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Drafting Cash Distribution and Tax Allocation Provisions

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Drafting Cash Distribution and Tax Allocation Provisions

The purpose of this outline is to give the reader an understanding of the methods, issues, and traps in partnership[1] distribution and allocation provision drafting. While this is an eminently practical goal, it requires an understanding of some relatively technical tax concepts lurking under the surface of partnership distribution and allocation provisions. In discussing these technical tax topics, this outline strives to impart the understanding necessary to draft such provisions. It is not intended to be a complete exploration of the subject.

After gaining an understanding of the technical tax issues under the surface, this outline turns to distribution provisions. Distribution provisions often take a "waterfall" or "layer cake" approach, but there are also important concepts hidden in the preamble to the waterfall. This outline starts with the distribution base—the amount to be distributed—discussing common ways of defining or splitting that distribution base. This outline also discusses a partner's "guaranteed payments" and how they can interconnect partnership distributions, as well as issues relating to distribution timing, optionality, and advances against future distributions.

Following the discussion of distributions, this outline discusses the three most common methods for drafting allocation provisions: mirroring the distribution provision, allocating net profits and reversing with net losses, and finally target allocations. Although each approach has its advantages and disadvantages, and each has its appropriate place, this outline generally takes the thesis that the approaches represent a more complex improvement on the prior approach, with mirroring the distribution provision as the simplest starting point, and target allocations representing the most powerful but most complex option.

This outline closes with a brief discussion of tax concepts related to the distribution and allocation provisions. First, there is a discussion of the tax capital account management rules; then, a discussion of disguised sale and compensation, with a primer on identifying them and options for addressing them.

Throughout, this outline presents sample partnership agreement language. This language is intended to exemplify the principle involved and is taken from actual partnership agreements, but is not intended to be applicable in all situations.

[1] This outline will refer to entities as "partnerships" based on their federal tax status, not their form under state or foreign business entity law. For this purpose, "partnership" includes partnerships (whether general, limited, or limited liability), limited liability companies, eligible electing foreign entities, and other entities treated for federal tax purposes as a partnership. "Partners" refers to the equity owners, whether they are partners, members, or shareholders. "Partnership agreement" refers to the entity's governing documents, whether it is called a partnership agreement, a company agreement, regulations, bylaws, or something else. What constitutes a partnership agreement is discussed in part I.B. The governing person of a partnership is referred to as the "general partner" but also applies to managers, managing members, managing partners, directors, or trustees.

I. Partner's Distributive Share

To understand partnership agreement tax allocation provisions and their relationship to the cash distribution provisions, one first needs to understand how a partner's distributive share is defined. Section 702 of the Internal Revenue Code of 1986 ("IRC") requires each partner to include in his taxable income his "distributive share" of the partnership's income, gains, losses, deductions, and credits. It is important to note that this is the partner's distribut*ive* share and not its distribut*ed* share. The partners are allocated their distributive share of the tax items of the partnership whether or not they receive distributions from the partnership. Partnership agreement tax allocation provisions define this "distributive share," usually in concert with the economic distribution and liquidation provisions. The distributive share informs and is informed by every distribution waterfall stage and every allocation clause. The authority behind a partner's "distributive share" is IRC § 704(b), but the descriptive interpretation is in Section 1.704-1 of Title 26 of the Code of Federal Regulations ("Treas. Reg.").

> ***IRC §704(b)*** *Determination of distributive share.--A partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) shall be determined in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances), if--*
>
> *(1) the partnership agreement does not provide as to the partner's distributive share of income, gain, loss, deduction, or credit (or item thereof), or*
>
> *(2) the allocation to a partner under the agreement of income, gain, loss, deduction, or credit (or item thereof) does not have substantial economic effect.*

A. Partners' Interest in the Partnership

> ***Treas. Reg. 1.704-1(b)(1)(i)*** *Basic principles. Under section 704(b) if a partnership agreement does not provide for the allocation of income, gain, loss, deduction, or credit (or item thereof) to a partner, or if … such allocation does not have substantial economic effect, then the partner's distributive share of such income, gain, loss, deduction, or credit (or item thereof) shall be determined in accordance with such partner's interest in the partnership*

The default rule of a partner's distributive share is that it is based on that "partner's interest in the partnership" ("PIP") unless the partnership agreement raises the partners out of PIP. PIP is defined under Treas. Reg. 1.704-1(b)(3) to be determined either under a loosely-described facts-and-circumstances test or under a "measured economic effect" test.

1. Path 1: Facts & Circumstances

If the partnership agreement is entirely silent on the topic of the partners' distributive shares, then PIP is based on a four-factor facts-and-circumstances test.

(viii) That partnership distributions, allocation or control of partnership operations is designed to effect an exchange of the burdens and benefits of ownership of property;

(ix) That the transfer of money or other consideration by the partnership to the partner is disproportionately large in relationship to the partner's general and continuing interest in partnership profits; and

(x) That the partner has no obligation to return or repay the money or other consideration to the partnership, or has such an obligation but it is likely to become due at such a distant point in the future that the present value of that obligation is small in relation to the amount of money or other consideration transferred by the partnership to the partner.

IRC § 704(c)(2)(B) also describes a disguised sale scenario where a partnership distributes previously-contributed property within 180 days (or the same tax year) of the distribution of like-kind property to the originally contributing partner. These will be examined as potential like-kind exchanges between the two partners.

Disguised compensation occurs when:

IRC § 707(a)(2)(A) *(i) a partner performs services for a partnership or transfers property to a partnership,*

(ii) there is a related direct or indirect allocation and distribution to such partner, and

(iii) the performance of such services (or such transfer) and the allocation and distribution, when viewed together, are properly characterized as a transaction occurring between the partnership and a partner acting other than in his capacity as a member of the partnership

Unfortunately, the IRS has not promulgated final regulations addressing disguised compensation. However, under the substance-over-form doctrine, it would be treated as if the distribution were compensation for services instead of a distribution to a partner.

Table of Contents