Help With Fractions: A Fractions Rule Primer

By David O. Kahn

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The "fractions rule" established by section 514(c)(9)(E) and the associated Treasury regulations have a well-deserved reputation for being a difficult and complex area of law. The rule comes into play when some types of tax-exempt qualified organizations (primarily pension funds and educational organizations) wish to acquire real estate on a leveraged basis through a partnership without incurring an unrelated business income tax on what would otherwise be debt-financed income. On a basic level, compliance with the fractions rule requires that the partnership agreement fall within the substantial economic effect safe harbor of reg. section 1.704-1(b) and that allocations under the partnership agreement cannot result in any qualified organization having a percentage share of overall partnership income in any tax year that is greater than its overall percentage of partnership loss for the tax year in which its share of loss will be smallest. The rule is qualified by several exceptions and limitations, and its application to some features that are common in modern real estate partnerships is not entirely clear. This report seeks to explain the fractions rule and describe its operation, significant limitations, and exceptions, and briefly discuss some of the practical problems that may affect practitioners seeking to draft agreements or advise clients in complying with the rule.

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I. Introduction

The "fractions rule" established by section 514(c)(9)(E) and the associated Treasury regulations has a fearsome reputation, intimidating even seasoned tax professionals. Unfortunately, this reputation is well-deserved. Nestled many levels deep in a chain of exceptions to exceptions to the tax on unrelated business income imposed by section 512, the fractions rule is itself chock full of exceptions, intricacies, and traps for the unwary. This report attempts to situate the fractions rule within the context of the unrelated business income tax, examine the manner in which the rule operates, and highlight some of the common errors that can be made and problems that can arise in transactions when compliance with the rule is necessary.

II. Situating the Fractions Rule

The background to the fractions rule is section 512, which imposes a tax on the unrelated business income of various entities that are otherwise tax exempt. It is easy to understand why lawmakers would impose a tax on unrelated business taxable income. The justification for exempting an entity engaged in charitable activities from tax is diminished or absent altogether when that entity's undertakings stray into the commercial realm, thereby potentially competing with taxable businesses. A soup kitchen may thus collect donations, operate a kitchen, and serve meals to the needy, unburdened by the federal income tax, but if the organization uses its facilities to provide catering services to paying customers, it will likely be subject to tax under section 512. This is so even if the profits from the unrelated business are used exclusively to support the organization's charitable endeavors.[1]

What if our soup kitchen receives a substantial contribution from a well-to-do benefactor, sufficient to fund operations for several years? Until the contributed funds are used to feed the needy, most would agree they should be prudently invested, which justifies a significant exception to the UBIT. Section 512(b) excludes various forms of income generally associated with passive investment activities from the tax that would otherwise be imposed. If our soup kitchen invests its surplus funds, the interest, dividends, and capital gains those investments produce

[1]Section 513(a); reg. section 1.513(a).

will generally not be subject to tax.[2] Likewise, an acquisition of assets generating royalty income or the purchase of real estate producing rent will not, under most circumstances, cause our charity to incur a federal income tax liability under section 512.[3] Subject to the limitations in section 512(b), our soup kitchen can thus prudently invest its endowment with impunity (or at least, generally, without incurring a liability for federal income tax).

The exception for investment income under section 512(b) is, however, susceptible to abuse. Consider the possibility, for example, that our soup kitchen might seek to leverage (literally) its ability to avoid tax on investment income by borrowing funds to invest or by purchasing securities on margin. Here, the code reflects the view that tax-exempt organizations should be focused principally on their charitable purposes and that significant borrowing for reasons unrelated to those purposes is generally undesirable. As a result, section 514 establishes an exception to the exception established by section 512(b) by treating what would otherwise be tax-free investment income as UBTI if it is debt financed. So if our soup kitchen buys securities on margin, all or a portion of any interest, dividends, or capital gain it realizes will be subject to tax as UBTI as a result of section 514(a).

The debt-financed income rules of section 514 are themselves fairly complicated, with a variety of exceptions and subtleties. While a thorough discussion of these rules is not the focus of this report, generally under section 514, the ratio of the ''average acquisition indebtedness,'' as defined in section 514(c)(7), divided by the property's average adjusted basis, determined under reg. section 1.514(a)-1(a)(2), is used to determine the portion of the gross income from the debt-financed property that is required to be treated as UBTI.[4] Expenses relating to the production of that income are, in most cases, deductible in the same proportion, but taxpayers are limited to the straight-line method to determine any allowance for depreciation.[5] Subject to various exceptions, debt-financed property is broadly defined as any property held for the production of income for which there is acquisition indebtedness.[6] ''Acquisition indebtedness'' generally means indebtedness (a) incurred to acquire or improve property, (b) incurred before the acquisition or improvement of property but that would not have been incurred but for that acquisition or improvement, or (c) incurred following the acquisition of property but that would not have been incurred but for that acquisition or improvement and that was reasonably foreseeable at the time of the acquisition or improvement.[7]

Section 514(c)(9), however, establishes an exception to the debt-financed income rules described above for debt-financed real estate investments acquired by some qualified organizations. This exception reflects an acknowledgement that leverage is a common, often essential, feature associated with investment in real property, and that an across-the-board unrelated business tax on debt-financed income thus discourages tax-exempt investors from acquiring and holding diversified portfolios that include real estate.[8] To be eligible for this exception, however, a tax-exempt entity must be a qualified organization as defined in section 514(c)(9)(C). They are limited to the following tax-exempt organizations:

- educational organizations (together with some affiliated supporting organizations) that normally maintain a regular faculty, curriculum, and enrolled student body in attendance at a location where educational activities are regularly carried on;
- qualified pension, profit-sharing, and stock bonus plans constituting qualified trusts under section 401;
- property-title-holding corporations that are exempt from tax under section 501(c)(25);[9] and
- retirement income accounts described in section 403(b)(9) maintained by churches and some related tax-exempt entities.[10]

When initially enacted in 1980, the section 514(c)(9) exception applied only to ''qualified retirement trusts'' and was thought justified because ''the exemption for investment income'' of those entities was viewed as ''an essential tax incentive which is provided to tax-qualified plans in order to enable them to accumulate funds to satisfy their exempt purposes — the payment of employee benefits.''[11] The subsequent extension of this benefit over time to a limited subset of other tax-exempt organizations is more difficult to justify from a policy perspective, but, justified or not, the four classes of organization listed above (but not our hypothetical soup kitchen) may today incur acquisition indebtedness to acquire or improve real property without causing the income produced by that investment to be subject to tax as debt-financed UBTI.[12]

Section 514(c)(9) thus permits some types of tax-exempt entities to invest in real estate on a leveraged basis without incurring tax on what would otherwise be

[2]Section 512(b); reg. section 1.512(b).
[3]*Id.*
[4]Section 514(a); reg. section 1.514(a)-1(a).
[5]Section 514(a)(2) and (3); reg. section 1.514(a)-1(b).
[6]Section 514(b)(1); reg. section 1.514(b)-1(a).
[7]Section 514(c)(1); reg. section 1.514(c)-1(a)(1).

[8]*See* S. Rep. No. 96-1036, 29 (1980), *reprinted at* 1980-2 C.B. 723, 726.
[9]Note, however, that while section 501(c)(25) property-title-holding corporations are themselves qualified organizations eligible for the benefit provided by section 514(c)(9)(A), this benefit is tempered by section 514(c)(9)(F), which requires that a holder of such a title-holding corporation treat its pro rata share of the title-holding corporation's income as UBTI unless that holder is itself a qualified organization within the meaning of section 514(c)(9)(C).
[10]Sections 514(c)(9)(C) and 170(b)(1)(A)(ii).
[11]S. Rep. No. 96-1036, 29 (1980), *reprinted at* 1980-2 C.B. 723, 726.
[12]It is worth noting that section 514(c)(9) provides relief from the UBIT only to the extent the imposition of the tax is the product of the debt-financed income rules under section 514. If the investment produces nonqualifying income for other reasons — for example, if it generates active or dealer income rather than passive investment income — this exemption is of no utility.

debt-financed UBTI, but once again, perhaps not surprisingly, there are various exceptions. In particular, section 514(c)(9)(B) provides that the foregoing rule will not apply in any case in which:

1. the price for the acquisition or improvement is not fixed and determined as of the date of the acquisition or the completion of the improvement;

2. the amount of the indebtedness or any other amount payable regarding the indebtedness, or the time for making any payment of any such amount, is dependent in whole or in part on any revenue, income, or profits derived from the property;

3. the property is at any time after the acquisition leased by the qualified organization to the seller of the property or a related party within the meaning of section 267(b) or section 707(b);

4. the property is acquired from specified related disqualified parties;

5. any person described in item 3 or 4 above provides the qualified organization with financing in connection with the acquisition or improvement; or

6. the property is held by a partnership.

Debt-financed real estate will produce UBTI, even if held by a qualified organization, if it falls within any of the six categories listed above.

The prohibition on holding leveraged real property in a partnership — item 6 above — is subject to yet another exception. To benefit, logically enough, the partnership itself must not fall into any of the prohibited classes set forth in items 1 through 5 above.[13] Also (and it is here, finally, that we arrive at the fractions rule), the partnership holding the real property must fit into one of the following three classes:

1. All of the partnership's partners must be qualified organizations described in section 514(c)(9)(C).

2. Each allocation to a partner that is a qualified organization is a ''qualified allocation'' within the meaning of section 168(h)(6). This generally requires that the qualified organization be allocated a fixed and unchanging share of each item of income, gain, loss, deduction, credit, and basis in the partnership.

3. The partnership must (subject to a de minimis interest exception) comply with the fractions rule.[14]

The presence of partners that are not qualified organizations very often precludes reliance on exception 1, and exception 2 very significantly limits the flexibility of the partnership and would frequently be inconsistent with desired economic objectives. As a result, neither of these options is typically of much practical benefit. Instead, qualified organizations seeking to acquire debt-financed real property through a partnership without subjecting the resulting income to federal income tax under section 514 are generally required to comply with the fractions rule.

Figure 1 sets out a simplified decision tree that may be useful to readers in determining whether the fractions rule is applicable in a particular situation.

III. The Fractions Rule Itself

A. The Basic Rule

The fundamental elements of the fractions rule, set forth in section 514(c)(9(E)(i), are as follows:

- other than allocations made under section 704(c), all allocations regarding the partnership must have ''substantial economic effect'' within the meaning of section 704(b)(2); and
- the allocation of items to any qualified organization cannot result in that organization having a percentage share of overall partnership income for any tax year that is greater than the partner's percentage share of the overall partnership loss for the tax year in which that share of loss will be smallest.

Deceptively simple in appearance, as discussed below, both of these requirements are full of complex conditions, limitations, exceptions, and subtle ambiguities.

1. Substantial economic effect. The substantial economic effect regulations under section 704(b) are designed to ensure that allocations consistent with, and that reflect, the partners' underlying economic arrangements are respected. Partnership allocations lacking substantial economic effect are subject to adjustment by the IRS ''in accordance with such partner's interest in the partnership (taking into account all facts and circumstances).''[15] Presumably, the motivation for requiring partnership agreements that will take advantage of the fractions rule to comply with the substantial economic effect regulations is that the potential for abusive behavior between taxable and tax-exempt partners is diminished if allocations under the partnership agreement reflect the actual economic arrangements among the parties.

The substantial economic effect regulations under section 704(b) operate by establishing a series of safe harbors within which partnership allocations will generally be respected by the Service. Partners (and those who draft partnership agreements) often seek to avoid the tax and economic uncertainty associated with potential reallocations under section 704(b) by structuring their arrangements to fit within one of these safe harbors. However, a failure to fit squarely within the substantial economic effect safe harbor is sometimes tolerated for a variety of reasons, including uncertainty about the exact

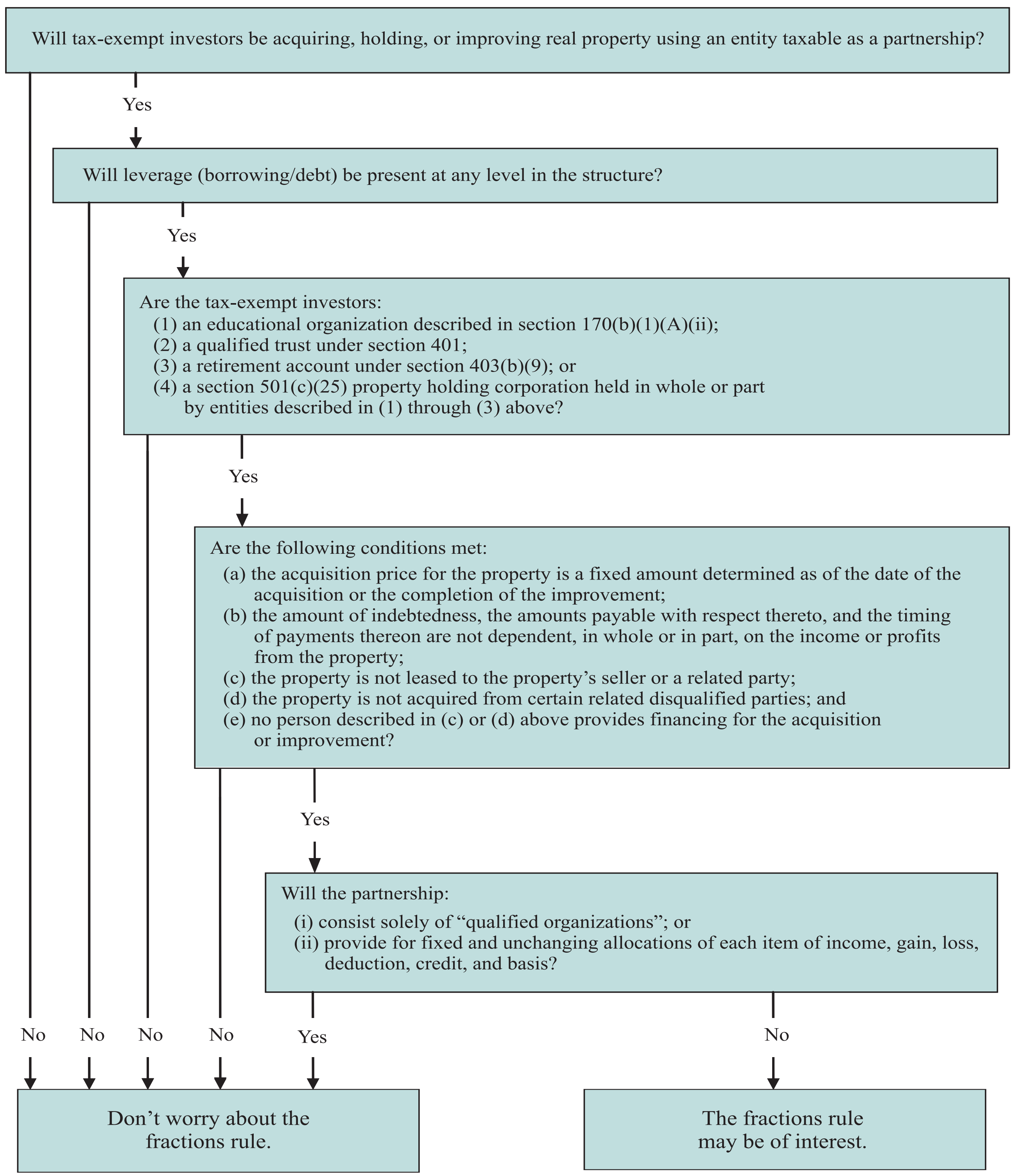
(Text continued on p. 957.)

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

[14]*Id.* For those keeping track, the fractions rule is at the end of a chain of exceptions to exceptions seven levels deep. Of course, as discussed below, the fractions rule itself is subject to various exceptions and exceptions to exceptions. Although I know no way of testing this claim, I've been unable to identify a longer string of exceptions anywhere else in the code or regulations. In effect, the fractions rule is likely the Mariana Trench of the federal tax system.

[15]Reg. section 1.704-1(b)(1)(i).

Figure 1. Getting to Fractions



requirements of the safe harbor, or a belief that an allocation is likely to be respected even if it falls outside the regulatory safe harbors because it is, in any event, generally in accordance with the partners' economic interests in the partnership. Partnerships subject to the fractions rule, however, have an additional motivation to be certain their allocations have substantial economic effect under the regulations: Falling outside the safe harbor causes the partnership to violate the fractions rule and thereby subjects qualified organization partners to taxation under section 514.

While a comprehensive exploration of the substantial economic effect regulations is beyond the scope of this report, a basic grasp of the regulations is necessary to evaluate partnership agreements when fractions rule compliance is desired. Although the basic notion underlying the requirement for substantial economic effect is relatively straightforward, the regulations implementing these rules are fairly challenging. Reg. section 1.704-1(b)(2) begins by establishing a two-part test for determining whether allocations have substantial economic effect. To have substantial economic effect, as of the end of the tax year to which they relate, allocations (somewhat tautologically) must have ''economic effect,'' and that effect must be ''substantial.''[16] These requirements are discussed in turn below.

a. Economic effect. The regulations under section 704(b) articulate the basic objective of the economic effect requirement as follows:

> In order for an allocation to have economic effect, it must be consistent with the underlying economic arrangement of the partners. This means that in the event there is an economic benefit or economic burden that corresponds to an allocation, the partner to whom the allocation is made must receive such economic benefit or bear such economic burden.[17]

An allocation arrangement is deemed to have economic effect if it meets one of three alternative tests set out in the regulations.

The first of these tests, sometimes referred to as the basic test for economic effect, requires that:

1. the partners' capital accounts must be determined and maintained in accordance with the partnership capital accounting rules set forth in reg. section 1.704-1(b)(2)(iv);[18]
2. liquidating distributions must in all cases be required to be made in accordance with the positive capital account balances of the partners; and
3. the partnership agreement must contain a qualifying deficit restoration obligation (DRO) within the meaning of reg. section 1.704-1(b)(2)(ii)(b)(3), which obligates partners to restore any deficit balance in their capital accounts following the liquidation of their interest in the partnership, or be subject to an equivalent obligation under state law or as the result of promissory notes contributed by partners to the partnership.[19]

Sensibly, an allocation will not necessarily fail to have economic effect under this test, or the two alternative tests for economic effect discussed below, because it involves an item for which capital accounts cannot be maintained in a manner that is consistent with reg. section 1.704-1(b)(2)(iv) (for example, items with a book-tax difference, allocations attributable to nonrecourse liabilities, various sorts of domestic and foreign tax credits, etc.), but reg. section 1.514(c)-2(b)(1)(ii) requires that those allocations be determined in accordance with the partners' interest in the partnership and be otherwise in compliance with reg. section 1.704-1(b)(4).[20] Also, allocations attributable to nonrecourse liabilities must comply with the rules articulated in reg. section 1.704-2.[21]

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[16] Reg. section 1.704-1(b)(2)(i).

[17] Reg. section 1.704-1(b)(2)(ii)(a).

[18] The partnership capital account maintenance rules in reg. section 1.704-1(b)(2)(iv) are sufficiently complex that they could themselves be the subject of an entire article. At a basic level, these rules require that a partner's capital account be increased by:

1. the amount of money and the fair market value of any property (net of liabilities the partnership is considered to assume) contributed to the partnership by the partner; and
2. the partner's allocable share of partnership income and gain (including tax-exempt and income and gain and some other specified items);

(Footnote continued in next column.)

and be reduced by:

1. the amount of money and the FMV of any property (net of liabilities the partner is considered to assume) distributed to the partner by the partnership; and
2. the partner's allocable share of partnership expenditure, loss, and deduction (including and excluding various specified items).

The capital account maintenance regulations also contain detailed rules addressing the assumption of liabilities by the partnership and by a partner, the contribution and distribution of promissory notes, the treatment of property subject to section 704(c) (generally property that has a built-in gain or loss when it is contributed to the partnership), some cases in which partnership property is subject to revaluation (book-ups and book-downs), depreciation and other cost recovery matters, transfers of partnership interests, and various other matters that may have a bearing on partnership capital accounts. For a more detailed discussion of the accounting rules established by reg. section 1.704-1(b)(2)(iv), see William S. McKee, William F. Nelson, and Robert L. Whitmire, *Federal Taxation of Partnerships & Partners*, para. 11.02[2][c]; Arthur B. Willis and Philip F. Postlewaite, *Partnership Taxation*, para. 10.04[3].

[19] Reg. section 1.704-1(b)(2)(ii)(*b*) and (*c*).

[20] Reg. section 1.704-1(b)(4) contains a series of ''special rules'' describing circumstances in which the allocation of some classes of item, such as items subject to revaluation, tax credits and credit recapture, excess percentage depletion, adjusted tax basis in oil and gas properties, items subject to adjustment or recapture in a partnership agreement, and allocations of creditable foreign taxes, will be deemed to be allocated in accordance with a partner's interest in the partnership.

[21] Again, these rules are too complex and lengthy to explain in a comprehensive fashion here, but in general:

- reg. section 1.704-2(e) generally requires that (a) allocations of nonrecourse deductions (deductions, losses, and other items attributable to a nonrecourse liability for which no partner bears the economic risk of loss) be

(Footnote continued on next page.)

From a fractions rule perspective, the first thing to note about the basic test for economic effect established by reg. section 1.704-1(b)(2)(ii)(*b*) is that partnership agreements that do not explicitly provide for liquidating distributions to be made in accordance with positive capital account balances arguably do not pass muster. While parties may in some cases be willing to tolerate the risk that such an arrangement lacks economic effect (perhaps based on a belief that the waterfall actually reflects the partners' desired and agreed-on economic arrangement and that any IRS reallocation ''in accordance with the partners' interests'' under reg. section 1.704-1(b)(3) is therefore unlikely to disturb the allocations in a material way), if the allocation lacks substantial economic effect, it fails the fractions rule, thus triggering potentially significant adverse consequences for qualified organization partners seeking to avoid UBTI.

Also, the third requirement under the basic test is generally problematic, particularly in the context of a partnership formed to acquire and hold real property. When acquiring real estate, parties often seek to limit their economic exposure by using a limited partnership or limited liability company. The protection provided by those structures would be undermined to a significant extent if the operative agreements were required to impose an unrestricted obligation to restore capital account deficits on partners to comply with section 704(b). Recognizing that most limited partnerships and LLCs will fail the basic test for economic effect, the regulations helpfully provide an ''alternative test for economic effect.''

To satisfy this alternative test, the partnership agreement must satisfy the first two requirements of the basic test — capital accounts must be maintained in accordance with the rules articulated in reg. section 1.704-1(b)(2)(iv), and liquidating distributions must be made in accordance with positive capital account balances — but in lieu of containing a qualifying DRO (or subjecting partners to the legal equivalent), the partnership agreement must contain a qualified income offset (QIO) within the meaning of reg. section 1.704-1(b)(2)(ii)(*d*), and may not otherwise allow allocations that cause or increase a deficit balance in a partner's capital account in excess of any limited dollar amount a partner is obligated to restore.[22]

made in a manner reasonably consistent with allocations of some other significant partnership item attributable to the property securing the nonrecourse liability, and (b) the partnership agreement contain a minimum gain charge-back provision meeting the requirements of reg. section 1.704-2(f); and

- reg. section 1.704-2(i) requires that losses, deductions, and section 705(a)(2)(B) items attributable to partner nonrecourse liabilities (nonrecourse liabilities for which a particular partner bears the economic risk of loss) be allocated to the partner who bears the economic risk of loss for the liability.

For a more complete discussion of the requirements of reg. section 1.704-2, see McKee, Nelson, and Whitmire, *supra* note 18, at para. 11.02[4][e]; Willis and Postlewaite, *supra* note 18, at para. 10.05[7].

[22]Reg. section 1.701-1(b)(2)(ii)(*d*).

A partnership agreement contains a QIO within the meaning of the regulations if it provides that a partner who has a capital account deficit in excess of his obligation to restore shall be allocated items of income and gain ''in an amount and manner sufficient to eliminate such deficit balance as quickly as possible.''[23]

The alternative test for economic effect presumably reflects Treasury's view that, even in the absence of a DRO, allocations have economic effect to the extent that partners are generally required to maintain positive capital account balances and the partnership is compelled to eliminate any unforeseen negative balances as quickly as possible. While the use of a QIO can resolve some of the economic and liability issues potentially associated with the use of a DRO, to the extent the partnership agreement fails to require that liquidating distributions be made in accordance with positive capital account balances (the second requirement under both the basic and alternative tests for economic effect), it arguably lacks economic effect under the regulations. As a result, even though a reallocation in accordance with the partners' interest in the partnership might largely or entirely sustain the allocation contemplated in the partnership agreement, that agreement fails one of the express requirements of the fractions rule.

The final way to satisfy the economic effect requirement under the section 704(b) regulations is the ''economic effect equivalence'' test set forth in reg. section 1.704-1(b)(2)(ii)(*i*). This third possible safe harbor provides that even if an allocation arrangement fails both the basic and alternative tests for economic effect, it will ''nevertheless be deemed to have economic effect, provided that as of the end of each partnership taxable year a liquidation of the partnership at the end of such year or at the end of any future year would produce the same economic results to the partners as would occur if [the basic test for economic effect] had been satisfied, regardless of the economic performance of the partnership.''

Unfortunately, the only example of the economic effect equivalence safe harbor provided in the regulations relates to a fairly simple general partnership agreement under which the partners either have an obligation under state law to restore capital account deficits or the partnership agreement contains a DRO. Given this test's linkage to the basic test for economic effect (which requires a DRO or functional equivalent) and the limited factual circumstances presented in the regulatory example, the extent to which the economic effect equivalence safe harbor can be relied on at all in the absence of an affirmative duty to restore capital account deficits is unclear.[24] As discussed above, a DRO is, for good business reasons, a relatively uncommon feature in agreements for limited partnerships and LLCs formed to hold

[23]*Id.*

[24]Several commentators have questioned whether the economic effect equivalence test requires the presence of a DRO or is limited in application to fairly simple general partnership arrangements. *See* Todd Golub, ''Target Allocations: The Swiss Army Knife of Drafting,'' *Taxes*, 157, 159-160 (Mar. 2009); Terrence Cuff, ''Several Thoughts on Drafting Target Allocation

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real estate. In any event, parties seeking to fit within the economic effect equivalence safe harbor must be satisfied (and confident that they can demonstrate to a skeptical IRS revenue agent) that, regardless of the performance of the partnership, a liquidation at the end of any tax year would always result in exactly the same results to the partners that would have resulted if the basic test for economic effect had been met. It is at best unclear whether this is possible when the operative agreement (a) uses a QIO rather than a DRO, and (b) fails to liquidate in accordance with capital account balances. As discussed above, uncertainty about whether an allocation arrangement fits within one of the three economic effect safe harbors may, for a variety of reasons, be tolerable to partners under some circumstances. However, in addition to the risk of reallocation by the Service, failing to satisfy an economic effect safe harbor means that one of the express requirements of the fractions rule is absent, and as a result, the fractions rule cannot confidently be used by qualified organization partners to avoid UBTI.

b. Substantiality. For an allocation scheme to have substantial economic effect within the meaning of reg. section 1.704-1(b)(2), not only must the allocations fit into one of the economic effect safe harbors discussed above, but that effect must also be substantial within the meaning of reg. section 1.704-1(b)(2)(iii). The apparent purpose of the substantiality requirement is to weed out allocations whose only function is to reduce the partners' aggregate tax liability. In contrast with the relatively mechanical requirements of the economic effect rules, the regulatory test for substantiality is more subtle and examines both the pretax and after-tax consequences of the allocation arrangement.[25] In particular, reg. section 1.704-1(b)(2)(iii) sets up a two-part test:

> 1. The economic effect of an allocation is substantial if there is a reasonable possibility it will affect substantially the dollar amounts received by the partners *independent of tax consequences*.
>
> 2. The economic effect of an allocation is not substantial if, at the time the allocations become part of the partnership agreement:
>   - the after-tax economic consequences of at least one partner may be enhanced; and
>   - there is a strong likelihood that the after-tax economic consequences of no partner will be substantially diminished.
>
> In each case, economic consequences are evaluated based on their present value and by taking into account each partner's tax attributes outside the partnership.[26]

In testing for substantiality, the regulations establish an irrebuttable presumption that the fair market value of partnership property is equal to its adjusted tax basis on the partnership's books, or book value if different from adjusted basis.[27] (This is the so-called value equals basis rule.)

The regulations help flesh out these rules by providing two examples of specific types of allocations deemed to fail the first test set forth above:

- Shifting allocations are those in which particular types of income or loss are allocated in a way such that there is a strong likelihood that (a) the changes to the partners' capital accounts will not differ substantially from those that would result without the allocation, and (b) the total tax liability of the partners will be reduced. An example would be an allocation that directed tax-exempt income of the partnership to a partner in a higher tax bracket, with offsetting amounts of taxable income allocated to a partner in a lower tax bracket.[28]
- Transitory allocations are those in which, over time, one set of allocations will be largely offset by another, such that there is again a strong likelihood that (a) the changes to the partners' capital accounts will not differ substantially from those that would result without the allocation, and (b) the total tax liability of the partners will be reduced. In addition to the value equals basis rule, reg. section 1.704-1(b)(2)(iii)(c) provides that, for this purpose, original and subsequent offsetting allocations will be presumed to be substantial in effect if there is a strong likelihood that they will not largely offset each other within five years. An example would be a partnership expecting relatively consistent levels of capital gain in each tax year, allocating capital gain exclusively to a partner with expiring capital losses in year 1, then offsetting that allocation with allocations of capital gain to the remaining partners in year 2.[29]

Again, however, keep in mind that even if the allocations are not shifting or transitory, to have substantial economic effect and thus permit qualified organizations to benefit from the fractions rule, the allocations must always pass the general tests for substantiality: (a) there must be a reasonable possibility of the allocations substantially affecting the dollar amounts received by the partners independent of tax consequences; and (b) the allocations must not cause the after-tax consequence of one or more partners to be enhanced without cost to the other partners.[30]

As mentioned above, the regulations regarding substantial economic effect are lengthy and complex. The foregoing discussion is a summary and necessarily omits

(Text continued on p. 961.)

Provisions,'' *Taxes*, 170 (Mar. 2009); McKee, Nelson, and Whitmire, *supra* note 18, at para. 11.02[1], n.31; Willis and Postlewaite, *supra* note 18, at para. 10.04[2][f].

[25]The importance of the substantiality requirement may be diminished somewhat in the context of the fractions rule, however, because many of the allocation arrangements this rule is designed to impede would, in any event, be prohibited by the fractions rule itself (as discussed in greater detail in Part III.A.2 below).

[26]Reg. section 1.704-1(b)(2)(iii)(*a*).

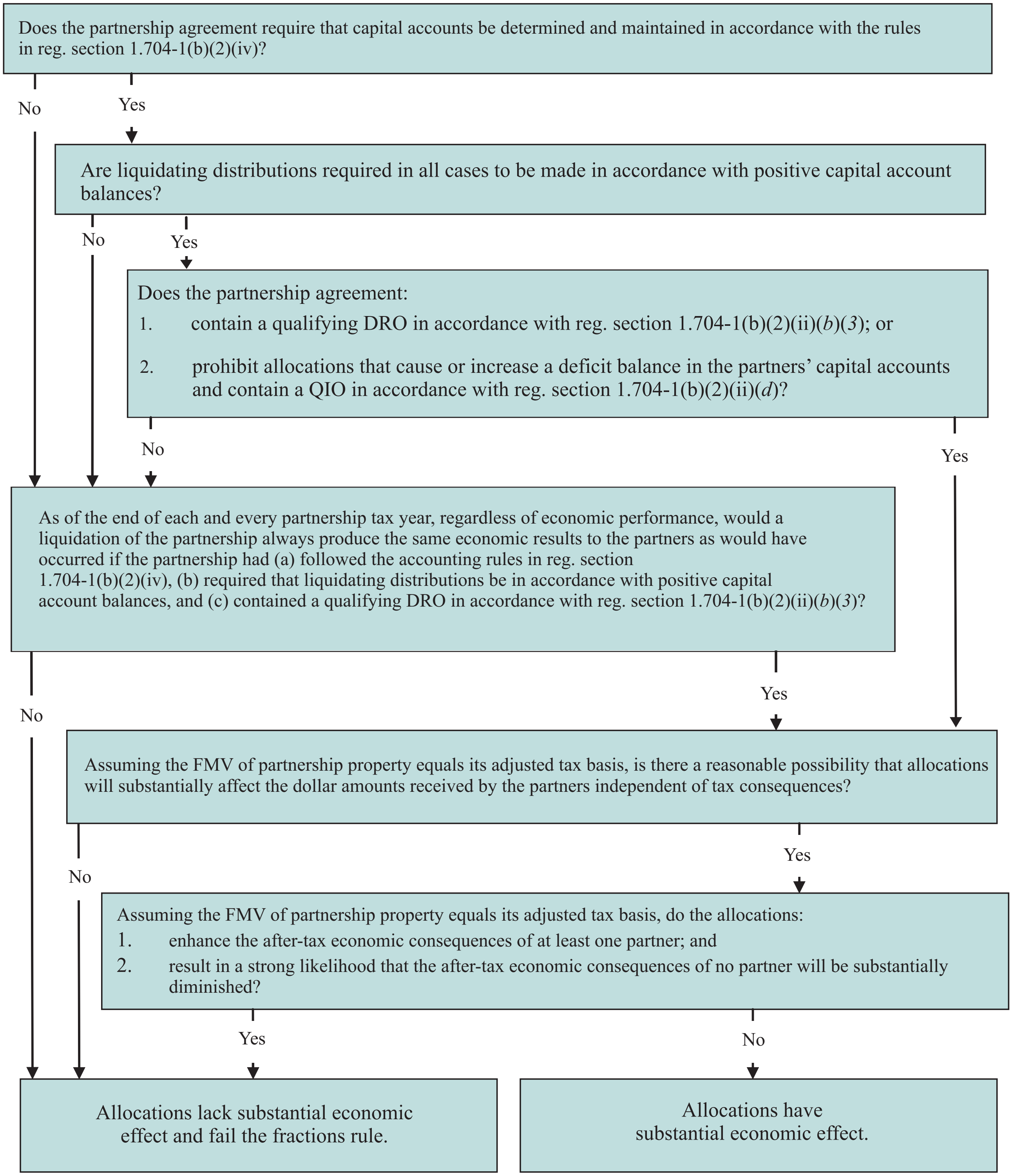
[27]Reg. section 1.704-1(b)(2)(iii)(*c*).

[28]Reg. section 1.704-1(b)(2)(iii)(*b*).

[29]Reg. section 1.704-1(b)(2)(iii)(*c*).

[30]Reg. section 1.704-1(b)(2)(iii)(*a*).

Figure 2. Substantial Economic Effect



many details and subtleties. Continuing in that vein, figure 2 summarizes the requirements imposed by the substantial economic effect regulations on partnership agreements that seek to benefit from the fractions rule.

2. The second half: The fractions in the fractions rule. The heart of the fractions rule, and the requirement from which the rule derives its name, is a limitation designed to allow some flexibility in the way items are allocated within a partnership having both taxable and qualified tax-exempt partners, while preventing tax-exempt participants from, in effect, sharing the benefit of their tax-exempt status with venture partners that are not otherwise exempt from taxation.[31] This report will first consider the fractions rule itself, together with a number of general rules of application. Following this, a number of narrower subrules and exceptions will be discussed.

a. The basic rule and its application. The fractions rule is as follows: Allocations of items to any partner that is a qualified organization cannot, in any year, result in such partner having a percentage share of overall partnership income that is greater than that partner's share of partnership loss for taxable year in which such partner's share of loss will be the smallest.[32]

In discussing the rule, the regulations set up a convenient term — the "fractions rule percentage" — defined as a qualified organization partner's percentage of overall partnership loss for the partnership tax year in which that percentage will be the smallest. The fractions rule percentage thus encapsulates the second half of the fractions rule, the limit above which allocations of overall partnership income to a qualified organization partner can never be permitted to go without violating the rule.

For purposes of these rules, the terms "overall partnership income" and "overall partnership loss" are defined in the regulations to include those items of income, gain, loss, and deduction (including items not deductible in computing taxable income or properly chargeable to capital, as described in section 705(a)(2)(B)) that increase or decrease the partners' capital accounts under the rules applicable to the maintenance of partnership capital accounts.[33] Sensibly, tax items allocable under section 704(c) (and the various regulations providing for section 704(c) allocations) are, for this purpose, specifically excluded from the calculation of overall partnership income and loss.

The fractions rule is applied at the partnership rather than the partner level, so a violation of the rule regarding any qualified organization partner causes all qualified organization partners to fall outside the rule, even if allocations to those partners, considered in isolation, would not otherwise have been problematic.[34]

Partnerships must generally satisfy the fractions rule on both an actual and a prospective basis for each tax year of the partnership commencing with the first tax year in which the partnership holds debt-financed property and has one or more qualified organization partners.[35] Thus, subject to the various exceptions discussed immediately below, if the partnership could or does allocate a percentage of overall partnership income in any year to a qualifying tax-exempt partner in excess of that partner's fractions rule percentage (which is, again, the lowest percentage of overall partnership loss that will ever be allocated to that partner), the partnership violates the fractions rule and will potentially generate debt-financed UBTI to its qualified organization partners in each year it holds debt-financed real estate.

Predictably, however, there are several exceptions to the foregoing rule. The regulations establish four cases in which a foreseeable fractions rule problem will not immediately cause the partnership agreement to fail the rule:

1. Allocation of income and gain made under a provision in the partnership agreement that charges back minimum gain attributable to the distribution of proceeds of a nonrecourse liability or partner nonrecourse debt is taken into account for purposes of the fractions rule only when that allocation is actually made.[36]

2. A QIO (see Part I.A above) provision allocating items of loss or deduction away from a qualified organization to avoid causing or increasing a deficit capital account balance that the qualified organization is not obligated to restore is disregarded in tax years in which no such allocation is made, but only if, at the time the QIO becomes part of the partnership agreement, all relevant facts, circumstances, and information (including financial projections) reasonably indicate that it is unlikely such an allocation will be made during the life of the partnership.[37]

3. Items of partner nonrecourse deduction allocated under reg. section 1.704-2, together with compensating allocations of other items allocated to other partners, are not taken into account for purposes of the fractions rule until the tax years in which they occur.[38]

4. Amendments to partnership agreements that cause the partnership to violate the fractions rule are ordinarily taken into account only for the tax year of the change and subsequent tax years.[39]

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[31]*See* reg. section 1.514(c)-2(k)(4); H.R. Conf. Rep. 100-495, 1987 USCCAN 2313-1245, at 354-357.

[32]Section 514(c)(9)(E)(i)(I); reg. section 1.514(c)-2(b)(1)(i); reg. section 1.514(c)-2(c)(2).

[33]Reg. section 1-514(c)-2(c)(1)(i). For a summary of the partnership capital accounting rules, see *supra* note 18.

[34]T.D. 8539 (May 11, 1994), *Doc 94-4744, 94 TNT 92-11*.

[35]Reg. section 1.514(c)-2(b)(2).

[36]Reg. section 1.514(c)-2(e)(4). Treasury regulations extend this minimum gain charge-back exception to some types of tiered partnership arrangements as well. Reg. section 1.514(c)-2(m)(1)(ii).

[37]Reg. section 1.514(c)-2(h).

[38]Reg. section 1.514(c)-2(j)(1). Also, to the extent those allocations reduce another qualified organization's fractions rule percentage and are not motivated by tax avoidance, or are attributable to proceeds distributed as a reasonable preferred return, as discussed below, they may be disregarded entirely. Reg. sections 1.514(c)-2(d)(2) and 1.514(c)-2(j)(2).

[39]Reg. section 1.514(c)-2(b)(2)(ii).

Figure 3. Preferred Return Checklist

- ☐ Is the preferred return set forth in a binding, written partnership agreement?
- ☐ Is the preferred return calculated only on weighted average unreturned partner capital?
- ☐ Is the preferred return rate commercially reasonable?
  - ☐ Is the preferred return within the safe harbor – no greater than 4 percentage points more than, or 150 percent of, the highest long-term applicable federal rate for the month the partner's right to the preferred return is first established or the preferred return is computed?

    or

  - ☐ Is the preferred return otherwise "commercially reasonable" in light of all relevant facts and circumstances?
- ☐ Is the preferred return less than or equal to the total aggregate preferred returns ***actually distributed*** to the partner on or before the partnership return due date (not including extensions) and all prior tax years, less the aggregate amount of corresponding (preferred) income and gain allocated to the partner in all prior years?

Outside these categories, even future fractions rule failures will generally prevent a partnership agreement from meeting the rule's requirements in all tax years.[40]

b. Reasonable preferred returns and guaranteed payments. Careful readers will not be surprised to learn that both the statute establishing the fractions rule and the implementing regulations create various exceptions and refinements to the basic rule described above. In particular, while guaranteed payments and preferred returns to a qualified organization partner might ordinarily cause a partnership agreement to fail the fractions rule, the statute and regulations carve out exceptions for those items, provided, of course, that conditions are met.[41]

The first of these conditions is that, to qualify for exception, preferred returns or guaranteed payments are required ''to be set forth in a binding, written partnership agreement.''[42] This contrasts with the approach otherwise taken by the fractions rule regulations, which generally treat the partnership agreement as consisting of ''all agreements among the partners, or between one or more partners and the partnership, concerning affairs of the partnership and responsibilities of partners, whether oral or written, and whether or not embodied in a document referred to by the partners as the partnership agreement,'' and including, in appropriate circumstances, even informal understandings among the parties.[43]

Several additional requirements applicable to preferred returns and to guaranteed payments are discussed below.

i. Preferred returns. Items of income and gain allocated to a partner that constitute a current or cumulative reasonable preferred return for capital are disregarded for purposes of computing overall partnership income under the fractions rule.[44] The preferred return may consist either of individual items of income (including gross income) and gain (including minimum gain attributable to nonrecourse liability or partner nonrecourse debt proceeds distributed to a partner) or of what would otherwise be overall partnership income.[45] Those preferred returns are disregarded for fractions rule purposes whether they are allocated to a qualified organization or a taxable partner.[46]

A preferred return is ''reasonable'' only if it is calculated on unreturned capital at a rate that is commercially reasonable; again, based on all relevant facts and circumstances.[47] Unreturned capital must be calculated on a weighted-average basis and is defined as the amount of

[40]Reg. section 1.514(c)-2(b)(2)(i).
[41]Section 514(c)(9)(E)(ii)(II); reg. section 1.514(c)-2(c)(1)(ii); reg. section 1.514(c)-2(d).
[42]Reg. section 1.514(c)-2(d)(1).
[43]Reg. sections 1.514(c)-2(b)(2)(i) and 1.704-1(b)(2)(ii)(*h*).
[44]Reg. section 1.514(c)-2(d)(2).
[45]*Id.*
[46]T.D. 8539.
[47]Reg. section 1.514(c)-2(d)(4)(i).

money and the FMV of property (net of liabilities assumed by the partnership) contributed by the partner to the partnership, less all money and property (again, on a net basis) distributed by the partnership to the partner as a return of capital.[48] All relevant facts and circumstances are taken into account in determining whether a distribution constitutes a return of capital for this purpose, but a written designation in the partnership agreement will ordinarily be respected if it is economically reasonable.[49]

The regulations create a safe harbor within which a preferred return will be deemed commercially reasonable.[50] Under this safe harbor, a preferred return on capital is deemed reasonable if it is no greater than 4 percentage points more than, or 150 percent of, the highest long-term applicable federal rate (AFR) for the month the partner's right to the preferred return is first established or any month in the partnership tax year for which the return is computed.[51] For illustrative purposes, during the period from June 2006 through October 2009, the long-term AFR varied from a low of 2.96 percent to a high of 5.36 percent, with the mean value being about 4.55 percent. In this range, it will always be more beneficial to calculate the safe harbor using the ''AFR plus 4 percent'' method. (Only when the long-term AFR exceeds 8 percent, a relatively rare occurrence in recent years, will the ''150 percent of AFR safe harbor'' method yield superior results.) Thus, during this period the maximum safe harbor rate for guaranteed preferred returns under the fractions rule regulations varied from a low of 6.96 percent to a high of 9.36 percent, with the average safe harbor rate being approximately 8.6 percent. The regulations state that a return in excess of the safe harbor amount may be commercially reasonable based on all the relevant facts and circumstances.[52]

Lastly, the regulations establish a timing rule under which an allocation for a preferred return of capital is disregarded only if it does not exceed (a) the total aggregate amount of reasonable preferred returns *actually distributed* to the partner for the tax year of the allocation on or before the partnership return due date (not including extensions) and all prior tax years, less (b) the aggregate amount of corresponding (preferred) income and gain allocated to the partner in all prior years.[53] This timing rule is generally intended to compel a matching of the timing of the tax and economic consequences of permitted preferred allocations.[54]

The rules applicable to preferred returns under the fractions rule are summarized in the checklist in Figure 3.

ii. Guaranteed payments. The rules applicable to reasonable guaranteed payments generally mirror those for preferred returns, with a couple of variations. The regulations treat current or cumulative reasonable guaranteed payments to qualified organization partners for capital or services as a deductible item in computing overall partnership income or loss, while the guaranteed payment itself is not treated as an allocable share of overall partnership income or loss in the hands of the recipient qualified organization.[55]

A guaranteed payment for services is treated as reasonable in amount if it is reasonable under reg. section 1.162-7 (relating to the deduction of reasonable compensation for services, and which generally includes amounts that ''would ordinarily be paid for like services by like enterprises under like circumstances'').[56] A guaranteed payment for capital is generally evaluated under the same standards as a preferred return, described above, and is eligible for the same safe harbors.[57]

Regarding timing, the regulations permit reasonable guaranteed payments to be deducted by the partnership only when paid in cash; however, a payment made after the end of a tax year but before the due date for filing the return (not including extensions) may be treated as having been paid in the prior tax year.[58] Once again, this timing rule is apparently designed to require a relatively close matching of the tax and economic consequences of disregarded guaranteed payments.[59]

The rules for guaranteed payments under the fractions rule are summarized in the checklist in Figure 4.

c. Charge-backs and offsets. A second set of exceptions to the fractions rule relates to charge-backs and offsets. Reg. section 1.514(c)-2(e)(1) specifies that allocations of what would otherwise be overall partnership income made to charge back or reverse prior disproportionately large allocations of overall partnership loss, and allocations of what would otherwise be overall partnership loss made to reverse prior disproportionately small allocations of overall partnership income, in each case to a qualified organization partner, are, for purposes of the fractions rule, disregarded in computing overall partnership income or loss.[60] A prior allocation is disproportionately large or small if it exceeds or is less than the qualified organization partner's fractions rule percentage (that is, the smallest share of overall partnership loss that could ever be allocated to the qualified organization).[61] Prior disproportionate allocations may be reversed in full or part and in any order, but they must be reversed in the same ratio or ratios as originally made.[62] Also, to fall within this exception, the balance of overall partnership income or loss must be allocated in a manner that would independently satisfy the fractions rule.[63] Finally, subject to some limited exceptions, a charge-back reversing part

[48]Reg. section 1.514(c)-2(d)(5)(i).
[49]Reg. section 1.514(c)-2(d)(5)(ii).
[50]Reg. section 1.514(c)-2(d)(4)(ii).
[51]*Id.*
[52]Reg. section 1.514(c)-2(d)(4)(ii). There is an absence of guidance on how a determination regarding the reasonableness of a preferred return outside the safe harbor should or would be made.
[53]Reg. section 1.514(c)-2(d)(6)(i).
[54]T.D. 8539.
[55]Reg. section 1.514(c)-2(d)(3). The regulations note that this rule does not otherwise affect the possible characterization of the guaranteed payment as UBTI under the code. *Id.*
[56]Reg. section 1.514(c)-2(d)(4)(i).
[57]Reg. section 1.514(c)-2(d)(4) and (5).
[58]Reg. section 1.514(c)-2(d)(6)(ii).
[59]T.D. 8539.
[60]Reg. section 1.514(c)-2(e)(1)(i).
[61]Reg. section 1.514(c)-2(e)(2)(i).
[62]*Id.*
[63]*Id.*

Figure 4. Guaranteed Payment Checklist

- [ ] Is the guaranteed payment set forth in a binding, written partnership agreement?
- [ ] If the guaranteed payment is for services, is it reasonable within the meaning of reg. section 1.162-7?
- [ ] If the guaranteed payment is for capital, is it calculated only on weighted average unreturned partner capital?
- [ ] If the guaranteed payment is for capital, is the rate commercially reasonable ?
  - [ ] Is the guaranteed payment rate within the safe harbor — no greater than 4 percentage points more than, or 150 percent of, the highest long-term applicable federal rate for the month the partner's right to the preferred return is first established or the preferred return is computed?

    or

  - [ ] Is the guaranteed payment rate otherwise "commercially reasonable" in light of all relevant facts and circumstances?
- [ ] Is the guaranteed payment paid in cash before the due date (excluding extensions) of the return for the tax year in which the payment will be deducted by the parntership?

of a partnership's overall income or loss fits within this exception only if it consists of a pro rata portion of each item of partnership income, gain, loss, and deduction other than nonrecourse deductions, partner nonrecourse deductions, and any compensating allocations.[64]

In addition to permitting the reversal of prior disproportionate allocations as described above, allocations of income or gain to a partner under a minimum gain charge-back attributable to prior nonrecourse deductions or partner nonrecourse deductions, as well as allocations of income or gain to other partners to charge back compensating allocations of other losses, deductions, or items described in section 705(a)(2)(B), are excluded from the calculation of overall partnership income or loss for purposes of the fractions rule.[65] The regulations require the partnership to determine the extent to which a charge-back subject to this exception is attributable to nonrecourse deductions (or separately, on a debt-by-debt basis to partner nonrecourse deductions). This is done by reference to the proportion of the partner's percentage share of partnership minimum gain or (again, on a debt-by-debt basis) partner nonrecourse debt minimum gain, at the end of the immediately preceding tax year to which nonrecourse deductions or partner nonrecourse deductions are attributable.[66] For this purpose, the partnership is required to determine the extent to which a partner's share of partnership minimum gain or partner nonrecourse debt minimum gain is attributable to deductions "in a reasonable and consistent manner."[67] The regulations specify that when none of the exceptions in reg. section 1.704-2(f)(2) through (5) apply, the applicable ratio will be that which (a) the aggregate amount of nonrecourse deductions previously allocated but not charged back to the partner in prior tax years bears to (b) the sum the amount specified in (a), plus the aggregate amount of distributions previously made to the partner of proceeds of a nonrecourse liability allocable to an increase in partnership minimum gain not charged back in prior tax years.[68]

The regulations also permit some minimum gain charge-backs attributable to the distribution of nonrecourse debt proceeds to be disregarded for purposes of

[64]Reg. section 1.514(c)-2(e)(2)(ii). The regulations except from this pro rata allocation requirement some minimum gain charge-backs attributable to the distribution of nonrecourse debt proceeds, and they provide that the IRS may expand the list of exceptions by revenue rulings or other published guidance, which has not yet occurred.

[65]Reg. section 1.514(c)-2(e)(1)(ii); reg. section 1.514(c)-2(e)(1)(iii); reg. section 1.514(c)-2(e)(3).

[66]Reg. section 1.514(c)-2(e)(3).

[67]*Id.*

[68]*Id.*

the fractions rule.[69] Those allocations are disregarded to the extent that they charge back prior disproportionately large allocations of overall partnership loss (or part of that loss) to a qualified organization.[70] However, this exception applies only to the extent the disproportionately large allocation consisted of depreciation from real property (other than items of nonrecourse deduction or partner nonrecourse deductions) that was later used to secure the nonrecourse liability that served as the source for the distributed proceeds, and only if those proceeds were distributed as a return of capital in the same proportion as the allocation.[71]

Lastly, charge-backs and offsets attributable to allocations of items of income or gain made to a partner under a QIO, or in tax years beginning after January 1, 2002, that are mandated by the code or Treasury regulations, other than subchapter K or the regulations thereunder, are disregarded for purposes of computing overall partnership income and loss under the fractions rule.[72]

The rules for charge-backs and offsets under the fractions rule are summarized in the checklist in Figure 5.

d. Other exclusions, exceptions, and rules. In addition to the foregoing broad categories of exclusion, the regulations implementing the fractions rule delineate a number of somewhat more narrow but still potentially helpful exceptions and rules, which are discussed below.

i. De minimis interest exception. Reg. section 1.514(c)-2(k)(2) establishes a de minimis interest exception, which excuses qualified organization partners from complying with the fractions rule altogether. To fit within this exception:

1. qualified organizations may not hold, in the aggregate, greater than 5 percent of the capital or profits of the partnership; and
2. taxable partners must own a substantial interest in the partnership and participate in the partnership on substantially the same terms as the qualified organization partners.[73]

This exception reflects the reasonable view that if qualified organizations hold but a relatively small interest in a partnership and invest on substantially the same terms as taxable investors holding a material interest in the partnership, the risk of inappropriate use of the partnership to exploit the tax-exempt status of the qualified organizations is minimized.

ii. De minimis allocation exception. Reg. section 1.514(c)-2(k)(3) establishes a de minimis allocation exception under which a qualified organization's share of partnership items of loss and deduction (other than nonrecourse and partner nonrecourse deductions) that are allocated away from the qualified organization to other partners are disregarded for purposes of determining such organization's fractions rule percentage if:

1. the allocations were "neither planned nor motivated by tax avoidance"; and
2. the total amount of loss or deduction so allocated is less than both (a) 1 percent of the partnership's aggregate items of gross loss and deduction for the tax year, and (b) $50,000.[74]

This exception presumably reflects a desire by the IRS not to sweat the small stuff, at least as long as the partners are not motivated by bad intentions.

iii. Reasonable partner-specific items of deduction and loss. The regulations also provide exceptions for some partner-specific items of deduction and loss.[75] Provided they are allocated to the partners to whom they are attributable, the following types of expenditure are disregarded for purposes of the fractions rule:

1. expenditures for additional record keeping or accounting incurred in connection with the transfer of a partnership interest;
2. additional administrative costs resulting from the presence of a non-U.S. partner;
3. state and local taxes, and expenditures related to those taxes; and
4. other expenditures designated by the IRS through revenue ruling or otherwise.[76]

The utility and logic of this set of exceptions is fairly obvious; it permits reasonable allocations to the partner or partners responsible for (or deriving primary benefit from) the activities giving rise to the allocated costs without causing a violation of the fractions rule.

iv. Exclusion of unlikely losses and deductions. Allocations of "unlikely losses or deductions (other than items of nonrecourse deduction)" to the partner or partners that bear the economic burden of those items are disregarded in calculating overall partnership income and loss for purposes of the fractions rule as long as a principal purpose of the allocations is not tax avoidance.[77] To be "unlikely" for this purpose, a loss or deduction must have a low likelihood of occurring, taking into account all relevant facts, circumstances, and information available to the partners, including bona fide financial projections.[78] The regulations cite as examples of items that could, under appropriate circumstances, fit within this exception:

- tort or other third-party litigation giving rise to unforeseen liabilities in excess of reasonable insurance coverage;
- unanticipated labor strikes;
- unusual delays in securing required permits or licenses;

[69] Reg. section 1.514(c)-2(e)(4).
[70] Reg. section 1.514(c)-2(e)(4)(ii).
[71] *Id.*
[72] Reg. section 1.514(c)-2(e)(1)(iv) and (v).
[73] Reg. section 1.514(c)-2(k)(2)(i). An example in the regulations indicates that a 30 percent interest held by a taxable partner is a substantial interest for purposes of this exception; however, this 30 percent figure is arguably better understood as a safe harbor than as an absolute floor. Reg. section 1.514(c)-2(k)(2)(ii).
[74] Reg. section 1.514(c)-2(k)(3).
[75] Reg. section 1.514(c)-2(f).
[76] *Id.* As of the date of this report, the IRS does not appear to have availed itself of this final option.
[77] Reg. section 1.514(c)-2(g).
[78] *Id.*

Figure 5. Charge-Backs and Offsets

- ☐ If the allocation charges back or reverses a prior disproportionate allocation:
  - ☐ Are prior allocations reversed in the same ratio or ratios as originally made?

    and

  - ☐ Is the balance of partnership income or loss allocated in a way that independently satisfies the fractions rule?

    and

  - ☐ Do the reversing allocations consist of a *pro rata* portion of all items of partnership income, gain, loss, and deduction?

- ☐ Is the allocation a permitted minimum gain chargeback attributable to prior nonrecourse deductions, partner nonrecourse deductions, or related items described in reg. section 1.514(c)-2(e)(1)(ii)-(iii), calculated in compliance with reg. section 1.514(c)-2(e)(3)?

- ☐ Is the allocation a permitted minimum gain chargeback attributable to the distribution of nonrecourse debt proceeds meeting the requirements of reg. section 1.514(c)-2(e)(4)(ii)?

- ☐ Is the allocation (a) made pursuant to a qualified income offset within the meaning of reg. section 1.704-1(b)(2)(ii)(*d*), or (b) otherwise mandated by a statute or regulation outside of Subchapter K?

- abnormal weather conditions (after taking location and season into account);
- significant delays in leasing property due to unanticipated severe economic downturn in a geographic area;
- unanticipated cost overruns; and
- the discovery of environmental conditions requiring remediation.[79]

The regulations provide that the fact that a partnership agreement includes a provision for allocating a particular loss or deduction does not give rise to an inference whether that item is unlikely within the meaning of the regulation.[80]

v. Changes in partners' interests. Finally, the regulations provide some common-sense rules for dealing with changes in the partners' interests in a fractions-rule-compliant partnership.[81] In this regard, a qualified organization that acquires a partnership interest from another qualified organization is, to the extent of the acquired interest, treated as a continuation of the prior qualified organization partner for purposes of the fractions rule.[82] Other changes in partnership allocations resulting from transfers or shifts of partnership interests:

> 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.[83]

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[79] *Id.*
[80] *Id.*
[81] Reg. section 1.514(c)-2(k)(1).
[82] *Id.*
[83] *Id.*

vi. Tiered partnership arrangements. Modern real estate investment often involves structures more complex than a single partnership and its partners. For various reasons, it is not at all uncommon for real estate investments to be organized using one or more subsidiary partnerships or other more complex structures. Anticipating those structures, the regulations provide that tiered partnership arrangements will satisfy the fractions rule only if the following two requirements are met:

1. tax avoidance is not a principal purpose for using the tiered ownership structure;[84] and

2. the partnerships can demonstrate under any reasonable method that the ownership structure at issue satisfies the requirements of the regulations relating to and implementing the fractions rule.[85]

Regulatory examples explicate a series of methods that might be used to make the required showing. These include:

- the collapsing approach, which entails collapsing the multiple tiered partnerships into a single theoretical partnership in which all ultimate partners participate, and then testing for fractions rule compliance on that basis;[86]
- the entity-by-entity approach, which involves testing each partnership arrangement in a tiered chain independently for fractions rule compliance, treating as a qualified organization for this purpose any intermediate partnership in which a qualified organization directly or indirectly holds an interest;[87] and
- the independent chain approach, which allows fractions rule compliance to be tested independently for different lower-tier partnerships held through a common tiered chain, provided items from those lower-tier partnerships are separately allocated.[88]

Unfortunately, the regulatory examples are limited and involve only relatively simple fact patterns, which may limit practitioners' ability to extrapolate and predict with a high degree of confidence whether a particular real-life structure meets the requirements of the regulations. Qualified organizations seeking to enjoy the benefits of the fractions rule with investment structures involving complex arrangements of tiered partnerships are well advised to proceed with caution.

vii. General antiabuse rule. Finally, it is fitting to close our review of the substance of the fractions rule with the general antiabuse rule articulated in the regulations:

> 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.[89]

As will be recognized by any reader who has gotten this far, the fractions rule, with its myriad tiered exceptions and cross-referenced subchapter K complexities, can be fairly complicated stuff. In working through these subtleties, it is sometimes easy to lose sight of the reason for and basic role played by the fractions rule. This antiabuse rule should serve as a reminder to practitioners and others that while technical compliance with the rule is no doubt necessary, meeting a more basic smell test is possibly equally important.

IV. Practical Issues

The prior sections of this report have attempted to identify the function and context for the rule and provide a basic outline of the rule and its principal exceptions. In contrast, this section will identify and briefly discuss several practical issues (in no particular order) arising commonly in drafting and reviewing partnership agreements that seek to comply with the fractions rule.

A. Targeted Allocations

It is fairly common for modern real estate partnership agreements to contain a waterfall arrangement governing distributions, including in many cases liquidating distributions, and then to employ a forced or targeted allocation provision in an effort to cause capital accounts to be adjusted appropriately to reflect the desired distribution scheme.[90] This style of drafting partnership allocations avoids describing how specific items of income, gain, loss, and deduction will be allocated among partners. Instead, it establishes a general, nonspecific mandate that partners' capital accounts be adjusted in a manner so as to, as nearly as possible, match the amounts that would be distributed to the partners under the waterfall in a hypothetical liquidation in which all partnership assets are sold for book value and all partnership liabilities are satisfied. It is unclear whether such an agreement can be said to comply with the fractions rule.

As an initial matter, a typical forced allocation provision's lack of specificity regarding the manner in which partnership items are to be allocated makes it difficult to be confident, or perhaps more importantly, makes it

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[84]Reg. section 1.514(c)-2(m)(1)(i). In this regard, the regulation specifies that separating individual properties in separate chains of partnerships so that the fractions rule is effectively applied on a property-by-property basis is not, in and of itself, a tax avoidance purpose. *Id.*

[85]Reg. section 1.514(c)-2(m)(1)(ii). The regulation requires that the tiered ownership structure satisfy reg. section 1.514(c)-2(b)(2) through 1.514(c)-2(k). *Id.*

[86]Reg. section 1.514(c)-2(m)(2), Example 1.

[87]Reg. section 1.514(c)-2(m)(2), Example 2.

[88]Reg. section 1.514(c)-2(m)(2), Example 3. The practical effect of this method is that one or more noncompliant lower-tier partnerships will not necessarily taint all allocations flowing upstream to qualified organization partners.

[89]Reg. section 1.514(c)-2(k)(4).

[90]For a more in-depth discussion of targeted allocations, including potential issues arising under the substantial economic effect regulations of section 704(b), see Cuff, *supra* note 24, at 171; Golub, *supra* note 24, at 157.

difficult to prove to a skeptical return preparer or revenue agent, that in no case is it possible for allocations of partnership income to a qualified organization to be greater than that organization's share of partnership loss for the tax year in which that share will be the smallest. By specifying a result rather than an allocation method, the forced allocation approach fails to engage in a satisfying way with the fractions rule, which, at its core, concerns the percentage share of income and loss allocated to qualified organization partners. In effect, the very flexibility that contributes to the appeal of the forced allocation — allocate however you want as long as you get the desired result — creates a challenge to a qualified organization partner seeking to demonstrate that allocations will always and in all circumstances comply with the fractions rule.

Also, many forced allocation arrangements provide for liquidating partnership distributions to be made under a waterfall rather than in accordance with adjusted positive capital account balances, and therefore arguably fall outside the substantial economic effect safe harbor because they lack economic effect within the meaning of the regulations.[91] As discussed in Part III.A.1.a above, in many cases parties outside this regulatory safe harbor are willing to tolerate the risk of reallocation, possibly in the belief that the waterfall genuinely reflects the partners' interest in the partnership and, as a result, an IRS reallocation is unlikely to materially disturb the results of the forced allocation. Qualified organization partners, however, are unlikely to find this line of analysis as satisfying, because falling outside the substantial economic effect safe harbor means that the partnership fails the fractions rule, at least if the language of section 514(c)(9)(E)(i)(II) is taken at face value.[92] While this problem can be sidestepped with careful drafting (perhaps by integrating an explicit requirement that liquidating distributions be made in accordance with positive capital account balances with an arrangement that adjusts capital accounts to match the desired distribution waterfall), such an approach potentially injects some element of economic uncertainty into the partnership, and, given the absence of guidance on the issue, is of uncertain utility in fractions rule compliance. Ultimately, until the IRS or courts enter the fray, it is prudent to recognize that the use of targeted or forced allocation provisions jeopardizes the ability of a partnership to comply with the fractions rule.

B. Clawbacks

The clawback, another common feature in modern partnership agreements, may also cause concern from a fractions rule perspective. Typically such a provision seeks to cause a partner to return to other partners some portion of partnership profits or gains allocated or distributed in one period, usually if partnership results in subsequent periods fail to meet expectations.[93] The terms and requirements of partnership clawback provisions are subject to considerable variation, and it is far from clear how, if at all, they should be understood to affect partnership allocations. It may be possible to view a clawback purely as a contingent capital contribution obligation that does not affect partnership allocations, as a permitted species of DRO, as a guaranteed payment, or as a contingent allocation provision. As with forced allocations, there is no guidance on how clawback provisions should be understood to affect fractions rule compliance. Practitioners and qualified organizations concerned with this issue should evaluate carefully whether (a) the presence or terms of a clawback cause a partnership agreement to fall outside the substantial economic effect safe harbor discussed in Part III.A.1 above; and (b) the clawback may be viewed as an allocation provision, and if so, whether that allocation could cause the partnership agreement to fail the fractions rule.

C. Curative Allocations

Even partnership agreements that fit squarely into one of the substantial economic effect safe harbors often contain a so-called curative allocation provision intended to unwind or mitigate the potential effect of one or more regulatory allocation provisions in the agreement. The general concept is that if, for example, it becomes necessary to allocate minimum gain, partner minimum gain, nonrecourse deductions, or partner nonrecourse deductions, or if allocations are required to effectuate a qualified income offset feature, the curative allocation provision will minimize or eliminate the economic and tax effect of those regulatory allocations on the partners to the extent possible.

As discussed in Part III.A.1.a, to meet the requirements of the fractions rule, partnership agreements must generally satisfy the rule on both an actual and prospective basis commencing with the first tax year in which the partnership holds debt-financed property and has one or more qualified organization partners.[94] Helpfully, the regulations contain exceptions to this requirement for allocation provisions relating to things like minimum gain, partner minimum gain, nonrecourse deductions, partner nonrecourse deductions, and qualified income offsets, which are generally taken into account for purposes of the fractions rule only when the allocation is actually made.[95] Unfortunately, it is unclear, and the regulations do not state, whether a curative allocation provision can also be ignored for fractions rule purposes unless and until it is activated.

For this purpose, it may be possible to view a curative allocation provision as an integral part of the regulatory allocations themselves — merely an instruction on the

[91]Reg. section 1.704-1(b)(2)(ii). *See* Part III.A.1.a above for a summary of this requirement.

[92]*See* Cuff, *supra* note 24, at 171, 186-191.

[93]For a general discussion of clawback provisions in partnership agreements, see Steven R. Schneider, ''How Do Investment Fund Clawback Provisions Affect Partnership Income Allocations?'' *J. Passthrough Entities* 37 (July-Aug. 2004).

[94]Reg. section 1.514(c)-2(b)(2).

[95]*See, e.g.*, reg. section 1.514(c)-2(e)(4), 1.514(c)-2(h), and 1.514(c)-2(j)(1).

manner in which the necessary regulatory allocations are to be implemented — in which case the provision can arguably be ignored, at least as long as the regulatory allocations themselves are ignored, for purposes of determining whether a partnership agreement is compliant with the fractions rule. In contrast, curative allocation provisions are typically drafted as separate, independent allocation sections within a partnership agreement, and if they are respected as such, their mere presence in the agreement potentially causes an immediate fractions rule failure.

This ambiguity about how a curative allocation provision is viewed should prompt those seeking to draft fractions-rule-compliant agreements to weigh the potential benefits of the curative allocation provision against the risk and uncertainty that its inclusion produces. To the extent this balance weighs in favor of retaining the curative allocation, it may be helpful to specify that the provision is intended only to provide guidance on the manner in which the regulatory allocations themselves should be implemented, and that it is viewed by the partners as a part of the regulatory allocation provisions rather than as a stand-alone feature of the agreement.

D. Savings Clauses

A final topic worthy of some discussion is the use of the questionably named ''savings clause'' in partnership agreements seeking to meet the requirements of the fractions rule. Those provisions, often introduced with or containing some variation of the clause ''notwithstanding any other provision contained in this agreement,'' typically provide, with varying degrees of specificity, that a partnership agreement is intended to comply with the fractions rule and that the agreement's provisions will interpreted or applied in a manner that makes that objective possible.

Regarding fractions rule compliance, partnership agreements may be viewed as ranging across a broad spectrum, with agreements that very clearly fail to meet the requirements of the rule at one end, and those that absolutely satisfy the rule on the other. In the author's view, at both extreme ends of the spectrum, the use of a savings clause is of questionable value. For a partnership agreement that clearly fails to satisfy the fractions rule, the imposition of a savings clause likely does not ''save'' the partnership agreement, but may inject ambiguity and uncertainty. Likewise, for a simple partnership agreement that obviously satisfies the fractions rule, a savings clause is arguably unnecessary surplusage that adds nothing but unneeded complexity.

However, both the tax law relating to partnerships generally and the fractions rule specifically are, as is by now apparent, complex and subject to significant uncertainty. Most partnership agreements do not rest on either end of the spectrum described above, but instead fall in more ambiguous territory. While obviously not a substitute for careful and thoughtful drafting, in those cases, the use of a fractions rule savings clause may arguably be of some help. Under those circumstances, a fractions rule savings clause can make clear that the parties intend that the agreement meet the requirements of the rule, and it can assist the parties in interpreting provisions of the agreement that might otherwise be subject to some uncertainty.

When the use of a fractions rule savings clause is determined to be desirable, drafters may wish to consider:

- Including a clear statement of the parties' intent to comply with the fractions rule.
- Summarizing the requirements of the rule with reasonable specificity, including both the requirements of the fractions rule itself (section 514(c)(9)(E)(i)(I)), and the necessity that the partnership agreement fit within the substantial economic effect safe harbor under section 704(b). (Often the parties called on to apply or interpret a partnership agreement, or even to prepare the partnership's tax returns, will be less than perfectly fluent with the requirements of the fractions rule, so providing some reasonable degree of guidance in the agreement itself can be useful.)
- Explicitly delineating what is to occur if the savings clause alters what would otherwise be the normal allocation scheme required under the agreement. It is often desirable to require that, to the extent the savings clause actually interferes with normal partnership allocations, those changes will be reversed in subsequent periods to the extent that can be accomplished without violating the fractions rule.

V. Conclusion

Albert Einstein is said to have quipped, ''The hardest thing in the world to understand is the income tax.'' Among the various rules that make up the tax Einstein objected to, the fractions rule arguably ranks as one of the most challenging. Just understanding when compliance with the rule might be useful can be difficult, while the rule itself, laden as it is with obscure cross-references and layers of exceptions, can befuddle even experienced professionals and advisers. More daunting still are the surprisingly large areas in which guidance is lacking and in which the application of the rules is unclear.

This report attempts to situate the fractions rule in the context of the UBIT, summarize the operation of the rule and its principal requirements and exceptions, and discuss briefly some practical issues that can arise in drafting or reviewing partnership agreements when compliance with the fractions rule is sought. It is my sincere hope that those who venture into this difficult branch of tax law will find the foregoing paragraphs both a useful outline of the rules themselves and a helpful guide to the areas in which the law is unclear.