Allocations and Distributions in Partnership Agreements

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Objectives

- Distinguish *allocation-based agreements* from *distribution-based agreements*, and understand their relative merits
- Distinguish *layered allocations* from *target allocations*
- Understand the current preference for distribution-based agreements using target allocations
- Identify and explain some of the book and tax accounting issues associated with distribution-based agreements using target allocations

Terminology

- **Distribution provisions**
  - Govern when and in what priorities and shares ***cash*** is distributed to partners
  - Distributions are generally not taxable
- **Allocation provisions**
  - Govern how ***book profit or loss*** is allocated among the partners for capital account purposes
  - Taxable income or loss generally follows book profit or loss
  - Partners pay tax on taxable income allocations
- **Partner**
  - Includes a member in a limited liability company that is classified as a partnership for federal income tax purposes

Terminology

- **Capital Accounts**
  - *"Book" capital accounts*: are based on the accounting rules in Section 704(b) regulations (a/k/a "Section 704(b) capital accounts")
    - Contributed property is recorded at FMV when contributed
    - The carrying value of assets can be adjusted to FMV on certain events
    - Includes tax-exempt income and non-deductible expenses
  - *GAAP capital accounts*: are based on owner's equity as computed for financial accounting purposes (in accordance with GAAP)
  - *Tax capital accounts*: are based on tax basis of partnership assets and generally correlates to the partner's tax basis for his partnership interest ("outside basis") excluding partnership debt

This presentation focuses on Section 704(b) capital accounts

Two Types of Agreements

- **Allocation-based agreements**
  - ***<u>Allocation provisions control economics</u>***
  - First allocate income and loss to capital accounts according to detailed allocation rules
  - Then liquidate according to capital accounts
    - Operating cash flow distributions are often made according to specified percentage interests, but liquidating distributions are always made in proportion to capital account balances
- **Distribution-based agreements**
  - ***<u>Distribution provisions control economics</u>***
  - Distribute cash according to detailed rules, and allocate income or loss to track the expected distributions
    - Layered allocations, or
    - Target/forced allocations, or
    - Combination/hybrid (target allocations only on liquidation)

Two Types of Agreements

- **Early practice**
  - Initially, allocation-based agreements were the norm
    - Allocation-based agreements always use layered allocations
  - As economic deals got more complex (IRR returns, variable carried interests, etc.), allocation-based agreements created problems
    - Errors in drafting complex layered allocation provisions could lead to unintended economic results
    - Even if the drafting was correct, accounting errors could produce untended economic results
    - Other disparities between cash distributed and capital accounts
    - Special allocations increase complexity and opportunities for errors

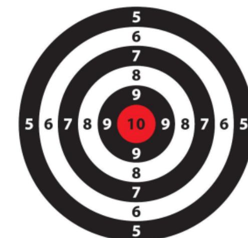
Two Types of Agreements

- **Modern practice**
  - Partners and lawyers responded by moving to distribution-based agreements
  - Initially, distribution-based agreements used layered allocations that traced the expected cash distributions
    - Same economics/allocations disparity risks, but it was an accounting problem not a deal economics problem
  - Target allocations were invented to eliminate the need to draft complex layered allocation provisions
    - The accountants just "plug" to the economics as necessary
  - Distribution-based agreements with target allocations are now the norm in complex deals

Layered vs. Target Allocations

- **Layered allocations**
  - Compute each partner's share of profit and loss directly based on specific allocation rules
  - Generally results in "layers" of allocations (see example at slides 18-21)

- **Target allocations**
  - Compute each partner's share of profit and loss indirectly based on the partner's distributive share of total partnership capital (target capital account)
  - Each partner's profit or loss is the amount needed to cause the partner's ending capital to equal the target capital account (i.e., hypothetical liquidating value)
  - The target capital account balance is reduced by minimum gain (i.e., deductions and loss funded by debt)



Layered vs. Target Allocations

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

Ex. 1 - Allocation-Based Agreement

- **Facts**
  - M contributes $1MM cash, and S contributes $0, to Newco
  - Newco buys $1MM assets for a widget manufacturing business to be managed by S
  - No debt
- **Economic deal**
  - First, 10% preferred return to M
  - Next, return of M's capital
  - Next $1MM, 80% to M and 20% to S
  - Residual, 50% to M and 50% to S

Ex. 1 - Allocation-Based Agreement

- **Distributions**
  - Operating cash is distributed according to the economic deal
  - Liquidating distributions are distributed according to the partners' positive capital accounts (maintained according to the Section 704(b) capital account maintenance rules)
    - Note that capital accounts control final distributions, making this an allocation-based agreement
  - The operating agreement contains a qualified income offset in lieu of a deficit restoration obligation (DRO) (see Appendix 1)

Ex. 1 - Allocation-Based Agreement

- **Allocations**
  - a. Profits:
    - (i) *Excess Loss Recapture*: First, to partners in proportion to and to the extent of the excess of (1) the cumulative losses allocated under Section b(v) over (2) the cumulative profits previously allocated under this Section a(i)
    - (ii) *Capital Loss Recapture:* Next, to partners in proportion to and to the extent of the excess of (1) the cumulative losses allocated under Section b(iv) over (2) the cumulative profits previously allocated under this Section a(iii)
    - (iii) *Preferred Return:* Next, to partners in proportion to excess of (1) the sum of (A) cumulative losses under Section b(iii) plus (B) Preferred Return over (2) the cumulative profits previously allocated under this Section a(ii)
    - (iv) *80/20 Allocation:* Next, until the aggregate amount of profits under this Section a(iv) equals the sum of (1) $1MM plus (2) the cumulative losses allocated under Section b(ii), 80% to M and 20% to S
    - (v) *50/50 Allocation:* Thereafter, 50% to M and 20% to S

Ex. 1 - Allocation-Based Agreement

- **Allocations (con't)**
  - b. Losses:
    - (i) *<u>50/50 Profit Chargeback</u>:* First, to partners in proportion to and to the extent of the excess of (1) the cumulative profits allocated under Section a(v) over (2) the cumulative losses allocated under this Section b(i)
    - (ii) *<u>80/20 Profit Chargeback</u>:* Next, to partners in proportion to and to the extent of the excess of (1) the cumulative profits allocated under Section a(iv) over (2) the cumulative losses allocated under this Section b(ii)
    - (iii) *<u>Preferred Return Profit Chargeback</u>:* Next, to partners in proportion to and to the extent of the excess of (1) the cumulative profits allocated under Section a(iii) over (2) the cumulative losses allocated under this Section b(iii)
    - (iv) *<u>Capital Loss</u>:* Next, to partners in proportion to and to the extent of their unreturned capital contributions
    - (v) *<u>Excess Loss</u>:* Thereafter, 50% to M and 50% to S (subject to regulatory prohibition on adjusted capital account deficits)

Ex. 2 - Distribution-Based Agreement

- **Same facts and deal terms as Example 1**
- **Distributions**
  - All distributions are made according to the economic deal
    - Note that capital accounts do not control liquidating distributions, making this a distribution-based agreement
- **Allocations**
  - Net profit or loss is allocated to the members as necessary to cause each member's capital account to equal, as nearly as possible, (i) the amount the member would receive if all Newco assets at the end of the allocation period were sold for cash at their [book values], all Newco liabilities were satisfied according to their terms, and any remaining cash was distributed to the members according to the distribution waterfall, minus (ii) [minimum gain].

IRS Requirements

- **Issue:**
  - Section 704(b) generally says that the allocation provisions in a partnership agreement will be respected if they have "substantial economic effect"
  - If no provisions, or no substantial economic effect, allocations are made according to the partners' interest in the partnership (PIP)
  - Does a target allocation provision have substantial economic effect?
- **Conclusion:**
  - A distribution-based agreement with a target allocation provision will often satisfy the substantial economic effect test (based on the actual effect of the allocations), but in any event should conform to the partners' interest in the partnership (PIP).
  - The technical analysis for this conclusion is in Appendix 1.

Target Allocations – Issues

- **Overview**
  - ***Target allocations are not a cure-all***
  - Target allocations raise a number of issues (as discussed in the following slides), some of which can be addressed by the partnership accountant based on provisions in the partnership agreement, but some of which must be addressed by the partnership's managers and accountant apart from the partnership agreement
  - ***To maintain flexibility to address issues that can't be, or are not, addressed in the partnership agreement, the partnership agreement generally should give the partnership's managers the right to override the allocation provisions as necessary to reflect the partners' relative economic interests in the partnership***

Target Allocations – Issues

- Tax distributions
- Special allocations
- Net versus gross allocations
- Character of allocations
- Section 704(c) allocations (contributed property)
- Reverse Section 704(c) allocations (new partners)
- Stuffing allocations
- Varying distributions for operations versus capital events
- Regulatory allocations and curative allocations
- Section 514(c)(9)(E) (fractions rule)

Target Allocations – Issues

- **Tax distributions**
  - **Issue:** S may be allocated taxable income without any cash distributions. A common solution is to provide for "tax distributions" to the partners to the extent of their tax liabilities
  - Many issues, including:
    - Tax rate (actual versus assumed)
    - Federal versus federal and state taxes
    - Timing of distributions (annual, estimated payment dates, other)
    - Penalties and interest on post-filing adjustments
    - Clawback for subsequent losses, or cumulative calculation
  - ***The partnership agreement should generally treat tax distributions as advances against regular distributions to avoid distorting the intended economics***

Target Allocations – Issues

- **Special allocations**
  - In a distribution-based agreement, special allocations of specific items of income or expense must be grafted into the distribution provisions in order to have any effect
    - It is not sufficient to simply account for the special allocations through the credits or charges to the capital accounts (because the capital accounts don't impact the economic deal)
  - Example: reduction or waiver of management fees for specific investors
    - Handle as a rebate?
    - Treat as a deemed rebate and capital contribution?
    - Special capital calls for the affected item?

Target Allocations – Issues

- **Net versus gross allocations**
  - **Issue:** What do you do if there isn't enough net profit or net loss to fully adjust the capital accounts to the target capital amount?
    - In Example 2, assume LLC has $120,000 of net profit in year 1, and no net profit in year 2
    - Year 1: S is allocated $4,000 of net profit (20% of $20,000 of net profit in excess of X's preferred return); capital accounts match distribution rights
    - Year 2: X's capital account should be increased by $4,000 and Y's capital account should be reduced to zero
      - If the LLC agreement only allocates net profit or net loss, there is no way to balance the capital accounts to the distribution rights in year 2
      - Can the IRS impute a guaranteed payment (capital shift) to M chargeable to S?
      - If the LLC agreement permits allocations of items of gross income and expense, S can be allocated $4,000 of expense items, and M can be allocated $4,000 of income items, to balance the capital accounts in year 2

Target Allocations – Issues

- **Net versus gross allocations (con’t)**
  - Net allocations are typically used rather than gross allocations
    - Imbalances and “capital shifts” are trued up in later years (no imputed guaranteed payments)
  - Hybrid approach: Gross allocations are used only in year of liquidation

Target Allocations – Issues

- **Character of allocations**
  - Target allocations address the ***amount*** of net profit or net loss to be allocated to each partner’s capital account, and are generally silent regarding the ***character*** of the individual items of net profit or not loss to be allocated
  - The default is to allocate to each partner the same share of each item of partnership profit or loss as the partner’s share of the total partnership net profit or net loss*
  - Be alert for situations where this default allocation might not produce intended or equitable results

*** Reg. 1.704-1(b)(1)(vii).**

Target Allocations – Issues

- **Section 704(c) allocations (contributed property)**
  - Tax allocations with respect to contributed property must take into account the difference in the book and tax basis for the property
  - **Traditional method:**
    - First, allocate book basis items with respect to the contributed property to all partners;
    - Second, allocate tax basis items with respect to the contributed property to the non-contributing partners up to their share of book items; and
    - Third, allocate any leftover tax items to the contributing partner
  - **Remedial or Curative Method**
    - Allocate gross or fictional tax items if necessary due to the "ceiling rule"
  - **Issue:**
    - Target allocations do not specifically allocate "book items with respect to the contributed property"

Target Allocations – Issues

- **Reverse 704(c) allocations (new partners)**
  - If capital accounts are "booked up" when a new partner is admitted (or on certain other events), the book up creates a book/tax difference for all existing partnership property, which must be accounted for under Section 704(c)
    - Referred to as "reverse 704(c) allocations" because they relate to existing partnership property rather than contributed partnership property
  - Same issue as with regular Section 704(c) allocations (prior slide): target allocations do not specifically allocate "book items with respect to the contributed property" (which is the starting point for determining Section 704(c) tax allocations)

Target Allocations – Issues

- **Stuffing allocations to departing partners**
  - **Issue:** When a partner is redeemed, the partnership agreement may provide for a disproportionate allocation of net profit (and related taxable income) to the departing partner so that the departing partner's redemption gain is eliminated
    - Similar in effect to a capital shift (guaranteed payment) to the departing partner
  - Stuffing allocations are widely used by securities investment partnerships that do not use mark-to-market accounting, even though the legal authority for the practice is questionable*
  - When used, a stuffing allocation overrides the determination of target allocations for remaining partners and the provisions need to be coordinated

*** Needham, *The Problem With Stuffing Allocations*, 141 Tax Notes 737 (Nov. 18, 2013)**

Target Allocations – Issues

- **Varying distributions for operations and capital events**
  - Some partnership agreements provide for different distribution waterfalls for cash from operations versus cash from capital transactions (including liquidation)
  - For those partnerships, a partner's hypothetical liquidating distribution share will be based on the rules for cash from capital transactions, which will likely will not match the partner's actual share of distributions based on the rules for cash from operations
  - Target capital account allocations might not reflect the "partner's interest in the partnership" and might have to be adjusted

Target Allocations – Issues

- **Regulatory allocations and curative allocations**
  - Regulatory allocations generally apply to items of expense that do not have economic effect (e.g., deductions attributable to nonrecourse debt and partner nonrecourse debt) and corresponding items of income
  - A curative allocation provision is generally included which has the effect of reversing the regulatory allocations (i.e., items of gross income are first allocated to offset regulatory allocations)
  - These allocations override the target allocation provisions; the interaction can be complicated

Target Allocations – Issues

- **Section 514(c)(9)(E) (fractions rule)**
  - If the partnership has tax-exempt investors and the partnership will incur debt to acquire property, the tax-exempt investors may recognize taxable income associated with the debt-financed property
  - To qualify for an exception for real property, among other requirements, the partnership's allocations must have substantial economic effect under Sec. 704(b)(2)
  - This means that the partnership agreement must be an allocation-based agreement and cannot use target/forced allocations

Summary

- Distribution provisions deal with cash (economics); allocation provisions deal with profit and loss (accounting)
- In allocation-based agreements, the allocation provisions control the economics (distributions are determined by capital accounts); in distribution-based agreements, the distribution provisions control the economics (capital accounts do not affect distributions)
- Layered allocations allocate profit/loss to the partners based on specific layers and shares; target allocations allocate profit/loss based on a targeted capital account
  - Both approaches should comply with IRS requirements

Summary

- For “straight up” deals where each partner shares according to contributed cash, an allocation-based agreement with layered allocations is workable
- For more complex deals, current practice prefers a distribution-based agreement using target allocations
- In either case, pay careful attention to deal specific issues, such as tax distributions, special allocations, debt-funded expenses, character issues, etc.
  - *Don’t assume a target allocation provision is sufficient to provide the accountant with authority to resolve all capital accounting issues*

Disclaimer

- This document is not intended to provide advice on any specific legal matter or factual situation, and should not be relied upon without consultation with qualified professional advisors.
- Any tax advice contained in this document and any attachments was not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties that may be imposed under applicable tax laws, or (ii) promoting, marketing, or recommending to another party any transaction or tax-related matter.

Appendix 1 – Substantial Economic Effect Test for Target Allocations

IRS Requirements

- **Section 704(b) – Requirements for Allocations**
  - **General Rule**: A partner's allocations are determined according to the partnership agreement if the allocations in the agreement
    - Have "**substantial economic effect**";
    - Are in accordance with the "**partner's interest in the partnership**"; or
    - Are **deemed** to be in accordance with the partner's interest in the partnership*
  - **Default Rule:** If the general rule does not apply, tax items are allocated according to the **partner's interest in the partnership**
  - **Purpose:** prevent abuse; e.g., allocations of tax-exempt income to taxable partners matched by offsetting allocations of taxable income to tax indifferent partners

*****Only applies to special items such as credits, depletion, nonrecourse deductions, etc.

IRS Requirements

- **Substantial economic effect test**
  - **Two part analysis**
    - Economic Effect
    - Substantiality
  - **Economic effect**
    - Basic test
    - Alternative test
    - Equivalence test
  - **Substantiality**
    - No shifting tax consequences
    - No transitory allocations

IRS Requirements

- **Substantial economic effect test (con’t)**
  - **Basic economic effect test**
    - *Principle*: “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.”
    - *Expressed as a formula:* Contributions +/- allocations = distributions
    - *Three requirements:*
      - Follow capital account maintenance rules
      - Make liquidating distributions according to capital accounts
      - Deficit restoration obligation (“**DRO**”)

IRS Requirements

- **Substantial economic effect test (con't)**
  - **Alternative test for economic effect** (if no DRO)
    - Qualified income offset*
    - No deficit capital account balance
  - **Economic effect equivalence test**
    - An end of year liquidation would produce the same results as under the basic test; a/k/a the "dumb but lucky" test

*** Requires special allocations of gross income and gains if there are specified unexpected adjustments, allocations, or distributions that would create a deficit capital account**

IRS Requirements

- **Substantial economic effect (con't)**
  - The substantial economic effect tests all contemplate an allocation-based partnership agreement, whereby capital accounts control the economics
  - *Distribution-based agreements with target allocations clearly do not satisfy the basic or alternative substantial economic effect tests*
  - But such agreements may satisfy the economic effect equivalence test, or likely are in accordance with the partners' interests in the partnership

IRS Requirements

- **Default rule (partner's interest in the partnership)**
  - A partner's interest in the partnership signifies the manner in which the partners have agreed to share the economic benefit or burden (if any) corresponding to the item being allocated.
  - Takes into account all the facts and circumstances relating to the economic arrangement of the partners
  - Factors include:
    - Relative contributions to the partnership
    - Interest in economic profits and losses
    - Interest in cash flow and other non-liquidating distributions
    - Rights of partners to distributions of capital on liquidation

IRS Requirements

- **Conclusion**
  - *A distribution-based agreement with target allocations should be respected under the Section 704(b) regulations. In any event, it should produce the same results as the regulations' default rule (i.e., partners' interests in the partnership).*