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Section 704, Targeted Allocations and the Distribution Waterfall: Overcoming Challenges Absent IRS Guidance

THURSDAY, JULY 16, 2020, 1:00-2:50 pm Eastern

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Section 704, Targeted Allocations and the Distribution Waterfall

July 16, 2020

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Section 704(b), Targeted Allocations and the Distribution Waterfall

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Date: July 16, 2020

Allocations

One of the key benefits of a partnership is the flexibility in allocating partnership items among the partners.

Allocations of a partner's distributive share of partnership income, gain, loss, deductions or credit will be respected if they

(1) are either in accordance with the partners' interests in the partnership or

(2) if they have substantial economic effect.

<u>Allocations are not the same as distributions</u>.

Partners' Interest in the Partnership

Allocations are generally in accordance with the partners' interests in the partnership if all allocations are being made in accordance with the respective contributions of the partners.

For example, if A and B each contributed $100, allocations would be in accordance with the partners' interests in the partnership if all partnership items are shared 50-50.

Liquidating distributions can be made in accordance with the partners' respective interests in the partnership.

Substantial Economic Effect

AB is a partnership that owns 3 properties. All income allocated 50% to A, except 60% of income from property 1 is allocated to A. This is a special allocation.

Special allocations will be respected if they have substantial economic effect. Substantial economic effect is a <u>safe harbor</u>.

Two part analysis. Allocations must

(1) Have economic effect; and

(2) The economic effect must be substantial.

Economic Effect

General principle: If there is an economic benefit or burden that corresponds to an allocation, the partner to whom the allocation is made must receive the economic benefit or burden.

More simply, if a partner gets the benefit of an allocation of $100 of tax loss, the partner must suffer the $100 economic loss. If a partner suffers the burden of $100 of tax gain, the partner must get the $100 of cash.

This is accomplished by maintaining capital accounts and liquidating in accordance with those accounts.

Basic Test for Economic Effect

There are three requirements to satisfy the basic economic effect test:

(1) Capital account requirement

(2) Liquidation requirement

(3) Deficit make up requirement

Capital Account Requirement

To have economic effect, the partnership must maintain its capital accounts in accordance with the rules of Reg. §1.704-1(b)(2)(iv).

Generally, this is accomplished with a provision in the partnership agreement stating that "a capital account will be established and maintained for each partner in accordance with Treasury Regulation §1.704-1(b)(2)(iv)."

What does this do? A partner's capital account tracks and reflects the partner's equity investment in the partnership.

Capital Account Maintenance Rules

A partner's capital account equals

- FMV of contributions
- Plus allocable share of partnership income
- Less FMV of distributions
- Less allocable share of partnership loss

Partnership liabilities generally are not taken into account in calculating capital account balances.

Liquidation Requirement

For economic effect, liquidating distributions to the partners must be made based on positive capital accounts. In other words, no waterfall distributions.

If allocations have gone awry, positive capital account balances will not be the same amount as what would be received under the waterfall distributions. Consider including a savings clause in the partnership agreement to avoid/minimize this risk.

Deficit Make Up Requirement

If a partner has a deficit in his capital account upon liquidation of the partnership, the partner must have an unconditional obligation to restore the deficit. This deficit restoration obligation ("DRO") may be provided for in the partnership agreement or by state law.

A DRO may come from a partner contributing a promissory note to the partnership or having an obligation (whether imposed by the partnership agreement or state law) to make subsequent contributions to the partnership.

A partner can have a limited DRO.

Example

A and B contribute $100 each to AB partnership. The partnership agreement provides that 60% of partnership items are allocated to A and 40% are allocated to B. AB has a $200 loss.

	A's CA	B's CA
Contribution	100	100
Income	(120)	(80)
	(20)	20

For the entire allocation to have economic effect, A must have a DRO. Otherwise, B is bearing the economic risk for $20 of the losses.

Planning Opportunity

Treas. Reg. §1.761-1(c) provides a “partnership agreement” can be modified or amended with respect to a taxable year after the close of the taxable year, provided the amendment occurs on or before the due date for the partnership return (without extension).

This gives partners a planning opportunity to amend how they allocate income and losses after the close of the year. In particular, to provide for a limited DRO to the extent necessary to support a loss allocation.

Alternate Test for Economic Effect

(1) Capital account requirement.

(2) Liquidation requirement.

(3) Partnership agreement has a qualified income offset ("QIO") provision. The QIO must require that any partner with an unexpected negative capital account be allocated all of the next items of partnership income so as to eliminate the negative balances as quickly as possible.

(4) The allocation does not create or increase a deficit in a partner's capital account in excess of the partner's obligation to restore a deficit.

Substantiality

The economic effect of an allocation is substantial if there is a reasonable possibility that the allocation will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences.

In short, an allocation lacks substantiality if the allocation has favorable tax consequences to one partner without corresponding detrimental tax consequences to the other partners and no overall change on the partners’ capital accounts.

Substantiality

If the only effect of an allocation is to reduce taxes without substantially affecting the partners’ pre-tax distributive shares, the economic effect is not substantial.

Substantiality

Even if the general rule is satisfied, the economic effect is not substantial in the following cases:

(1) Shifting Tax Consequences

(2) Transitory Allocations

(3) After-Tax Effect

Shifting Tax Allocations

Occurs if there is a strong likelihood that:

(1) the net increases and decreases that will be recorded in the partners' respective capital accounts for such taxable year will not differ substantially from the net increases and decreases that would be recorded in the partners' capital accounts if the allocations were not contained and

(2) the total tax liability of the partners will be less than if the allocations were not contained in the partnership agreement (taking into account the tax consequences that result from the interaction of the allocation with the partner's tax attributes even if unrelated to the partnership).

Example

A and B are equal partners, but A is a tax exempt entity. AB has $100 of ordinary income and $100 of tax exempt income.

The partnership agreement allocates A the $100 of ordinary income and B the $100 of tax exempt income. The economic effect to both partners is the same, but the total tax liability for the partners is $0. Without the special allocation, the total tax liability would be $17.5 ($50 x 35%*).

This allocation lacks substantiality under the shifting tax consequences rule.

*For purposes of this webinar, the assumed tax rate is 35%.

Shifting Allocations

Exception: Value equals basis rule.

A partnership's assets are irrebuttably presumed to have a value equal to their basis (or book value if different from basis).

So, even if there is appreciated or depreciated property in the partnership that could be used to make future allocations, the appreciation or depreciation is ignored.

Transitory Allocations

If a partnership agreement provides for a possibility that one or more allocation ("original allocation") will be largely offset by one or more allocation ("offsetting allocation") and there is a strong likelihood that:

(1) the net increases and decreases that will be recorded in the partners' respective capital accounts for such taxable year will not differ substantially from the net increases and decreases that would be recorded in the partners' capital accounts if the allocations were not contained and

Transitory Allocations

(2) the total tax liability of the partners will be less than if the allocations were not contained in the partnership agreement (taking into account the tax consequences that result from the interaction of the allocation with the partner's tax attributes even if unrelated to the partnership.)

Example

A and B are equal partners, but A has $100 of NOLs that are expiring in the next 2 years. AB has $50 of income each year. AB allocates all $100 of income to A in years 1 and 2, and then $100 of income to B in years 3 and 4. Thereafter, income is shared equally.

The economic result is unchanged by this special allocation, but the allocation allows A to take advantage of expiring NOLs. The total tax liability is $17.5 ($50 x 35%), instead of $52.5 ($150 x 35%).

This is a transitory allocation and lacks substantiality.

Transitory Allocations

Exceptions:

- Value equals basis rule.
- 5 year rule: If at the time of allocation, there is a strong likelihood that the original allocation will not be largely offset within 5 years, presumption that economic effect of allocation is not transitory.
- Risky ventures. Because a risky venture is speculative in nature, there is not a strong likelihood that the offsetting profits/income will ever materialize.

After-Tax Rule

An allocation does not have substantial economic effect if, at the time the allocation is added to the partnership agreement,

(1) the after-tax economic consequences of at least one partner may be enhanced compared to such consequences if the allocation were not contained in the partnership agreement, and

(2) there is a strong likelihood that the after-tax consequences of no partner will be substantially diminished compared to the consequences if the allocation were not in the partnership agreement.

Example

Same as prior example, but AB allocates $90 of income to A in years 1 and 2, and $110 to B in years 2 through 4.

This allocation passes the other two tests, because there is a material effect on capital accounts (A gets $10 less). But, on an after-tax basis, A's economic position is improved, and B's economic position is not substantially diminished (it is actually better).

	A		B	
	Tax	After-Tax	Tax	After-Tax
With	$0	$90	$38.5	$71.5
W/O	$17.5	$82.5	$35	$65

This allocation violates the after-tax rule and lacks substantiality.

After-Tax Rule

The focus of this rule is on after-tax consequences, not pre-tax capital accounts. Thus, you cannot avoid lack of substantiality by using an unequal number of years.

Exceptions:

- Value equals basis rule.
- Risky venture.

No Substantial Economic Effect

If no substantial economic effect, a reallocation will occur in accordance with the partners' interest in the partnership. Presumption that partners share per capita (i.e., 50-50 if 2).

Factors to consider in rebutting this presumption:

- the partners' relative contributions to the partnership;
- the interests of the partners' in economic profits and losses (if different from taxable income and loss);
- interests in cash flow or other nonliquidating distributions; and
- rights to distribution on liquidation.

Problems with This Approach

Because substantial economic effect requires liquidation in accordance with positive capital account balances, allocations, rather than distributions, govern the economics. If the allocations are wrong, this can lead to a difference economic result than the partners anticipated. Consider instead:

- Targeted Allocations, where <u>distributions</u> are king.
- Savings Clause

  Except with respect to allocations required to be made under [Regulatory Allocation Provisions], notwithstanding any other provision of this Agreement to the contrary, any Profits or Losses (or items thereof) that are realized in connection with a transaction that causes the dissolution and winding up of the Company or are realized after the dissolution of the Company shall be specially allocated among the Members as required so as to cause the distributions to the Members under [the Liquidation Provision] to be made in the same amounts and proportions as would have resulted had such distributions instead been made under [Cash Flow Distributions].

THANK

YOU

QUESTIONS?

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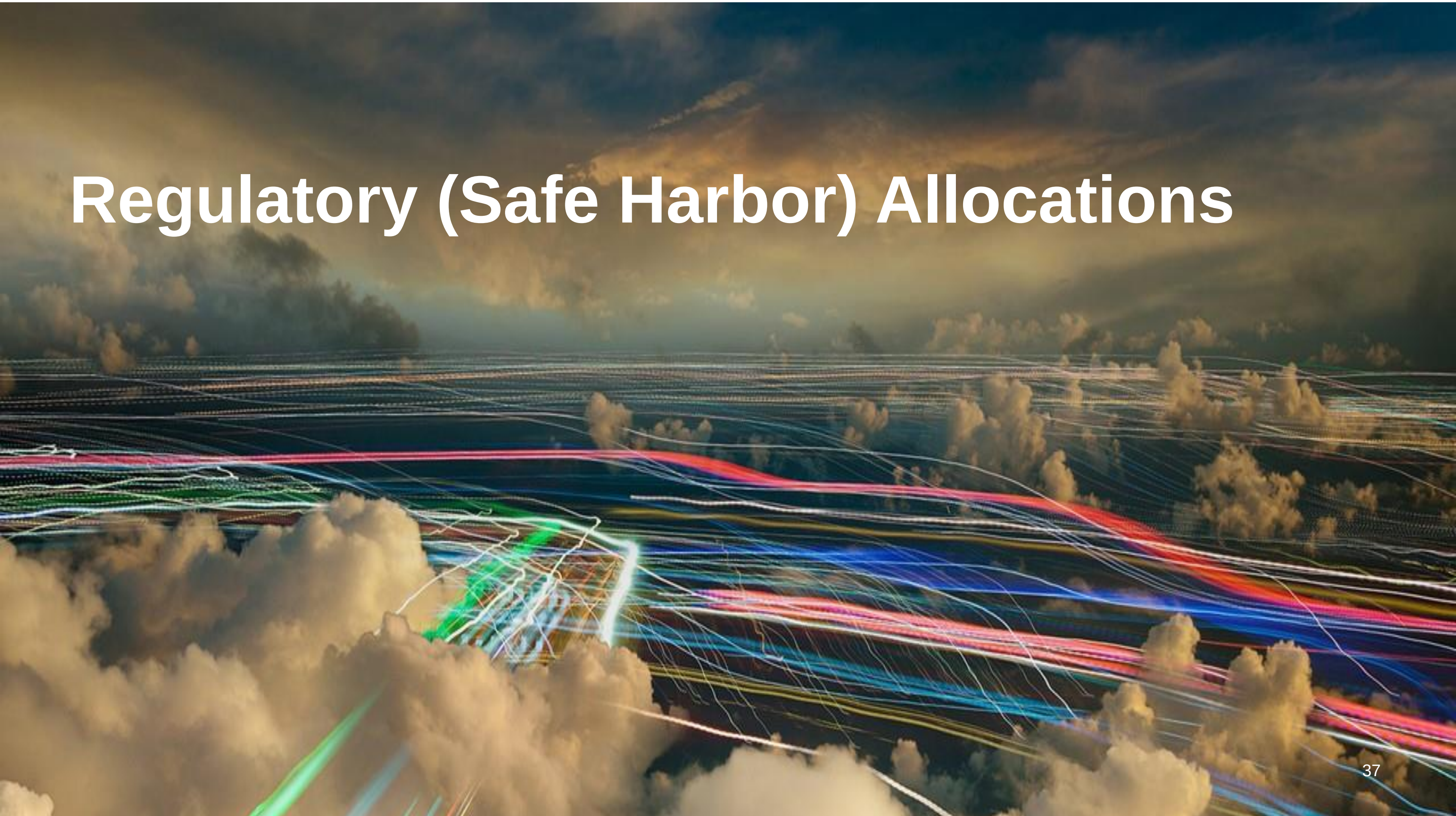
Targeted Allocations and the Distribution Waterfall

Regulatory (Safe Harbor) Allocations



Regulatory Allocations

What are they?

- Establish an ordering (or layers) for allocating partnership profit and losses after considering regulatory allocations.
- Generally, profits are allocated first to offset prior years' losses that eliminated the partners' contributed capital and undistributed profits that were reflected in their capital accounts at the time such losses were allocated, and finally to reflect the manner in which the profits would be distributed if the partnership had cash available to distribute.
- Losses are generally allocated in the reverse order of profits.
- Liquidating distributions generally will be made in accordance with positive capital account balances.
- Allocating profits to “fill-up” waterfall layers

Regulatory Allocations

Common Issues/Considerations

- Often the waterfall provisions are in the distribution section of the agreement.
- There may be a different ways of sharing profits versus sharing losses.
- The allocations may be tied to target capital accounts even though they are layered allocations.

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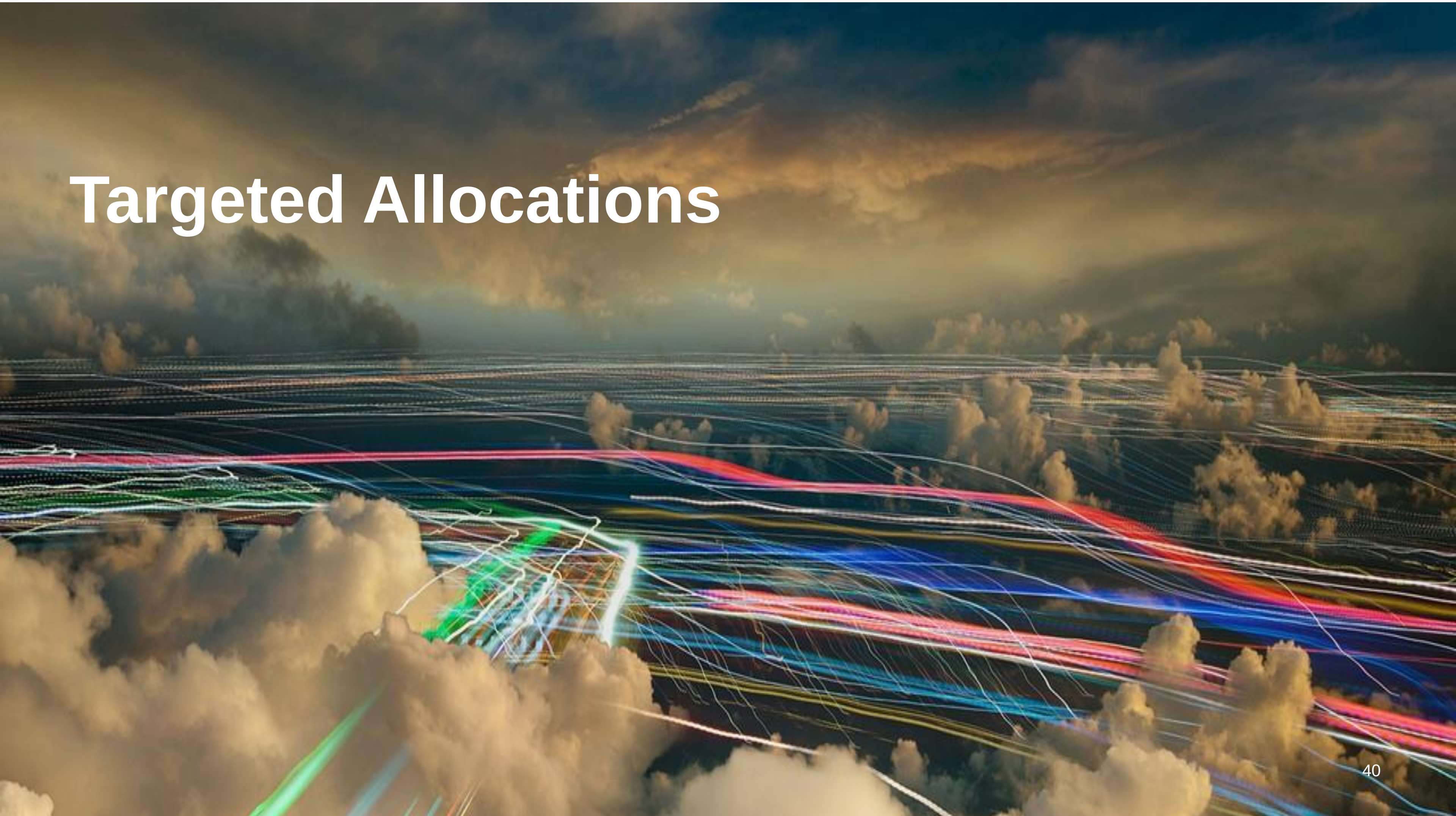
Targeted Allocations



Targeted Allocations

What are they?

- Specifies how cash will be distributed from operations and in liquidation of the partnership.
- Allocates profit/loss so that at the end of the taxable year, each partner’s capital account is equal to the amount that would be distributed to that partner in liquidation if all partnership assets were sold at their section 704(b) book value, less the partner’s share of minimum gain.
- They are distribution driven allocations that have the following characteristics:
  - Liquidation in accordance with the distribution provisions
  - “Plug” income so that capital accounts equal what a partner would receive upon a hypothetical liquidation if the assets of the partnership were sold for their section 704(b) value

Targeted Allocations

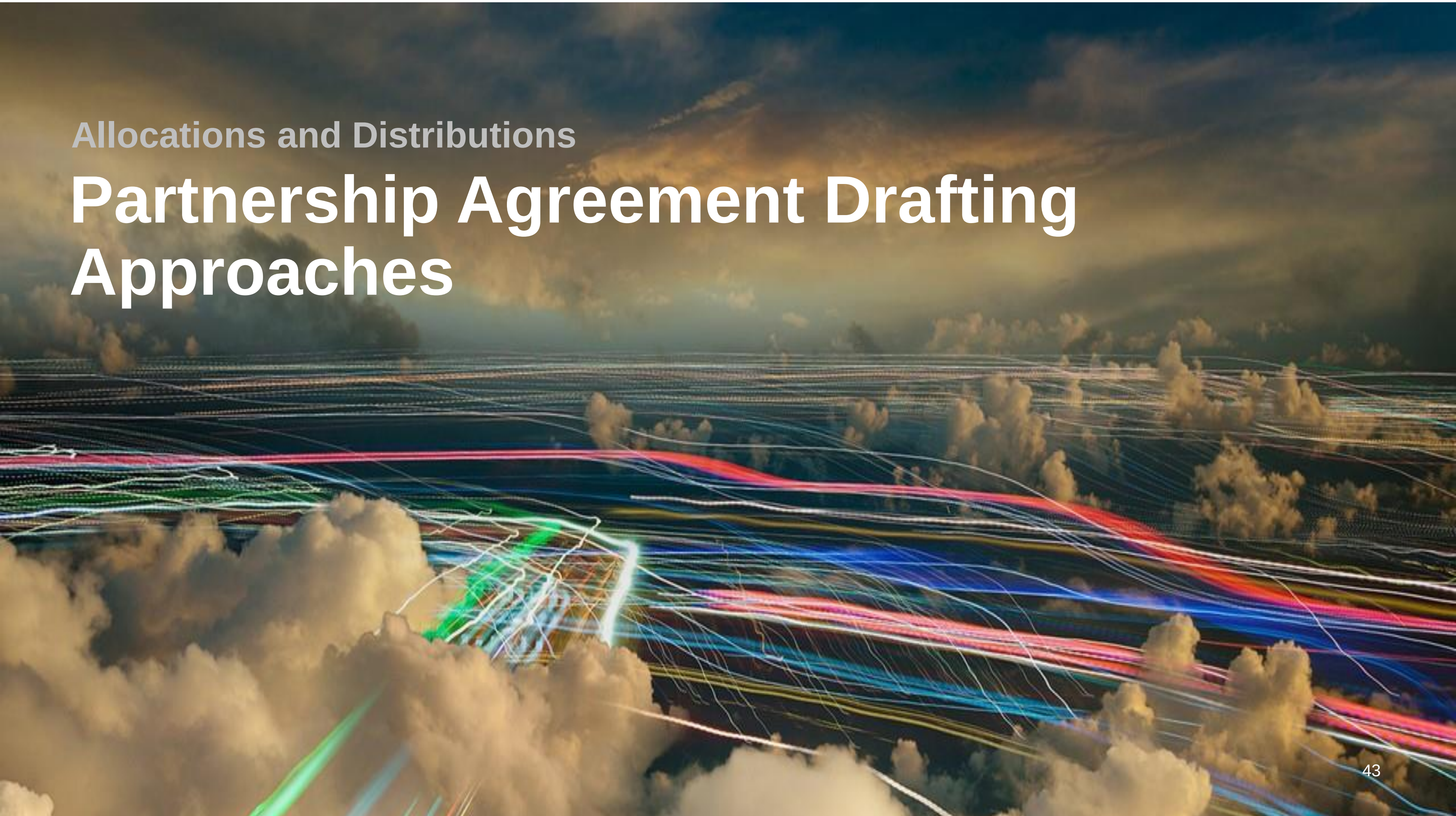
Common Issues/Considerations

- Targeted allocations won't satisfy the substantial economic effect safe harbor because they don't liquidate in accordance with capital account balances.
  - If drafted properly, should be respected under the economic equivalence test or else are consistent with PIP
  - Use of Qualified Income Offset provisions
  - Impact of current tax distributions
  - Impact on statutory allocations
  - Impact of revaluation events

- Targeted allocations may create taxable capital shifts

Allocations and Distributions

Partnership Agreement Drafting Approaches



Partnership Agreement Drafting Approaches

- **Allocation Driven**
  - Upon liquidation, distributions are made to the partners based on their capital account balances
  - Referred to as "allocation driven" because the allocations determine the capital accounts, which ultimately determine the economics
  - Sometimes referred to as "layer cake" allocations because there is often a waterfall – with multiple layers – in the allocation provisions

- **Distribution Driven**
  - Distributions are not based on capital accounts
  - Referred to as "distribution driven" because the allocations do not drive the economics
  - Therefore, partnership items must be allocated in such a way that they track the economics – i.e., the distributions drive the allocations

Partnership Agreement Drafting Approaches

- **Examples of Allocation Driven Agreements**
  - Safe Harbor Agreements
    - Agreements satisfying the test for “economic effect”
    - Agreements satisfying the “alternate test for economic effect”
  - Non-Safe Harbor Agreements That Liquidate by Capital Accounts
    - Agreements that allocate income and loss on a non-section 704(b) basis – for example, agreements that allocate GAAP income and loss, or both realized and unrealized income and loss, determined on a FMV basis

Partnership Agreement Drafting Approaches

- **Examples of Distribution Driven Agreements**
  - Targeted allocation agreements
  - Any other agreement that does not provide for liquidation by capital accounts

Partnership Agreement Drafting Approaches

Layered allocations compute ending capital under the following formula:

beginning capital + contributions + income - distributions - loss = ending capital

Targeted allocations plug income under the following formula:

target ending capital - [beginning capital + contributions - distributions] = income **or** loss

Safe Harbor and Targeted Allocations

The Classic 80/20 Example

The Classic 80/20 Example

Assumptions

- LP contributes $200 and GP contributes $0 to partnership
- Partnership buys two securities (1 and 2) for $100 each
- All distributions are made to LP until it gets its $200 back
- Then, distributions are made 80% to LP and 20% to GP
- In Year 2, the partnership sells 1 for $200 (gain of $100)
- Partnership distributes the $200 of proceeds to LP

Regulatory Allocation Provision

Section 1. Allocations.

(a) Net Income. Net Income for any period will be allocated:

(i) First, 100% to the LP until the total Net Income allocated under this Section 1(a)(i) equals the total Net Loss allocated under Section 1(b)(ii), and

(ii) Second, 80% to the LP and 20% to the GP.

(b) Net Loss. Net Loss for any period will be allocated:

(i) First, 80% to the LP and 20% to the GP until the total Net Loss allocated under this Section 1(b)(i) equals the total Net Income allocated under Section 1(a)(ii), and

(ii) Second, 100% to the LP.

Regulatory Allocation Methodology

LP

	Book	Tax
Contribution	200	200
Gain	80	80
Distribution	(200)	(200)
Total	80	80

GP

	Book	Tax
Contribution	0	0
Gain	20	20
Distribution	0	0
Total	20	20

Target Allocation Provision

“Except as otherwise provided in this Article, Profits and Losses (or items thereof) for any Fiscal Period shall be allocated among the Members in such manner that, as of the end of such Fiscal Period, the respective Capital Accounts of the Members shall be equal to the respective amounts that would be distributed to them, determined as if the Company were to (i) liquidate the assets of the Company for an amount equal to their Gross Asset Value and (ii) distribute the proceeds of liquidation pursuant to [section establishing waterfall of distributions].”

- Not all agreements have the “or items thereof” language
  - Puts pressure on guaranteed payment determination
  - Might make allocation fail economic effect equivalence and fall into PIP

Target Allocation Methodology

Targeted allocations are computed under a 6-step process:

Step 1. Determine beginning capital for each partner

Step 2. Account for contributions by and distributions to partner

Step 3. Add Steps 1 and 2 to determine adjusted capital account for each partner

Step 4. Determine aggregate ending capital

Step 5. Allocate aggregate ending capital to the partners in accordance with the distribution provisions

Step 6. Subtract Step 3 from Step 5 to determine income for each partner

Target Allocation Methodology

Step 1. Determine Beg. Capital

Step 2. Determine Contrib. and Dist.

Step 3. Adjusted Capital

Step 4. Determine Aggregate End. Capital

Step 5. Allocate Ending Capital

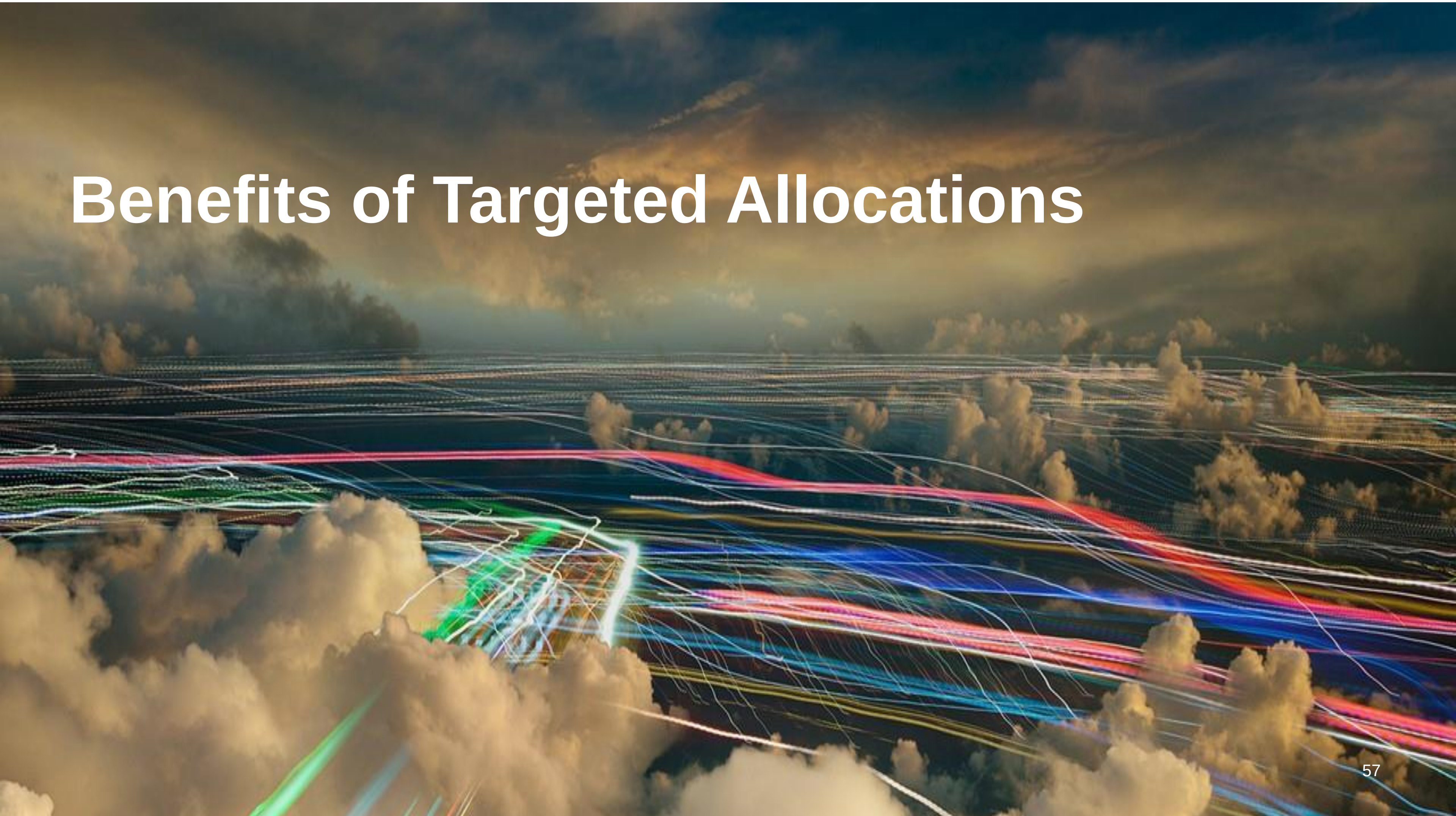
- 1st – Return Cap. to LP
- 2nd – Return remainder 80/20
  - Total Ending Cap.

Step 6. Taxable Income by Partner (subtract Step 3 from Step 5)

LP	GP	Total
200	0	200
(200)	0	(200)
0	0	0
		100
0	0	0
80	20	100
80	20	100
80	20	100

Benefits and Detriments of Target Allocation Approach

Benefits of Targeted Allocations



Benefits of Targeted Allocations

- **Primary Benefit-Certainty of Distributions**
  - Target allocations attempt to replicate "safe-harbor" allocations without requiring liquidating distributions to be in proportion to positive capital account balances
    - Safe harbor, Treas. Reg. § 1.704-1(b)(2)
  - If capital accounts don't reflect parties' economic deal, safe harbor allocations can alter the economics

Benefits of Targeted Allocations

- **Example: Preferred Returns**
  - A and B each contribute $500 to partnership P on 1/1 Year 1
  - B is entitled to a preferred return of 10% on unreturned capital
  - Next distributions go 1st to B to return its capital, then to A to return its capital
  - Remaining distributions split 60% to A and 40% to B

  - P invests capital in two assets, Asset 1 and Asset 2, investing $500 in each asset
  - P sells Asset 1 on 12/31 Year 1 for $700
  - P sells Asset 2 on 12/31 Year 2 for $500
  - P liquidates and distributes $1200 to A and B pursuant to partnership agreement
  - P engages in no other transactions

Benefits of Targeted Allocations

- **Example: Preferred Returns**
  - Capital Account Computation

	A	B	Total
Beginning Capital	$500	$500	$1000
Year 1 Preferred Return Allocation	$0	$50	$50
Year 1 Residual Profit Allocation	$90	$60	$150
Year 2 Preferred Return Allocation	$0	$0	$0
Year 2 Residual Profit Allocation	$0	$0	$0
Ending Capital Account Balances	$590	$610	$1200

Benefits of Targeted Allocations

- **Example: Preferred Returns**
  - Distribution Waterfall

	A	B	Total
Cumulative Preferred Return	$0	$100	$100
Return of B Capital	$0	$500	$500
Return of A Capital	$500	$0	$500
Residual Distributions	$60	$40	$100
Total Expected Distributions	$560	$640	$1200

Benefits of Targeted Allocations

- **Example: Preferred Returns**
  - Comparison of Capital Accounts to Distribution Waterfall

	A	B	Total
Capital Account Balance	$590	$610	$1200
Expected Distributions	$560	$640	$1200
Difference	$30	($30)	$0

Benefits of Targeted Allocations

- **Other Benefits**
  - Perceived ease of drafting
    - But puts pressure on drafter to draft distribution waterfall correctly
  - Less risk of surprise distribution result to parties

Issues with Targeted Allocations

Issues with Targeted Allocations

- **Tax Consequences of Distributions inconsistent with Capital Accounts**
  - Comparison of Capital Accounts to Distribution Waterfall

	A	B	Total
Capital Account Balance	$590	$610	$1200
Expected Distributions	$560	$640	$1200
Difference	$30	($30)	$0

- **What are tax consequences to A and B of distribution pursuant to Waterfall?**
  - Capital shift?
  - Guaranteed payment?
  - Distribution in excess of basis?

Issues with Targeted Allocations

- **Respecting Special Allocations**
  - Many partnerships desire to specially allocate depreciation deductions separately from the general economic arrangement
    - Special allocations of gain from the sale of the depreciated property allocated to offset special allocations of depreciation
  - Example: P allocates items generally 50% to A and 50% to B. However, P allocates depreciation 80% to A and 20% to B. When P sells the partnership property, P allocates the gain 80% to A and 20% to B in an amount equal to prior depreciation deductions.
  - Are these respected as having <u>substantial</u> economic effect?
    - Substantiality test not met if allocations of depreciation are "reasonably expected" to be offset by subsequent allocations of income or gain
    - If safe harbor allocation method chosen, generally respected because value of property deemed to be equal to basis, so gain not reasonably expected to offset depreciation
      - Targeted allocation method does not meet safe harbor for economic effect, so can't assume value = basis

Issues with Targeted Allocations

- **Fractions Rule**
  - Fractions Rule – IRC § 514(c)(9)(E)
    - Permits certain tax exempt partners to invest in leveraged real estate partnerships without realizing debt financed income
  - Fractions Rule requires that allocations have substantial economic effect within the meaning of IRC § 704(b)(2)
    - Targeted allocations do not meet safe harbor for economic effect

Issues with Targeted Allocations

- **Allocations of Nonrecourse Deductions**
  - Nonrecourse Deductions – cost recovery deductions when book value of partnership assets are less than nonrecourse debt secured by depreciated assets
  - Cannot have economic effect, so must be allocated in accordance with "partners interest in the partnership" – Treas. Reg. § 1.704-2(b)(1)
  - Certain allocations deemed to be in accordance with partners interest in the partnership – Treas. Reg. § 1.704-2(e)
    - Requires that partnership allocations generally meet safe harbor economic effect
    - Targeted allocations do not meet safe harbor for economic effect

Issues with Targeted Allocations

- **Allocations of Nonrecourse Debt**
  - Nonrecourse Debt – Debt for which no partner has economic risk of loss
  - IRC § 752(a) – partners include in the basis of their partnership interest allocable share of partnership debt
  - Partners include their share of partnership nonrecourse debt in proportion to their share of partnership profits – Treas. Reg. § 1.752-3(a)(3)
  - Partnership agreement may specify interest in partnership profits as long as it is consistent with allocations of significant item of income or gain that have substantial economic effect under IRC § 704(b)(2)
    - Targeted allocations do not meet safe harbor for economic effect

Issues with Targeted Allocations

- **Issues with Applying Allocations**
  - Targeted allocations require alternate calculations of actual capital account at BOY and target capital account at EOY:
  - Partnership return preparer must have systems in place to determine both amounts

Summary of Pros and Cons

- **Allocation Driven (Safe Harbor)**
  - Advantages
    - Safe harbor, Treas. Reg. § c 1.704-1(b)(2)
    - Fractions rule, § 514(c)(9)(E)
    - Allocations of nonrecourse deductions, Treas. Reg. § 1.704-2(b)(1)
    - Allocations of nonrecourse liabilities, Treas. Reg. § 1.752-2(a)
  - Disadvantages
    - Complex to draft properly
    - If wrong, interferes with deal economics

Summary of Pros and Cons

- **Distribution Driven (Targeted/Forced)**
  - Advantages
    - Easier to understand the economic deal
    - Easier to draft properly
  - Disadvantages
    - May produce unexpected tax results leaving allocations to accountants to determine with knowledge that they are often wrong
    - Allocations may be challenged

Questions?