negotiate with the sponsor a management fee rate that is lower than that charged to other

[12] See Reg. § 1.514(c)-2(b)(2)(i)(expansive definition of "partnership agreement").

partners. Normally management fees are paid by the partnership, and each partner is specially allocated its share of management fee. Allocating a disproportionately low management fee to a QO generally will violate the Fractions Rule. This is because of the possibility, for example, that the partnership's only item of income or loss for a year may be the management fee, which in turn would establish a low Fractions Rule Percentage for the QO benefiting from the low fee.[13] A similar issue arises in connection with other partnership expenses that it is desirable and appropriate to allocate disproportionately among the partners. Reg. §1.514(c)-2(f) allows certain partner-specific deduction items to be shared disproportionately, but the list is so narrow that it is not very helpful.

This problem could be addressed by amending Reg. §1.514(c)-2(f) along the lines recommended in the 1993 NYSBA Report. There we recommended including a general rule that excludes from the determination of overall partnership income and loss any special allocation of deductions arising as a result of a partnership expense that is directly related to a specific partner or group of partners as a result of a benefit received by (or an obligation incurred by the partnership as a result of the presence of) such partners, provided that (i) such deductions are allocated solely to the partners to whom the expense is attributable and (ii) a principal purpose of the special allocation is not tax avoidance. A less desirable alternative would be to

[13] It the management fees were paid directly by the investors (rather than by the partnership) to the general partner or manager, it appears that the lee arrangement should not be taken into account for fractions Rule purposes But see Reg. §1.514(c)-2(b)(2)(i) and Reg. §1.704-1(b)(2)(ii)(h) (expansive definition of "partnership agreement"). However, a direct payment arrangement of that type is often precluded by ERISA or undesirable for administrative or other reasons.

identify additional specific expenditures (including management fees and the other items identified in the 1993 NYSBA Report) by revenue ruling or revenue procedure as contemplated by Reg. §1.514(c)-2(f)(4).

- Subsequent adjustments to allocations. Subsequent events may require adjustments to the relative sharing ratios among the partners of profits, losses and distributions. Such events include multiple closings (in which new participants dilute the participation of the original partners), later capital contributions by one or more partners (e.g., to fund new investments, capital improvements of existing investments, or expenses), partner defaults or partner opt-outs (e.g., due to legal restrictions) with respect to subsequent capital contributions, and redemption of a partner's interest for regulator, or other reasons. All of these features are typical in investment partnership yet any one of them may cause a violation of the Fractions Rule.

Violation of the fractions Rule may occur because, with narrow exceptions, the fractions Rule rigidly limits, at the inception of the partnership, the QO’s highest lifetime percentage of overall partnership income to the QO's lowest lifetime percentage of overall partnership loss, notwithstanding subsequent changes in circumstances. For example, if in connection with a subsequent capital contribution the QO makes a contribution but one or more other partners do not, a corresponding increase in the QO's share of overall profit (and loss) might be construed to violate the Fractions Rule, since the increased profit share may exceed the QO's prior loss sharing ratio. Conversely, if any other partner (whether a taxable partner or different QO partner) makes a contribution but the QO does not. a corresponding reduction in the QO's share of overall loss (and profit) might be construed to violate the Fractions Rule, since the QO's prior profit share may exceed the QO's reduced loss sharing ratio. Similar issues arise if the QO or a taxable partner defaults and it is desirable to increase the profit and loss shares of the non-defaulting partners. Reg. § 1.514(c)-2(k)(1)(second sentence) does not seem very helpful, because (i) it suggests that any shift in allocations that is contemplated by the partnership agreement (which the above shifts often will be) may be a problem, and (ii) even if such shifts are permitted, it is unclear how to apply the rule that such allocations "generally will be taken into account only in determining whether the partnership satisfies the fractions rule in that taxable year of the change and subsequent taxable years." That is, it is unclear whether the Fractions Rule is reapplied based on the new allocations beginning at the time of the shift, or whether prior allocations may continue to be relevant in applying the Fractions Rule going forward.[14]

[14] Reg § 1.514(c)-2(b)(2)(ii) is also not helpful: "A subsequent change to a partnership agreement that causes the partnership to violate the fractions rule ordinarily causes the partnership's income to fail the [Real Estate Exception] only for the taxable year of the change and subsequent taxable years." Apparently this rule would not even apply with respect to the above events to the extent the required allocation adjustments are specified in the original partnership agreement (which would be typical and desirable) and hence are not really "a change" to the partnership agreement. Moreover even if the rule did apply, it would merely postpone am Fractions Rule violation until the year of the allocation adjustment and each subsequent year.

Hence there is concern that the mere presence of provisions of the above type may violate the Fractions Rule, even if the allocation shifts never occur As a result, significant contortions are required (which frequently fail to achieve fully the parties' reasonable business objectives) in drafting a partnership agreement to address subsequent contributions, defaults and the like in a manner that minimizes risk under the Fractions Rule.

This problem could be addressed in part by amending Reg. § 1.514(c)-2(k)(1) to clarify that shifts in allocations arising from the above events will not violate the Fractions Rule, provided that (i) the Fractions Rule (applied by reference to the adjusted allocations) continues to be satisfied in the future, and (ii) a principal purpose of the shift is not tax avoidance. The preceding standard might be made more stringent by also requiring that the shift be attributable to a change in the economic interests of the partners.[15]

- Preferred/subordinated capital. Section 514(c)(9)(E)(ii)(II) and Reg. § 1.514(c)-2(d) permit certain special income allocations to a QO with respect to a preferred return on

[15] Unfortunately, these regulatory amendments still would not address typical multiple closing arrangements in which a partner admitted at a later closing either (i) in exchange for contributing a pro rata share of capital plus an "interest f actor." is entitled to special "catch-up" allocations of prior income and loss to put it in the same position as previously admitted partners, or (ii) is entitled to share only in allocations with respect to investments acquired by the partnership after the partner's admission, not in investments acquired prior to such date. While the latter concern might technically be solved by setting up a new partnership for subsequent investments, such a step is costly and administratively cumbersome and also is probably not feasible under the fractions Rule if allocations to the historic partners (who would have an interest in both partnerships are to be determined on a "pooled" basis.

capital or a guaranteed payment to the extent such allocations are supported by contemporaneous cash distributions. However, loss allocations that are necessary to give effect to a preference of capital itself are not permitted. For example, the regulations do not permit a special allocation of losses to a taxable partner that contributes subordinated capital before losses are allocated to a QO contributor of preferred capital.[16] As a result, contrary to the economic objectives of the parties, generally it is necessary to allocate cumulative net losses to the partners in proportion to their aggregate invested capital, thereby treating all capital as equal in priority. As an alternative to special loss allocations to a subordinated capital partner, the partnership agreement could, consistent with the Fractions Rule, provide for special distributions to the preferred capital partner to the extent of its preferred capital, notwithstanding the pro rata allocation of cumulative net losses. Under this approach, however, to the extent the partnership incurs cumulative net losses. the allocation of such losses in part to the preferred capital partner would be inconsistent with the cash sharing arrangement and hence would violate the substantial economic effect requirement. Accordingly, it is generally impossible to effectuate a preferred/subordinated capital arrangement without violating section 514(c)(9)(E) in its current form.

The subordinated capital problem could be addressed by amending the regulation to disregard for Fractions Rule purposes special allocations of losses (and any subsequent reversing allocations of income) to a partner that

[16] Such an allocation provision would violate the Fractions Rule because of the possibility that the partnership's only item for a year would be a loss specially allocated to the taxable subordinated capital partner, so that the QO's Fractions Rule Percentage would be zero.

contributes subordinated capital.[17] In addition to the existing requirement that any such allocations have substantial economic effect, such an exclusion could be subject to the condition that the excluded allocations are not made with the principal purpose of tax avoidance In non-Fractions Rule partnerships, subordinated capital is typically dealt with through allocations of this type, which reflect the economic substance of the arrangement. Moreover, excluding such allocations seems permissible under the regulator) authority of section 514(c)(9)(E)(iii).

Alternatively, if the possibility of interim, temporary special loss allocations to a taxable subordinated capital partner under the preceding approach raises a concern, the preferred/subordinated capital problem might be addressed by amending the regulation to allow the subordinated capital partner's deduction(s) only to the extent the subordinated capital is actually forfeited. This rule could be similar to the approach taken currently in Reg. §1.514(c)-2(d) with respect to preferred returns and guaranteed payments,

[17] It would also be necessary to disregard subsequent “catch-up” allocations of losses to the preferred capital partner, since the preferred capital partner could be a taxable investor rather than a QO. For example, assume that a QO invests S50 of subordinated capital and a taxable partner invests S50 of preferred capital, and that, except for the subordination feature, the two partners share on a 50-50 basis. In the absence of the preferred/subordinated capital distinction, cumulative net losses would be allocated, like all other items, 50% to the QO and 50% to the taxable partner. In contrast, under the preferred subordinated capital arrangement, net losses are allocated (i) first. 100°o to the QO to the extent of its $50 subordinated capital, (ii) second, 100% to the taxable partner to the extent of its $50 preferred capital, and (iii) then 50% to each partner. Despite having substantial economic reflect and lacking any tax abuse potential, the 100% loss allocation to the taxable preferred capital partner under clause (ii) would need to be excluded from the determination of overall partnership income and loss to avoid a violation of the Fractions Rule

although it may be more complicated.[18] This alternative approach should not offer any opportunity to allocate artificial or transitory losses to a taxable partner, and therefore should not offend the policy behind section 514(c)(9)(E). However, we believe this alternative approach to the preferred subordinated capital issue is less desirable than the first approach, because (I) it is likely to be more complicated, (2) the first approach more accurately reflects the business arrangement of the parties, since the subordinated capital partner economically bears the initial losses that are allocated to it under that approach, and (3) the first approach does not appear to present significant abuse potential.

- Preferred returns. Reg &l.514(c)-2(d) permits a special allocation of income to match a preferred return on capital only if there is a corresponding cash payment. This 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

[18] For example, a workable rule of this type might require creating at the time of a preferred capital distribution offsetting phantom income and loss allocations, in the amount of the distribution, to the preferred capital partner and the subordinated capital partner, respectively (compare the “remedial allocation” method of Reg. §l.704-3(d)). Otherwise, the partnership might not have sufficient income or loss in the year of distribution to support the priority distribution to the preferred capital partner. Such phantom allocations would need to be excluded in determining overall income and loss for Fractions Rule purposes.

the year of payment and subsequent years). This in turn severely limits the usefulness of the regulatory safe harbor for reasonable preferred returns. The final regulations alleviated this problem somewhat by expanding the availability of the guaranteed payment safe harbor. Nevertheless, as discussed more fully in our 1991 NYSBA Report and 1993 NYSBA Report, we continue to recommend that the cash-before-income requirement applicable to preferred returns be eliminated to permit allocations to be made in accordance with normal commercial practice. T his change could be accomplished by amendment of the regulations.

- Carried interest to QO. In some investment partnerships, a significant QO investor is invited to invest with the general partner and share in the carried interest earned with respect to other investor capital. The Fractions Rule precludes the special allocation of income to the QO that is necessary to effectuate such an arrangement.

3 Substantial economic eflect requirement. The substantial economic effect requirement raises the following problems:

- Clawback in excess of capital account deficit. Investment partnerships in which the general partner earns a carried interest often require the general partner to return to the partnership upon liquidation that portion of its carried interest necessary to ensure that (1) the general partner has not collected more than its carried interest percentage of partnership net profits determined on a cumulative basis and/or (2) the limited partners have recovered their capital and. in many cases, earned a preferred return on their capital. Such a clawback can require the general partner to recontribute to the partnership an amount in excess of its capital account deficit at liquidation.[19] A provision of this type, however, apparently would fail the substantial economic effect requirement (and hence section 514(c)(9)(E)), because proceeds on liquidation are not distributed in proportion to positive capital account balances.[20] While technically appearing to violate section 514(c)(9)(E), this departure from the substantial economic effect requirement would not seem to offend the policy underlying section 514(c)(9)(E),

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[19] For example, assume GP (a taxable entity) and QO form a partnership, investing $200 of capital in a 1:9l) ratio ($2 and $198. respectively). With respect to each investment sold, the partners are entitled to a return of their capital attributable to that investment plus a 10% annual noncompounded preferred return. Any remaining proceeds are distributed 20% to GP and 80% to the partners in proportion to their capital. Assume the partnership makes two $100 investments, the first of which is sold for SI 50 after 1 year, and the second of which is sold for SI 00 after 5 years. The $150 proceeds from the sale of investment 1 are distributed (i) $100 to the partners as a return of capital (ii) $10 to the partners as a preferred return, (iii) $8 to GP as a 20% carried interest and (iv) S32 to the partners in proportion to their capital. The profits are allocated in the manner in which cash is distributed, so that after the investment 1 proceeds are distributed. (GP's and QO's capital accounts will be SI and $99. respectively (i.e., the amount of their invested capital in investment 2). In year 5, the $100 proceeds from the sale of investment 2 are distributed SI to GP and S99 to QO as a return of capital. This reduces each partner's capital account to zero, and there is no further income or loss with which to adjust the capital accounts I low ever, the partners' cumulative preferred return on the capital attributable to investment 2 is S50 (10% on their SI00 investment over 5 years), which there is no cash to pay. (GP. on the other hand, has received an SK earned interest from investment 1. which it would not have received had the distributions been determined on a fully pooled basis. The parties may have agreed (as is the case in many investment partnerships) that GP is required on liquidation to return its previous carried interest (here. SK I to the extent the partners have not received their accrued preferred return, despite the possibility (as in this example) that GP's clawback amount may not be reflected by a deficit capital account.

[20] <u>See</u> Reg. $l.704-l(b)(2)(ii). Theoretically, the substantial economic effect problem could be alleviated or eliminated by providing for special allocations of net loss. or even gross items of low to the general partner and income to the other partners in the year of liquidation to bring the capital accounts into conformity with the clawback arrangement to the extent possible. However, such allocations would violate the Fractions Rule.

because it would merely have the effect of deferring until liquidation the taxable partner’s loss (and the QO's income) with respect to the clawback amount.

We believe this problem could be addressed, pursuant to the regulatory authority of section 514(c)(9)(E)(iii) and consistent with Congressional intent (see II.C.2 below), by amending the regulations to provide that, in connection with the liquidation of a partnership, the payment by a taxable partner to a QO and/or to other partners (either directly. or indirectly by means of a capital contribution to the partnership) of an amount in excess of the contributing partner's capital account deficit will be disregarded for purposes of section 514(c)(9)(E) if such payment is not made with a principal purpose of tax avoidance.

- General uncertainty. Because of the complexity of the section 704(b) regulations, it is often difficult or impossible (and, for purposes other than section 514. it is rarely necessary l to conclude with absolute certainty that every partnership allocation that is employed or could arise has or will have substantial economic effect, Opinions and disclosures on substantial economic effect, for example. typically reach no stronger than a “should” conclusion. However, section 514(c)(9)(E) permits no leeway on this issue.

C. Recommendations

In light of the above and similar problems, we believe that the application of section 514 to leveraged real estate partnerships can be made reasonably workable only by amending the flawed statute. As a much less desirable alternative, some but not all of the problems identified above might be addressed by regulator, amendments.

As a preliminary matter, we acknowledge that the statute and regulations in their current form successfully implement an apparent policy of zero or near-zero[21] tolerance for shifting losses from a QO to a taxable partner, and that the statutory and regulatory amendments suggested below in certain circumstances may be somewhat less ironclad in that respect. We strongly believe, however, that any incremental benefit to the fisc which current law may achieve in comparison to the more flexible and targeted alternatives described below do not justify the enormous transaction costs and other burdens of complying with the overreaching and rigid section 514(c)(9)(E) requirements. Section 514(c)(9) reflects in part the intention of Congress to foster (or at least permit) nonabusive leveraged real estate partnership investments by QOs. It seems inconsistent with that intention to impose onerous and arbitrary' obstacles that in many circumstances do not further the policy of preventing loss-shifting. Accordingly, we urge a more balanced approach that should achieve substantially the same revenue objectives in a manner that does not unduly interfere with nonabusive commercial transactions.

1. Statutory amendment. Only a statutory amendment can go to the heart of the problem, which is the combination of the over inclusive, mechanical test of section 514(c)(9)(E) and the “cliff” effect of major sanctions for even a minor violation (i.e., converting the debt-financed portion of every QO's entire

[21] See footnote 11 for a fact pattern in which the Fractions Rule encourages the deferral of income taxes

return to UBTI). For that reason, we strongly recommend that the statute be amended in both of the following ways:

a. Eliminate the Fractions Rule. Eliminate the Fractions Rule by replacing section 514(c)(9)(E) with a two-part test to the following effect:

"(E) Certain Allocations Permitted.--

(i) In General.--A partnership meets the requirements of this subparagraph if--

(I) each allocation with respect to the partnership has substantial economic effect within the meaning of section 704(b)(2), and

(II) no allocation to a partner of the partnership which is a qualified organization is made with a principal purpose of avoiding income tax.

For purposes of this clause, items allocated under section 704(c) shall not be taken into account.

(ii) Regulations --The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this subparagraph, including regulations which may (I) provide for the treatment of allocations (including allocations of deductions attributable to nonrecourse liabilities) that cannot have substantial economic effect, and (II) provide for the exclusion or segregation of allocations from the requirement of clause (i)(1)."

We believe the "substantial economic effect" test in clause "(i)(1)" above would significantly deter abusive allocations without impeding normal commercial transactions as the Fractions Rule does. This is particularly so given the adoption, since section 514(c)(9)(B)(vi) was first enacted in 1984, of significant limitations on both the amount of tax benefits generated by real estate partnerships and the ability of taxable investors to use those benefits. Those limitations include: (1) the significant expansion and refinement in December 1985 of the final section 704(b) regulations, including the "substantiality" requirement Reg. § 1.704-1 (b)(2)(iii); (2) the 1994 adoption of the partnership anti-abuse rules of Reg. §1.701-2: (3)the lengthening of the depreciation period for commercial real estate to 39 years: (4) the 1986 enactment of the section 469 passive activity loss rules: (5) the 1986 extension of the at-risk, rules to real estate investments: and (6) the strengthening of the alternative minimum tax. While several of these limitations were just taking effect when section 514ic)(9)(B)(vi) was amended in 1986-88, subsequent experience has demonstrated their effectiveness in limiting the generation and use of losses in real estate partnerships. Collectively, these developments significantly alleviate any historic need for the Fractions Rule.

The "principal purpose" test in clause "(i)(ll)" above is based on the 1986 Act predecessor to the Fractions Rule (quoted in relevant part in footnote 4 above), substituting "a principal purpose" for "the principal purpose" (which Congress presumably concluded granted too much discretion to taxpayers.[22] To lend some objectivity to the principal

[22] See the following footnote for a fact pattern that might violate the "a principal purpose" test.

purpose test, we would also recommend guidance (e.g., in the form of legislative history or regulatory authority) to the effect that an allocation will be deemed not to be made with a tax avoidance principal purpose if either (1) the aggregate interests of QOs in the class of interest receiving a "bad" allocation are sufficiently small or (2) the taxpayer can demonstrate that the allocations are comparable to those in partnerships in which taxable partners predominate.

We recommend that regulations issued under the authority described in clause "'(ii)" above (1) provide in effect that nonrecourse deductions must be allocated among the partners generally in proportion to their capital contributions to the partnership, (2) address other allocations that cannot have substantial economic effect, along the lines of Reg. § 1.514(c)-2(b)(1)(ii), and (3) disregard for purposes of determining substantial economic effect a clawback payment of the type described in II.B.3 above and other appropriate items (such as allocations that do not accelerate deductions or defer income of a taxable partner and hence do not have a tax avoidance purpose or effect). Other regulations that might be considered include possibly strengthening for section 514(e)(9)(E) purposes the "substantiality" test of Reg. §1.704-l(b)(2)(iii), such as by (1) replacing the "reasonable possibility" standard described in clause "(a)" of such regulation with a more stringent standard (e.g., a "strong possibility" standard) and or (2) modifying in appropriate cases the presumption in clause "(c)" of the regulation that fair market value is equal to adjusted tax basis.[23] Consideration might also be given to strengthening the "substantiality" test as a somewhat more objective alternative to the statutory "a principal purpose" test suggested above.

b. Eliminate "cliff effect". In addition to amending section 514(c)(9)(E) as described above, we recommend altering the consequences of violating section 514(c)(9)(E) (as so amended) by eliminating the "cliff effect" of current law. Specifically, rather than treating the debt-financed portion of each QO partners entire return as UBTI, we recommend amending the statute to the following effect:

- Require the QO in determining its UBTI for each taxable year, to include as income the excess of (1) the debt-financed portion (determined under section 514 principles) of any partnership income actually allocated to the QO for such taxable year over (2) the debt-financed portion of partnership income that would have been allocated to the QO had section 514(c)(9)(E) been satisfied. In addition, permit the QO to deduct for UBTI purposes the excess of (1) the debt- financed portion of partnership losses actually allocated to the QO for a year over (2) the debt-financed portion of the losses that would have been allocated to the QO had section 514(c)(9)(E) been satisfied, but only to the extent such

[23] Under the current fair-value-equals-basis presumption, for example, special allocations of depreciation deductions to a taxable partner followed by a chargeback of income on sale could, subject to any limitation on allocations of nonrecourse deductions, satisfy the current substantiality rules as well as the heightened "strong possibility" standard suggested in text, even though the panics may be highly confident when the property is acquired that the property will not decline in value (or at least that lax depreciation will exceed economic depreciation). To address this concern, the "substantiality" test might be applied to such special depreciation allocations by reference to the reasonable valuation expectations of the parties when the partnership agreement is entered into rather than based on the fair-value-equals-basis presumption

deduction is attributable to a reversal of income included in UBTI under the preceding sentence. [24] The deduction permitted by the preceding sentence is needed to address appropriately shifts in allocations that arise from timing rather than permanent differences, and is consistent with current law.[25]

- Tax the taxable partner as though it had reported on its tax return, in lieu of any partnership income or loss actually shown, the income or loss the taxable partner would have been allocated had section 514(c)(9)(E) been satisfied, but only to the extent such treatment would accelerate income or defer deductions of the taxable partner. This rule would generally (1) disallow the taxable partner's deduction for any losses claimed by it in excess of those losses properly allocable to the taxable partner under section 514(c)(9)(E) and (2) treat as taxable income to the taxable partner the excess of any income properly allocable to the taxable partner under section 514(c)(9)(E) over the income actually reported by it.[26]

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[24] Alternatively, the later year reversal may be represented by a reduction in income allocated to the QO rather than by an increase in losses.

[25] For example, assume that in year I the QO is allocated income that exceeds by $100 the income properly allocable to the QO under section 514(c)(9)(E), and that in year 5 the allocation is reversed by a loss allocation to the QO that exceeds by $100 the loss properly allocable to the QO under section 514(c)(9)(E). The QO should have UBTI of $100 in year 1 and a UBTI deduction of $100 in year 5.

[26] Thus, in the example in the preceding footnote, if the QO's only partner were a taxable investor, (1) in year 1 the taxable partner s taxable income would be increased (or its deductible loss would be reduced) by $100, and (2) in year 5 the taxable partner's income would be reduced (or its loss would be increased) by $100.

Penalizing both the QO and the taxable partner in the above manner is intended to create a negative sum situation that will discourage the parties from taking an aggressive approach to allocations under this regime.

We urge eliminating the cliff effect for several reasons. First, the sanction is unduly harsh, because it imposes a uniformly severe penalty regardless of the magnitude of the violation. Even an immaterial violation of section 514(c)(9)(E) can convert to UBTI all debt-financed partnership income allocated to each QO partner for all years. In contrast, the alternative penalty described above is proportionate to the violation but still a true downside penalty that should be stringent enough to be an effective deterrent. Second, as a related point, the risk of an immaterial violation of the complex substantial economic effect requirement is often high. Therefore, even if the statute were changed to require only satisfaction of the substantial economic effect test, the cliff effect would still be overly harsh given the likelihood of an inadvertent violation. It would be harsher still if the substantial economic effect requirement were coupled with a subjective “a principal purpose” test as proposed above. Third, it is inequitable to penalize solely the QO partners for a partnership's violation of section 514(c)(9)(E). Typically a taxable deal sponsor is the architect of the transaction, controls the partnership documents, and is the party most likely to benefit from the type of income and loss shifting allocations that section 514(c)(9)(E) was intended to prevent. Hence under current law there is a disjunction between those participants who may have the greater incentive to violate section 514(c)(9)(E) and those participants who bear the cost of the violation. In addition to the resulting fairness issues, this disjunction often creates an awkward negotiating dynamic, because the taxable sponsor and other taxable investors in the transaction (since they may benefit from, but do not suffer the consequences of. a section 514(c)(9)(E) infraction) naturally tend to resist the QO's interest in strictly complying with section 514(c)(9)(E).

Particularly given the long life of many real estate partnerships, we recommend that transition rules make available to partnerships formed prior to the enactment of any statutory amendment the benefits of the amendment for taxable years following enactment. This might be accomplished by permitting existing partnerships to elect irrevocably for post-enactment years to apply either the new law or prior law.

2. Regulatory amendments. The problems described in II.B above could be remedied -- but only in part -- by regulatory amendments within the framework of the current statute. However, we consider a regulatory approach much less desirable than reworking the statute. This is partly because some of the critical problems described above cannot be solved merely by regulation, and partly because the problems described above are not an exclusive list of the difficulties that practitioners face or may face in the future. In short, creating targeted regulatory solutions to a handful of transaction-specific problems would at best be a patchwork approach that would fail to address the structural difficulties in the statute giving rise to those and other potential problems.

As support for regulatory changes, section 514(c)(9)(E)(iii) authorizes regulations "necessary to carry out the purposes of this subparagraph, including regulations which may provide for exclusion or segregation of items." The legislative history to section 514(c)(9)(E)(iii) indicates that (1) this regulatory authority should be exercised consistent with the purpose of limiting allocations of income and loss that are designed to shift tax benefits from QOs to taxable partners.

(2) to the extent existing regulations with respect to substantial economic effect conflict with the Fractions Rule. Treasury "in general" is expected to give the fractions Rule precedence over the substantial economic effect requirement, and (3) Congress expected that in no circumstance would it be appropriate to waive application of both the Fractions Rule and the substantial economic effect rule.[27]

Short of amending the statute, we recommend amending Reg. §1.514(c)-2 in each of the following ways:

First, address the problems discussed in ll.B.2-3 above to the extent possible by amending the regulation in the manner described in that discussion.

Second, amend the "prospective allocation" rule of Reg. §1.514(c)-2(b)(2)(i) to clarify that a hypothetical allocation prohibited by the Fractions Rule is not taken into account before it occurs. The prospective allocation rule is extremely harsh, because (1) it imposes on taxpayers and their advisors the daunting or impossible task of anticipating prior to closing every conceivable allocation that may occur in the future, and (2) it apparently can cause the Fractions Rule to be violated by a hypothetical future allocation that never occurs, and is unlikely ever to occur, even though such a phantom allocation poses no abuse or cost to the government.

[27] S Rep No. 445. 100th Cong., 2d Sess 503 (1988).

As a related clarification, the regulations should be amended to confirm that a “savings clause” will be respected. Because of the difficulty of knowing prospectively whether future partnership allocations will satisfy section 514(C)(9M1.). a “savings” provision is sometimes included in real estate partnership agreements to the effect that, notwithstanding any other provision of the agreement, allocations will be adjusted to the extent necessary to comply with section 514(c)(9)(F.).[28]

Third, further amend Reg. § 1.514-2(b)(2)(i) to provide that, subject to the recommendation in the following paragraph, if an actual allocation violates section 514(c)(9)(E), the violation is treated as occurring only for the taxable year of the actual allocation and subsequent taxable years, not retroactively, provided the allocation is not made with a principal purpose of tax avoidance. Like the preceding recommendation, this recommendation is based on the difficulty of anticipating all possible future events and the fact that, until a prohibited allocation occurs, the partnership's actual operation has been consistent with permitted allocations and therefore has not been abusive. The current exceptions to the retroactive disqualification rule do little to alleviate this problem because they are so narrow in scope.[29]

Fourth, if an actual allocation violates section 514(c)(9)(E) in any year, (1) excuse the violation if the

[28] Typically a savings clause is accompanied by a curative allocation provision that reverses, through subsequent allocations, the effect of any adjustments under the savings clause to the extent such reversing allocations can be made without violating section 514(c)(9)(E), similar to the manner in which allocations under a qualified income offset provision are typically reversed. A savings clause is risk) as a business matter, since any adjustments under the savings clause that cannot be reversed by subsequent allocations will alter the relative economics of the parties.

[29] See Keg § 1.514(c)-2(e)(4), (g), (h), (j)(2), and (m)(l)(ii).

taxpayer can demonstrate that the allocation did not have a tax avoidance principal purpose or a tax avoidance effect (such as an allocation that did not accelerate deductions or defer income of a taxable partner), and (2) permit the parties to disregard the violation with respect to future years if future allocations themselves satisfy section 514(c)(9)(E). In connection with proposed rule (2), we recommend that the parties be allowed to amend the partnership agreement to the extent necessary to cause future allocations to satisfy section 514(c)(9)(E), provided such amendment is made within a reasonable period after discovery of the section 514(c)(9)(E) violation.[30] Because of the complexity of section 514(c)(9)(E) in its current form, even a taxpayer that attempts in good faith to comply with the rules may commit a technical foot fault. Given the significant risk of an inadvertent violation of section 514(c)(9)(E), a combined excuse/cure provision of the above type would appropriately alleviate the catastrophic UBTI consequences to the QO investors where the parties have acted in good faith.

We recommend that any such regulatory changes, because they could be helpful to many currently operating partnerships, be made effective retroactive to the original effective date of the current regulations, or at least apply with respect to post-amendment taxable years of existing partnerships.

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[30] Cf Reg. $301.9100-1(a)(granting the Service discretion to extend the time for making an election or applying for relief upon a showing of good cause and satisfaction of other conditions). The most sympathetic ease for such an amendment rule would be the discovery by the parties of an inadvertent section 514(C)(9)(E) violation in connection with preparing or amending the partnership's tax returns. A somewhat less sympathetic case would be the discovery of a violation in connection with an audit.