KIRKLAND & ELLIS

PRESENTATION TO: UNIVERSITY OF TEXAS 71ST ANNUAL TAXATION CONFERENCE

Deceptively Simple: Targeted Allocations in Private Equity Deals

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Partnership Allocations

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Key Terminology

- Cast of characters
  - Fund
  - Investors / Limited Partners (“LPs”)
  - Sponsor / General Partner (“GP”)
  - Principals / GP Members
- Waterfall and related concepts
  - Lead-in (All-Partner vs. Partner-by-Partner)
  - Return of Capital (European vs. American)
  - Preferred Return / Hurdle (Interest equivalent, IRR, etc.)
  - Carried Interest / Carry / Promote
  - Clawback
- Distributions vs Allocations

Partnership Allocations – Underlying Principles

- ***Key point***: Partners’ recognition of income, gain, loss, etc. is not tied to cash – can have tax without cash or cash without tax
- Goal is for allocations to be made consistently with “partners’ interests in the partnership,” potentially via “substantial economic effect”
  - “Economic effect” = Allocations must reflect the economic entitlements of partners and follow special accounting rules
  - “Substantial” = Anti-abuse rule that polices tax-motivated special allocations
- Starting point: capital contributions and distributions are credits/debits, respectively
  - Realization transactions and “book-up” events (rare in closed-end funds) result in allocable items
- Tax items arise in recognition transactions; “tax follows book”

Interaction Between Capital Accounts and Partner Economics: Allocation-Driven Agreements

- Look for the liquidation provision. Does it say liquidating distributions are made "in accordance with the provisions of [the waterfall section]" or "in accordance with positive Capital Account balances"?
- Distribution-driven agreements
  - Much more common
  - Liquidation based on distribution waterfall; may satisfy "economic effect equivalence" under 1.704-1 Regs
  - Allocation provision pushes allocable items to Partners so as to match their capital account balances with their rights/obligations upon liquidation (as calculated by reference to capital account valuations)
  - Economic rights are generally dictated by the distribution waterfall
  - Greater economic certainty; potential tax uncertainty
- Allocation-driven agreements
  - Liquidation based on capital account balances
  - Allocation provisions are generally independent of distribution waterfall
  - Economic rights are ultimately dictated by capital account balances (and, indirectly, allocations to capital accounts)
  - Arguably necessary for certain arrangements; less economic certainty
  - Much more labor-intensive, especially for tax attorneys
- Some hybrids exist (e.g., liquidate based on capital accounts, but force amendments if results would differ)

Sample Allocation Language: Distribution-Driven LPA

- Items of Partnership income, gain, loss, expense or deduction for any fiscal period shall be allocated among the Partners in such manner that, as of the end of such fiscal period and to the greatest extent possible, the Capital Account of each Partner shall be equal to the respective net amount, positive or negative, that would be distributed to such Partner from the Partnership or for which such Partner would be liable to the Partnership under this Agreement, determined as if, on the last day of such fiscal period, the Partnership were to (a) liquidate the Partnership's assets for an amount equal to their book value (determined according to the rules of Treas. Reg. §1.704-1(b)(2)(iv)) and (b) distribute the proceeds in liquidation in accordance with [Liquidation Provision / Distribution Waterfall].
- References to "minimum gain" sometimes included
- Some regulatory allocation language often included

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