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Target Allocations for the Rest of Us

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TARGET ALLOCATIONS:
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I. Introduction.

It is commonplace for partnerships to use target allocations in order to ensure that partners receive the economic deal they bargained for.[1]

Partnerships using target allocations tie allocations of income and loss to the partnership agreement's distribution provisions—sometimes referred to as the distribution waterfall—so that liquidating distributions do not depend upon the partnership's capital accounts. Allocation rules found in the tax regulations, on the other hand, use layered and complex allocation provisions that tie allocations of income and loss to the partnership agreements capital accounts, because liquidating distributions are required to match partners' positive capital account balances and thus secure economic significance.[2]

Target allocations attempt to meet the tax regulations obsession with economic substance through capital accounts halfway by comparing each partner's partially adjusted capital account balance to the amount distributable to that partner under the distribution allocation provisions assuming a hypothetical sale of partnership assets followed by a mock liquidation and distribution of the proceeds. Any gap between the two is filled by partnership profits or losses, as needed.[3]

But target allocations do not liquidate in accordance with positive capital account balances. They liquidate in accordance with the agreements' distribution provisions where cash-driven priorities such as return on capital, return of capital, and other economic priorities are reflected. This attempts to ensure that the partners receive their bargained for business deal.[4]

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[1] Report on Partnership Target Allocations, Report No. 1219, New York State Bar Association Tax Section, Sept. 23, 2010, p.2 (the "NYSBA Report"). References to partnerships and partnership agreements include limited liability companies ("LLC" or "LLCs") taxed as partnerships for federal tax purposes and their company agreements. References to partner or partners include members in LLCs.

[2] Treas. Reg. § 1.704-1(b)(2)(ii)(b)(2). All references to "Section," "Sections," "§" or "Code" in this report are to sections of the Internal Revenue Code of 1986, as amended, or the Treasury Regulations promulgated thereunder unless otherwise indicated.

[3] NYSBA Report, p. 1.

[4] One way to spot whether an agreement is a target allocation agreement is to determine whether the partners receive liquidating distributions in accordance with their positive capital accounts balances. Examining the terms of the termination and liquidation provision contained in an agreement should answer that question. If the agreement states that once the creditors are fully paid, any remaining assets are to be distributed to the partners in accordance with their positive capital account balances, the agreement follows the traditional regulatory approach. Should, however, any remaining assets after the payment of creditors are to be distributed in accordance with the distribution waterfall, the agreement follows the target allocation approach. Be aware, however, that some rare agreements are hybrid agreements whereby they appear to follow the distribution provisions yet liquidate in accordance with capital accounts. These are not truly target allocation agreements as referred to herein.

In fact, the distribution provisions control cash distributions made during the partnership's operating life as well as when the partnership liquidates. Cash is distributed to the partner entitled to it under the business deal if the distribution provisions are correctly drafted.[5]

Partners view target allocation agreements as cash-driven and more readily understandable.[6] And they believe that their economic deal is respected because partnership cash (and property) distributions end up in the intended partners' hands. Whereas suspicion abounds, and rightfully so, that regulatory allocations and distributions don't always match the partners' business deal. Many taxpayers prefer economic certainty and are willing to live with tax uncertainty—target allocations have not been approved or rejected by the Internal Revenue Service (hereinafter the "Service").

My purpose is to explain how we got to where we are today through examining the genesis of the current "safe harbor" regulations, their problems, how target allocation provisions work to address those problems, and when target allocations don't work. As previously stated, the underlying driver of regulatory allocations is recording cash contributions and distributions plus profits and losses in a partner's capital account and then liquidating based on the balance; whereas the underlying driver of target allocations is the distribution allocation provisions, which controls who receives cash and property during the partnership's life or upon liquidation. My wish is not to persuade you that one approach is superior to the other because both have their place. Furthermore, this is not a complete treatment of either regulatory or target allocations meant for the experienced partnership tax professional. This is an overview of target allocations juxtaposed against regulatory allocations meant for business lawyers who might find a summary on this subject useful.

II. How Did We Get Here?

Tax shelter activity was commonplace during the 1970s and the 1980s and threatened the tax system. Even though the Tax Reform Act of 1976 curtailed many of the known tax shelters at that time through the enactment into the Code of anti-shelter provisions, that wasn't enough.[7] "[N]o sooner were the apparent leaks in the dike plugged than new ones appeared."[8] Even though economic concepts recognizable today were used by the Internal Revenue Service and the courts during that time period, more was needed.[9] That effort took the shape

[5] The terms "distribution provision" and "cash distribution provision" as used in this paper are meant to mean the same thing and refer to the distribution of cash and property under a partnership agreement's distribution provision.
[6] These are also referred to as "forced allocations" or "targeted allocations."
[7] Dennis J. Ventry, Jr., "Tax Shelter Opinions Threatened the Tax System in the 1970s," Tax Analysts, May 15, 2006. Reference to the Code in this sentence is a reference to the Internal Revenue Code of 1954, as amended.
[8] Jerome Kurtz, "Kurtz on "Abusive Tax Shelters," Tax Notes, Feb. 18, 1980. Jerome Kurtz was Commissioner of Internal Revenue from 1977 until 1980. During that time, he launched a crackdown on abusive tax shelters by both corporations and individuals.
[9] *See, e.g.*, Orrisch v. Commissioner, 31 A.F.T.R. 2d 73-1069 (9th Cir. 1973), *aff'g* 55 T.C. 395 (1970). Curiously, one commentator may have presaged the abandonment of capital accounts as a necessary tool in determining economic effect. He observes that courts and commentators of the time have "[the] unfortunate tendency to assume that an allocation has at least some economic effect if it is reflected in the partners' capital accounts." He goes on to state that Orrisch, "the grand old case on partnership allocations . . . illustrates one critical point that cannot be overemphasized: the partners' capital accounts may have no economic significance." D.J. Weidner, Partnership Allocations and Capital Accounts Analysis, 42 Oh.St.L.J. 467, 470 (1981). Modern day target allocation enthusiasts appear to hold similar views by relegating capital accounts to necessary boiler plate language needed only to support—after the fact—that a partnership's distributions are made in accordance with the alternate test for

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