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Structuring Waterfall Provisions in LLC and Partnership Agreements

Navigating Complex Distribution Structures, Minimizing Negative Tax Consequences

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Today's faculty features:

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STRUCTURING WATERFALL PROVISIONS IN LLC AND PARTNERSHIP AGREEMENTS

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Agenda

I. Waterfall Provisions Generally
II. Determining and Drafting Waterfall Provisions
III. Understanding Economic Arrangements of Parties
IV. Tailoring Accounting and Tax Allocations
V. Implications of New IRS Partnership Audit Rules

Nomenclature

This presentation generally uses the terms "partnership" and "partner" to mean either (a) a partnership that is classified as such for tax purposes and its partners, or (b) a limited liability company (LLC) that is so classified and its members. The business, legal, and tax considerations for both types of entities and their owners are the same unless otherwise noted.

I. Waterfall Provisions Generally

I. Waterfall Provisions Generally

A. Waterfall provisions define how money and other property are distributed by a partnership to its partners

1. Distributions to partners are analogous to dividends paid by corporations, but partnership and limited liability company laws provide greater flexibility in deciding how to apportion such payments
2. Waterfalls are used in partnership agreements for a wide range of investment and operating businesses, including private equity funds and real estate partnerships

B. Distribution provisions specify when distributions are made to partners and to which partners

1. Distributions can be made to redeem equity interests in partnerships, but are more commonly made to allow partners to participate in the cash flows and profits of investment funds and operating businesses

C. The term "waterfall" implies that certain partners are granted priority distribution rights over other partners

1. Without such priorities, distributions would be made in accordance with state laws and generally would be made to partners in proportion to amount invested by the partners in the partnership
2. Partnership agreements override applicable laws in determining how to make distributions

II. Determining and Drafting Waterfall Provisions

II. Determining and Drafting Waterfall Provisions

A. Relative Economic Rights

1. If all partners share in all distributions proportionately to their capital invested in the partnership, then a waterfall is unnecessary
2. Waterfalls are designed to allow a partner to receive a percentage of profits of the partnership that exceed that partner's relative capital contributed to the partnership
   a. The percentage of profits that does not correlate with the percentage of capital contributed to the partnership is referred to as the "carried interest" in private equity funds
   b. It is important to distinguish profits interests from capital distributions, which have different tax implications
3. When some partners have priorities to distributions over others, the nature of those priorities are specified in partnership agreements
4. Types of priorities are defined in waterfall provisions (e.g., return of capital; "preferred return"; "catch-up" and "carried interest")
5. Waterfall provisions are typically categorized in two ways: (1) "back-ended" or "European" or (2) "deal-by-deal"
6. Types of distribution matter (e.g., cash flow, dispositions, tax, in-kind)

B. Timing of Distributions

1. Specific times – Quarterly, Annually, Estimated Taxes
2. Specific events – Capital Events, Receipt of Cash

II. Determining and Drafting Waterfall Provisions, Continued

C. Amount of Distributions

1. Proceeds from dispositions, after payment of expenses and obligations
2. Reinvestment
3. Preconditions to making distributions Repayment of debt, payment of fees, reserves, etc.

D. Recalls of Distributions

1. Distributions are subject to recall rights by a private equity fund under specified situations
   a. Distributions made out of the initial capital contributions made by new partners
   b. Distributions made from the proceeds of a company sold within a "quick flip" period (generally 12 – 24 months), up to the amount invested by the fund in the company sold
   c. Distributions recalled to allow a fund to make indemnification payments
   d. Distributions of up to the amount previously contributed by partners to the partnership that were used for partnership expenses
   e. Distributions recalled to fund partnership audit adjustments under new partnership audit rules
   f. Excess tax distributions
2. Such recalls are subject to time limits and other partnership restrictions and limits

II. Determining and Drafting Waterfall Provisions, Continued

E. Waterfall provisions should only address distributions to partners, not payments of fees, liabilities

F. Include a catch-all provision to address orphaned money or non-investment income

G. If the partnership agreement includes tag-along, drag-along, change of control provisions, they should also incorporate waterfall apportionments

III. Understanding Economic Arrangements of Parties

III. Understanding Economic Arrangements of Parties

A. Initially, apportion amount to be distributed among investors

B. Identify whether there is a Back-Ended/"European" Waterfall or "Deal-By-Deal" Waterfall

C. Back-Ended/"European" Waterfall vs. Deal-By–Deal Waterfall

1. Will Investors receive 100% of their capital contributions first or just a portion of their capital contributions?
2. If deal-by-deal, then investors recoup the cost of deals disposed of, plus allocable expenses
3. Write-offs and permanent write-downs are deemed dispositions

D. Priority Returns

1. Once investors receive their capital distribution, they may be entitled to a priority return (or "preferred return"). Some investors prefer that the preferred return be paid before capital contributions are returned (similar to interest first on debt).
2. A private equity fund preferred return is typically 8% per annum, compounded annually
3. Credit funds have lower preferred return rates – 6%
4. Venture funds do not typically pay a preferred return
5. Real estate funds may use multiple "IRR" hurdles as the preferred return measurement. IRR hurdles are difficult to draft than more commonly understood preferred return hurdles.

III. Understanding Economic Arrangements of Parties, Continued

E. “Catch-Up”

1. The catch-up provides for a profit distribution to the general partner to allow it to receive its carried interest
2. While typical for private equity funds waterfalls, the waterfall for other types of vehicles may include not be a "catch-up"

F. Carried Interest/Promote

1. After the catch-up is paid, profits are distributed to enable the general partner to receive its carried interest (typically 20%)
2. Multiple levels of increase
3. Based on overall returns (“crossed”) or investment-by-investment
4. Investor-by-Investor Basis
5. Clawback obligations

III. Understanding Economic Arrangements of Parties, Continued

G. Different Waterfalls for Different Situations

1. Common situations with separately-stated waterfalls
   a. Current cash flow
   b. Capital events
   c. Liquidation
2. If distributions in one waterfall are affected by distributions made under other waterfalls, make sure provisions are carefully coordinated
3. Remember a catch-all (no orphaned money)

III. Understanding Economic Arrangements of Parties, Continued

F. In-Kind Distributions

1. Entity distributes property instead of cash
2. Property is typically not as fungible as cash, so it matters what property you get
3. Are in-kind distributions prohibited?
4. Do certain partners have the right to choose what property is distributed to whom?
5. Do all partners share equally in each form of property?
   a. Distributions of undivided interests in property
   b. Often unwieldy to manage after distribution
6. Does a partner want a first right to asset on liquidation?
   a. Consider right to distribution of asset with obligation to contribute value in excess of liquidation rights
7. Valuation issues

III. Understanding Economic Arrangements of Parties, Continued

F. In-Kind Distributions (continued)

8. Tax considerations for in-kind distributions
   a. *Non-liquidating distribution*: partner inherits partnership's basis for the property ("inside basis") and reduces the basis of the partner's partnership interest ("outside basis") by the same amount
   b. *Liquidating distribution:* partner's outside basis (after taking into account any cash distributions) becomes the basis of the distributed property (according to specified basis allocation rules if more than one property is distributed)
   c. *Capital Accounts:* adjusted by FMV of distributed property
   d. *Anti-Mixing Bowl (Disguised Sale) Rules:*
      – A distribution of contributed property can trigger gain to the contributing partner
      – Distribution of property to a partner that previously contributed cash to the partnership can be recast as a deemed sale by the partnership of the distributed property in exchange for the prior cash contribution
      – Distribution of property to a partner that previously contributed property to the partnership can be recast as a deemed sale by the partnership and by the contributing partner
   e. *Hot assets*: non-pro rata distributions can trigger ordinary income
   f. *Get tax advice before making in-kind distributions!*

III. Understanding Economic Arrangements of Parties, Continued

G. Tax Distributions

1. *Context – the phantom/dry income problem*
   a. If a partnership has taxable income for a year and does not make any cash distributions, the partners may lack the funds to pay tax on their allocable share of partnership income
   b. Contrast to a corporation, which must pay tax on its taxable income
2. *Implementation issues*:
   a. Mandatory (shall) v. discretionary (may)
   b. Available funds: legally available; borrowed funds; debt agreement limitations; business needs
   c. Amount:
      – assumed tax liability v. actual tax liability (not common or recommended)
      – federal v. federal, state, and local taxes
      – character of income, including capital gains and Section 199A deduction eligible income
      – annual v. cumulative
      – Section 754 election effects on transferred interests
   d. Timing: annual v. quarterly v. estimated tax due dates
   e. Priority: in proportion to tax liability v. units/percentage interest or other (not common)
   f. Partner option to forego distributions
   g. Coordination with regular waterfall: treat as advances (not actual distributions); effect on calculation of preferred returns
   h. Clawbacks of excess distributions
   i. Side letters
   j. Amendments

III. Understanding Economic Arrangements of Parties, Continued

J. Capital Shifts

1. *Example 1*: Partnership P is owned in equal shares by three founding partners and has a pre-money value of $90x. X will invest $30x for a 1/3 interest in P. X's initial capital account is $30, but it has a liquidating value of $40 (1/3 x $120).
   - Does X recognize $10 of taxable income on the investment date to reflect the "shift" of capital from the founding partners to X?
2. *Example 2*: Same as example 1, except X will invest $30x for a 20% interest in P. X's initial capital account is $30, but it has a liquidating value of $24 (20% x $120).
   - Does each founder recognize $2 of taxable income on the investment date to reflect the "shift" of capital from the X to the founding partners?
3. *Example 3*: X is a partner in partnership P. X alone is entitled to an annual preferred return of 10%. At 12/31/20, the P has zero income or loss for the year and X's preferred return for the year is $2.25.
   - Does X recognize $2.25 of taxable income for 2020 to reflect the "shift" of capital from the other partners to X?

III. Understanding Economic Arrangements of Parties, Continued

J. Capital Shifts (continued)

4. No guidance from IRS
5. Most common approach is to not impute immediate income
6. BUT, capital shifts probably give rise to mandatory special allocations of income
   a. If the partnership is profitable, can result in a nearly immediate taxable income shift
   b. If the partnership is not profitable, a significant deferral can result
   c. *Caution:* partnership agreements that allocate "items of income or loss" can cause more immediate income allocations with respect to capital shifts
7. A capital shift can usually be avoided using a "return of capital" distribution/liquidation preference in the waterfall
   a. All partners obtain a return of their capital contributions, or pre-money value capital accounts, before allocating excess funds according to specified sharing ratios
   b. Underscores importance of understanding the economic deal and drafting to accommodate it

IV. Tailoring Accounting and Tax Provisions

IV. Tailoring Accounting and Tax Provisions

A. Distributions versus Allocations

1. **<u>Distribution provisions</u>** govern in what priorities and shares ***<u>cash</u>*** is distributed to partners; distributions are generally not taxable (return of basis)
2. **<u>Allocation provisions</u>** govern how ***<u>book profit or loss</u>*** is allocated among the partners; tax items generally follow book items
3. Allocation provisions determine the partners' relative tax liabilities (i.e., shares and character of potentially deductible losses and of taxable income) so they are an important secondary economic consideration in partnership deals

B. Two types of agreements

1. **<u>Allocation-based agreement</u>**
   a. Allocation provisions govern the economics
   b. Requirement to distribute liquidating proceeds according to capital accounts
2. **<u>Distribution-based agreement</u>**
   a. All distributions are governed by the waterfall, not by capital accounts
   b. Profit or loss is allocated based on expected distributions
3. Where the economic deal involves a multi-tier distribution waterfall, a distribution-based agreement is preferred and almost always used in current practice

IV. Tailoring Accounting and Tax Provisions, Continued

C. Layered versus Target Allocations

1. Initially, distribution-based agreements used "layered" allocations that traced the various tiers of the distribution waterfall
2. Modern practice is to use "target" allocations whereby the partnership makes whatever allocations are needed to cause the capital accounts to conform to each partners' distributable cash under the waterfall ("targeted ending capital")

Layered Allocation

Solve for ending capital using allocated income/loss:

	Beginning capital
+	Contributions
–	Distributions
+/–	*Allocated income / loss*
=	Ending capital

Target Allocation

Solve for allocated income/loss using targeted ending capital:

	Targeted ending capital*
–	Contributions
+	Distributions
–	Beginning capital
=	*Allocated income / loss*

* minus minimum gain related to nonrecourse debt

IV. Tailoring Tax Provisions with Waterfalls, Continued

C. Layered versus Target Allocations (continued)

3. **A target allocation provision is not a cure all**; many deal-specific issues can arise
    a. Integration with special allocations (e.g., placement costs)
    b. Net versus gross allocations
    c. Character of allocated income or loss
    d. Section 704(c) allocations (property contributions)
    e. Reverse Section 704(c) allocations (subsequent equity financing rounds)
    f. "Stuffing" allocations to departing partners
    g. Varying distribution rules for operating cash and capital events, or for individual investments
    h. Interaction with regulatory allocations and curative allocations
    i. Section 514(c)(9)(E) (fractions rule) – forced use of allocations-based agreement
4. Some agreements give the Manager/Board, either acting alone or with the consent of one or more key investors, authority to alter the allocations as necessary to achieve the intent of the partners consistent with their economic interests

V. Implications of New IRS Partnership Audit Rules

V. New Partnership Audit Rules

- ***What aspects of the new partnership audit rules require special attention by partnerships with distribution waterfalls?***

The items discussed are not necessarily an exhaustive list and generally do not cover considerations relevant to all partnerships (e.g., former partners, designation of partnership representative, election out, etc.)

V. New Partnership Audit Rules

Context and Certain Key Concepts

V. New Partnership Audit Rules

- **Effective date**
  - Tax years beginning after 12/31/17
  - Early adoption election available for tax years beginning after 11/2/15 and before 1/1/18*
    - Elected at time partnership is notified of an audit
    - Generally not advisable; some agreements prohibit
- **Two fundamental changes**
  - Deficiencies generally determined ***<u>and collected</u>*** at the partnership level
  - IRS deals exclusively with the "***<u>partnership representative</u>***"; partners have no statutory notice or participation rights

* 301.9100-22T

V. New Partnership Audit Rules

- **Certain key concepts**
  - **Imputed Underpayment**
    - IRS collects tax due ("imputed underpayment") from the partnership
    - Complex rules for grouping and netting adjustments, reallocations between partners, multi-year adjustments, etc.
    - Tax is calculated at the highest applicable rate (currently 37%)
      - Self-employment tax, net investment income tax, and withholding taxes are assessed separately (although it is not clear how that will be implemented)
  - **Modifications to an imputed underpayment**
    - Partner amended return or "pull-in" modifications
    - Partner tax rate modifications:
      - Tax exempt partners (0% tax rate)
      - C corporation partners (21% tax rate)
      - Capital gain and qualified dividends of individual partner (20% tax rate)
    - Other (limited application or future IRS guidance)

V. New Partnership Audit Rules

- **Certain key concepts (con't)**
  - **"Push out" Election**
    - Partnership can elect to require each "reviewed year" partner to take adjustments into account on their returns for the "adjustment year"
    - Tax is paid by the reviewed year partner regardless of whether such partner is still a partner
    - Downsides:
      - Additional 2% interest rate on resulting tax

Implications for Partnerships with Distribution Waterfalls

V. New Partnership Audit Rules

- **Four critical issues**
  - Imputed underpayment economic effects
  - Funding imputed underpayments
  - Modifications of imputed underpayments
  - Conflicts of interest in partnership tax audits

V. New Partnership Audit Rules

1. Imputed underpayment economic effect

– **Issue**: Absent specific provisions in the operating agreement, an imputed underpayment paid by the partnership reduces distributable cash available for the distribution waterfall

- Causes the tax to be withheld proportionately from the last tier of distributions in the waterfall
- *Will often (usually?) be the wrong result!*

V. New Partnership Audit Rules

1. Imputed underpayment economic effect

– **Example 1:** Investors contribute $1,000,000 to a land deal partnership. After one year the partnership sells the land for $2,800,000. The waterfall is as follows:

Pre-Audit Waterfall	Investors	Sponsor	Total
Tier 1 - Preferred Return	80,000	-	80,000
Tier 2 - Return of Capital	1,000,000	-	1,000,000
Tier 3 - 80/20 (up to 2x)	920,000	230,000	1,150,000
Tier 4 - 50/50	285,000	285,000	570,000
Totals	2,285,000	515,000	2,800,000

– On audit, the IRS determines the gain should have been reported as ordinary income rather than long-term capital gain (LTCG) and assesses tax at 37% on the gain.*

* Reg. 301.6225-1(h), Ex. 4 and 301.6225-3(b)(2) (reduction in LTCG is reported as an adjustment year LTCL)

V. New Partnership Audit Rules

1. Imputed underpayment economic effect

Imputed Underpayment	Investors	Sponsor	Total
Basis	1,000,000	-	1,000,000
Sale price	2,285,000	515,000	2,800,000
Gain	1,285,000	515,000	1,800,000
Tax rate	37%	37%	37%
Tax due	475,450	190,550	666,000
Percentage	71%	29%	
Post-Audit Waterfall (Default)			
Tier 1 - Preferred Return	80,000	-	80,000
Tier 2 - Return of Capital	1,000,000	-	1,000,000
Tier 3 - 80/20	843,200	210,800	1,054,000
Tier 4 - 50/50	-	-	-
Totals	1,923,200	210,800	2,134,000
Economic effect	361,800	304,200	666,000
Percentage	54%	46%	

V. New Partnership Audit Rules

1. Imputed underpayment economic effect

– Recommendation

- *The operating agreement should state that the imputed underpayment is collected from the partners based on a proper allocation of the underlying adjustments*
- The determination is typically made by the Manager

V. New Partnership Audit Rules

2. Funding imputed underpayments

- **Which partners bear the liability?**
  - Adjustment year partners or reviewed year partners?
  - Current and former partners?
- **How is the liability collected?**
  - Withholding from future distributions only?
  - If partner contributions are required, how are defaults handled?
- Absent a push out election, the default is to collect from only current adjustment year partners and only from distributions
- IRS can collect from the adjustment year partners (or specified former partners of a terminated partnership) according to their "proportionate shares" as determined by the IRS (which might be the intended economic allocation)

V. New Partnership Audit Rules

2. Funding imputed underpayments

– Recommendation

- *The operating agreement should specifically address how imputed underpayments will be paid, and should contemplate circumstances in which the partnership lacks sufficient funds to pay the imputed underpayment*
- Many agreements provide that an imputed underpayment is collected from the reviewed year partners, including former partners, using all available legal remedies, including by offset against future distributions
- Those agreements often do not specifically address offsetting adjustments taken into account by the partnership in the adjustment year (e.g., reclassification of LTCG to ordinary income as described in Example 1 above)

V. New Partnership Audit Rules

3. Imputed underpayment modifications

– **Issue**: Absent specific provisions in the operating agreement, modifications to an imputed payment will be shared by all partners (rather than being solely for the account of the partner to which the modification is attributable)

V. New Partnership Audit Rules

- **Imputed underpayment modifications**
  - **Example 2**: In Example 1, if the sponsor is a corporation, its share of the partnership level adjustments would be taxed at a 21% tax rate (rather than the default 37% tax rate).

V. New Partnership Audit Rules

- **Imputed underpayment modifications**

Imputed Underpayment	**Investors**	**Sponsor**	**Total**
Basis	1,000,000	-	1,000,000
Sale price	2,285,000	515,000	2,800,000
Gain	1,285,000	515,000	1,800,000
Tax rate	37%	**21%**	
Tax due	475,450	108,150	583,600
Percentage	81%	19%	
Post-Audit Waterfall (Default)			
Tier 1 - Preferred Return	80,000	-	80,000
Tier 2 - Return of Capital	1,000,000	-	1,000,000
Tier 3 - 80/20	909,120	227,280	1,136,400
Tier 4 - 50/50	-	-	-
Totals	1,989,120	227,280	2,216,400
Economic effect	295,880	287,720	583,600
Percentage	51%	49%	

V. New Partnership Audit Rules

- **Imputed underpayment modifications**
  - **Recommendation**
    - *The operating agreement should state that each partner's share of the imputed underpayment is adjusted for their respective modifications*
      - There might be situations where partnership tax liabilities are *increased* based on the attributes of particular partners (e.g., composite state returns?), so the applicable provisions of the operating agreement should account for both positive and negative modifications
    - The adjustments to relative distributions are probably implicit in the provision recommended above (requiring a "proper allocation" of the imputed underpayment), but an explicit statement is prudent

V. New Partnership Audit Rules

- **Conflict of interests in partnership tax audits**
  - **Common fact pattern**: the sponsor is designated as the partnership representative, and has a subordinate economic interest
  - **Issues**:
    - If tax audit adjustments exclusively or predominantly impact investors' priority returns, the sponsor does not have a direct economic incentive to vigorously contest the adjustments
    - If tax audit adjustments exclusively or predominantly impact the sponsor's subordinate returns, the sponsor might have an economic incentive to contest the adjustments at the expense of the investors
    - Same potential conflicts of interest with respect to pursuing modifications, pull-in procedures, and push-out elections

V. New Partnership Audit Rules

- **Conflict of interests in partnership tax audits**
  - **Example 3**: Same facts as Example 2, except
    - The gain is reclassified as short-term capital gain
    - The partnership operating agreement provides for a proper allocation of the imputed underpayment, taking into account modifications attributable to each partner
    - The sponsor is a corporation, and the IRS determines that there is no imputed underpayment with respect to the sponsor's allocable share of the adjustments (because there is no preferential rate on long-term capital gains of corporations)
    - The result is the sponsor (if named as the partnership representative) has no interest in expending partnership cash to contest the audit adjustments

V. New Partnership Audit Rules

- **Conflict of interests in partnership tax audits**
  - **Recommendation**
    - *If representing an investor, make sure the operating agreement gives the investors*
      - *Notice rights*: regarding material communications in partnership audit and appeal proceedings (including notice of commencement of the audit, any notice of proposed audit adjustments, and any appeals)
      - *Participation rights:* to participate in (and control if appropriate) audit and appeal proceedings where the investor has a material interest (or where the partnership representative's economic interest is not material or not proportionate to the investors' interests)
      - *Elections rights:* to have input into, or control, decisions regarding elections related to partnership audits, including with respect to amended returns or pull-in procedures, other modifications, or a push-out election
    - An "investor representative" procedure might be used if there are multiple investors with similar economic interests in audits

V. New Partnership Audit Rules

- ***Summary***

  Several aspects of the new partnership audit rules require special attention by partnerships with multi-tier distribution waterfalls:

  – Imputed underpayment economic effects

  – Funding imputed underpayments

  – Modifications of imputed underpayments

  – Conflicts of interest in partnership tax audits

VI. Q & A

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