Capital Account Challenges for Partnerships and LLCs: Tackling Calculations and Complex Operating Agreements

WEDNESDAY, JULY 23, 2014, 1:00-2:50 pm Eastern

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Capital Account Challenges for Partnerships and LLCs: Tackling Calculations and Complex Operating Agreements

July 23, 2014

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Capital Account Challenges for Partnerships and LLCs: Tackling Targeted Capital Account Calculations, Complex Operating Agreements and Other Tax-Related Issues

July 23, 2014
General Overview of Tax Allocation Principles and Substantial Economic Effect
Partner’s Investment in a Partnership

- There are four commonly used metrics for measuring a partner’s investments in a partnership and each has a different purpose:
  - Outside Tax Basis
  - Section 704(b) Book Capital Accounts
  - Accounting Book Capital Accounts
  - Tax Capital Accounts
Partner’s Investment in a Partnership

- **Outside Tax Basis** measures the Partner’s investment for purposes of determining taxable gain or loss on a disposition of a partnership interest by a partner, limitations on loss allocations, tax impact of distributions.

- Adjustments
  - Increases:
    - Tax basis of contributions
    - Share of taxable income
    - Share of partnership liabilities
  - Decreases:
    - Tax basis of distributions (limited)
    - Share of taxable loss
Partner’s Investment in a Partnership

- **Section 704(b) Book Capital Account** measures the Partner’s investment for purposes of the allocation rules of Section 704(b).

- **Adjustments**
  - Increases:
    - FMV of contributions
    - Share of book income (adjusted from taxable income using Section 704(b) rules)
  - Decreases:
    - FMV of distributions
    - Share of book loss (adjusted as above)
Partner’s Investment in a Partnership

- **Accounting Book Capital Account** measures the Partner’s investment for accounting purposes.
  - The adjustments, positive and negative, are determined under the applicable principles of accounting.
  - Beyond our scope, but usually different than either basis or Section 704(b) accounting.
Partner’s Investment in a Partnership

- **Tax Capital Account** measures the Partner’s equity investment using tax principles. The difference between tax capital account and outside tax basis is that partnership liabilities increase outside tax basis.

- **Adjustments**
  - **Increases:**
    - Tax basis of contributions
    - Share of taxable income
  - **Decreases:**
    - Tax basis of distributions (limited)
    - Share of Taxable Loss
**Allocations v. Distributions**

- **Distributions** are the distribution of actual cash or property by the partnership under Section 731 or the deemed distribution of cash under the liability allocation rules of Section 752.

- **Allocations** are the pass-through of the partnership taxable income, gain, loss, deduction and credit to the partners of the partnership. In an unfortunate use of terminology, Section 704 refers to “distributive share” rather than “allocable share” of tax items, but the concept is allocable share.
Section 704 Overview

- **Section 704(a):** a partner’s share of tax items of the partnership is determined under the partnership agreement, except as otherwise provided in the Code. It is important to note that this is the general rule.

- **Section 704(b)** limits the general rule by providing that if a partnership agreement doesn’t have a provision for allocation or the allocation lacks substantial economic effect (important term), allocations will be in accordance with the partners’ interest in the partnership.
Section 704 Overview

In addition to the general rule of Section 704(a) and (b), there are various overriding allocation provisions including:

- Section 704(c) – allocations related to contributed property with a basis different than its Section 704(b) book value.
- Section 704(d) – a loss allocation limitation if the loss allocated would exceed outside tax basis at year end.
- Section 704(e) – special rules for certain family partnership allocations.
Partnership Agreement

- What is the partnership agreement to which the general rule of Section 704(a) applies?
  - It includes all agreements among the partners whether or not designated as a partnership agreement or specifically incorporated into the agreement.
  - It can be more than one document.
  - It can be written, oral, or based on statute.
  - For eligible entities under the check the box regime of the Section 7701 regulations that are treated as partnerships, it will include governing documents such as LLC agreements, shareholder agreements, etc.
Allocations supported by Section 704(b)

- Allocations can be supported by Section 704(b) in a number of ways:
  - Substantial economic effect
    - Economic effect tests satisfied and
    - Allocation is substantial
  - Partners’ Interests in the Partnership ("PIP")
  - Deemed to be in accordance with PIP, including nonrecourse deductions, tax credits, economic effect equivalence
- There are potential overrides under Section 704 and elsewhere (e.g. Section 482).
Economic Effect

- There are three tests for economic effect under the Section 704(b) Regulations:
  - Primary Test (covered later)
  - Alternative Test (covered later)
  - Economic Equivalence Test
Basic Structure of Safe Harbor Provisions

- Substantial Economic Effect
  - Economic effect equivalence test
    - As of the end of each partnership tax year, a liquidation of the partnership would produce the same economic results to the partners as if each requirement of the basic test were satisfied regardless of the partnership’s economic performance.
    - This test is made as of the end of each tax year of the partnership.
Basic Structure of Safe Harbor Provisions

- Substantial Economic Effect
  - Capital Account Maintenance Rules - General
    - Adjustments to Capital Accounts for contributions and distributions are based on fair market value at the time of the event – the result is a “Book Value” for Section 704(b) purposes for those assets.
    - After Book Value for an asset is set, subsequent adjustments to partners’ Capital Accounts for basis relevant items such as gain or loss on disposition, depreciation and amortization are based on those Book Values rather than tax basis.
Basic Structure of Safe Harbor Provisions

- Substantial Economic Effect
  - Capital Account Maintenance Rules - General
    - Note that these Section 704(b) capital account book adjustments are **ONLY** for Section 704(b) Capital Account purposes. Allocations of tax items for inclusion on the tax return and for determining inside and outside basis are based upon tax basis and not Section 704(b) book value.
Basic Structure of Safe Harbor Provisions

- Substantial Economic Effect
  - Capital Account Maintenance Rules – Revaluations
    - Reasons desirable:
      - Maintain relative economic interests of the partners
      - Prevent capital shifts
    - The election to revalue capital accounts applies to all assets on contributions, distributions, and in accordance with industry standards for securities partnerships.
    - Differences created between partners’ book and tax capital accounts; must be taken into account under §704(c) principles.
Basic Structure of Safe Harbor Provisions

- **Substantiality**
  - Substantial - Even if allocations have economic effect, the effect must be substantial, therefore the regulations test for:
    - Transitory Allocations – allocations within a tax year that balance out.
    - Shifting Allocations – allocations over more than one tax year that are designed to balance out.
    - Overall Tax Effect – allocations that balance out using a more sophisticated after-tax analysis either in a single year or over more than one year.
Basic Structure of Safe Harbor Provisions

- Assumptions:
  - Fair market value is assumed to be equal to adjusted tax basis (or book value if books reflect a different value) and basis adjustments are presumed to be matched by corresponding changes in fair market value.
    - As a result, economic gain from disposition is not deemed to offset prior allocations.
    - This saves many allocations.
  - If the offsetting allocation is not expected for more than five years, then it won't be treated as a transitory allocation.
Basic Structure of Safe Harbor Provisions

- Partners’ Interest in Partnership
  - Interests in Partnership
    - Basic Test -
      - Determine the Economic sharing interests - look to sharing of income and distributions.
      - Risk of uncertainty if any variation from straight % allocations.
      - Facts-and-circumstances test including:
        - Relative contributions of partners
        - Relative interests in distributions upon liquidation
        - Relative interests in cash flow
        - Relative interests in economic profit and loss sharing ratios
Basic Structure of Safe Harbor Provisions

- Partners’ Interest in Partnership
  - Nonrecourse deductions
    - Nonrecourse deductions can't have economic effect, therefore are deemed to be allocations in accordance with the partners’ "interests in partnership."
    - A safe harbor is permitted under the minimum gain chargeback rules if:
      - The first two parts of the primary test are met;
      - Beginning with the first year of nonrecourse deductions and then throughout, the allocation of nonrecourse deductions is reasonably consistent with the allocation of some other significant partnership item attributable to the property securing the nonrecourse liabilities which has substantial economic effect;
Basic Structure of Safe Harbor Provisions

- Partners’ Interest in Partnership
  - Beginning with the first year in which there are nonrecourse deductions or a distribution of the proceeds of a nonrecourse liability that are allocable to an increase in minimum gain and then throughout, the partnership agreement contains a provision that complies with the requirements of a minimum gain chargeback as below; and
  - all other material allocations and capital account adjustments under the agreement have substantial economic effect.
Basic Structure of Safe Harbor Provisions

- Partners’ Interest in Partnership
  - Minimum Gain Charge Back
    - If there is a net decrease in partnership minimum gain for a year, the partners must be allocated items of income and gain for such year (and if necessary for subsequent years) in proportion to and to the extent of an amount equal to the partner's share of the net decrease in partnership minimum gain.
    - There are a variety of exceptions to the chargeback rule.
  - There are special allocation rules (the partner nonrecourse debt rules) that supplement the safe harbor if there is a nonrecourse debt where a partner bears the economic risk of loss.
  - There are also additional rules that apply to distributions of the proceeds of nonrecourse borrowings and tier partnerships.
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Capital Accounts Challenges for Partnerships and LLCs
The “Traditional Approach”
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Allocations

These are the provisions in a Partnership Agreement or Operating Agreement that allocate income, deductions and credit to each Partner/Member (for ease, both agreements are referred to simply as the “Agreement” and all owners are referred to as “Partners” in this slide).

Unlike a corporation, where all shareholders of a class of stock will have the same rights, there is great flexibility with respect to allocations, and “special allocations” are generally permitted, under which allocations of different amounts of income, deduction or credit can be allocated to each Partner.

The limit on the flexibility of allocations is that they will only be respected by the IRS if they have “substantial economic effect.”

Allocations differ from Distributions.
“Forced Allocations” have gained popularity over the past decade and, indeed, most agreements (in most industries, especially real estate) use forced allocations.

In “Forced Allocations” the Distributions that are desired as part of the deal drive the Allocations and Capital Accounts.

The Agreement is drafted so that the Distribution “waterfall” determines allocations, allocations are made to make the Capital Accounts such that the Distributions are made as anticipated.

Because the tax regulations evolved dealing with a traditional partnership in which Allocations determine Capital Accounts and Capital Accounts determine what is available for Distributions, this forced allocation approach arguably does not meet safe harbors in the regulations.

Understanding the “Traditional Approach” is essential to understanding the safe harbors and how to structure “Forced Allocations” to come as close to those safe harbors as possible.

Why is this important: if safe harbors are met, the IRS’s ability to disregard special allocations is more limited.
Decisions to make in drafting an Agreement:

- Will the Agreement follow the traditional approach of “forced allocations”?

**Traditional Approach**
- Creates greater certainty that the IRS will respect allocations
- Allocation provisions can get complicated if there is a waterfall

**Forced Allocations**
- Simpler drafting (which parties often view as more likely to reach the desired business results).
- IRS arguably has more ability to challenge special allocations.
Safe Harbors and Requirements 
(Traditional Approach)
Safe Harbors for “Special Allocations”

- Simple Agreements
  - If allocations are always in accordance with a member’s interest, and all items are allocated in the same proportion, then there is no need to meet a safe harbor because there are no “Special Allocations.”
  - If there is appreciated property being contributed, or this is possible, then a section dealing with “704(c) Property” is advisable.
  - If the LLC or partnership will obtain third-party borrowing (such as a mortgage), provisions addressing nonrecourse financing are advisable
  - Provisions regarding “minimum gain” are advisable.

- If there are “special allocations” then they will be respected if they have “substantial economic effect.” Detailed Treasury Regulations determine what has “substantial economic effect” means. On a very basic and vastly oversimplified level it means that the allocation results in an economic burden or benefit to the Member that is not merely a tax benefit.
Safe Harbors for “Special Allocations”

- The safe harbors were developed before LLC were widely used.
- As a result, one safe harbor deals with general partnerships, it requires:
  - The partnership maintains capital accounts;
  - Liquidations are in accordance with positive capital accounts; and
  - A partner must contribute to make up any capital account deficit on liquidation.
- The alternate safe harbor can be met by Limited Partnerships, and LLCs, lack the “deficit restoration obligation” listed above. This safe harbor requires:
  - The partnership maintains capital accounts;
  - Liquidations are in accordance with positive capital accounts; and
  - There is a “Qualified Income Offset” provision.
Meeting the Safe Harbor

- Alternate Test for Economic Effect.
  - The Alternate Test for Economic Effect is the safe harbor at issue in any entity treated as a partnership for tax purposes that does not have an unlimited deficit restoration obligation.
  - An unlimited deficit restoration obligation means that partners/member would have to contribute to make up for negative capital accounts – LLCs and LPs lack this deficit restoration obligation (which is one of the reasons they are popular).
  - Thus, and LLC or LP is concerned with the “Alternate Test for Economic Effect” safe harbor.
  - On occasion, practitioners say that an LLC or LP “must” meet this safe harbor for allocations to be respected, that is not the case. Rather, if this safe harbor is not met the IRS may determine allocations in accordance with the economics of the Agreement.
  - There is a separate “Economic Equivalence” provision in the Regulations that permits an LLC that fails to meet the safe harbor to be treated, nonetheless, as if it met the safe harbor, if certain conditions are present.
“Forced Allocations”

Also referred to as “Targeted Allocations,” they approach the Allocation provisions of the Agreement by making the Allocations each year that are required to meet the targeted result if the LLC was to liquidate at the end of that year.

As a result, Forced Allocations create much less certainty as to what the tax Allocations will be, but arguably create greater certainty than the traditional approach as to Distributions.
Agreements often have a number of detailed allocation provisions to deal with special tax issues, these issues involve: gain on contributed property, liability shifts, the consequences of refinancing, and the consequences on distribution of property, among other things. In addition, as previously mentioned in the context of the QIO, allocation provisions are drafted to prevent an allocation of income to a Member with a positive Capital Account when another Member’s Capital Account is Negative (this, in effect, requires the LLC to make up the Capital Account deficit first, before allocating positive income to a Member with a positive Capital Account).

Again, in the traditional approach allocations drive the economics of the LLC because they determine the amount credited to or debited from each Member’s Capital Account.

One problem with the allocations is people often see them as cryptic and don’t consider what they do. The following slides attempt to “demystify” the most common provisions.
Member Minimum Gain Chargeback.

- One of the reasons that the tax provisions in Agreements seem hard to understand is that they use phrases that have become “jargon” – these terms are defined in the Treasury Regulations, but they are perhaps unduly cryptic.

- The concept of “Minimum Gain” is easily understood in the following example:
  - LLC P purchases depreciable property for $1,000,000. The entire $1,000,000 is financed by nonrecourse debt (debt where the creditor can reach the LLC only, not Members). Assume that the property has a 5-year useful life for depreciation purposes, that it is depreciated on a straight-line basis and that it is placed into service in the beginning of the year with no mid-year or mid-quarter conventions applying. The property is depreciated in year 1 to $800,000.
  - The Minimum Gain with respect to the property is now $200,000, the amount by which the debt exceeds the basis in the property.

- The tax rules require a “Minimum Gain Chargeback”
  - This means nothing more than if there is an event that triggers the Minimum Gain in the property, such as the property being transferred in satisfaction of the debt, the Minimum Gain (here $200,000), must be allocated to the Members in proportion to the deductions that were allocated to them (here the depreciation).
  - In the example above, if 75% of the deduction was allocated to Member A and 25% to Member B, 75% of the Minimum Gain must be allocated to A and 25% to B via a Minimum Gain Chargeback, if the gain is triggered.
Company Minimum Gain Chargeback.

- Company (or Partnership) Minimum Gain is created when a Company borrows against property on a nonrecourse basis and depreciates the property. This can result in the basis of the property being less than the nonrecourse debt. In such an instance, there is “minimum gain,” which is the amount of gain the Company would recognize if it transferred the property in satisfaction of the debt, and for no other consideration. The Company Minimum Gain is the total amount by which there is minimum gain for all assets of the Company, taken together as if each asset was disposed of for no consideration other than satisfaction of the debt. This provision indicates how each member will be allocated such Company Minimum Gain.

- There is a Partnership Minimum Gain chargeback requirement in Treasury Regulation Section 1.704-2(f). That is, this provision is required to comply with the Treasury Regulations (but it is not relevant if there is no borrowing anticipated, however still good to include in case borrowing occurs.)
Common Allocation Provisions.

- Section 704(c) Property.
  - Section 704(c) Gain is built-in gain at the time the property was contributed.
  - Section 704(c) Minimum gain is different, it is the amount by which non-recourse debt exceeds the basis of the property.
  - Example, A contributes property to a LLC P that is worth $250, with a tax basis of $100 and nonrecourse debt on the property of $150. B contributes cash of $250 and each has a 50% interest in profits and losses of the LLC.
  - If P sold the property for $250 the day after the contribution, A would be allocated $150 of gain on the property (the $150 of Section 704(c) gain).
  - If, in the alternative, P went bankrupt and the lender foreclosed on the property, A would be allocated $100 of gain, the Section 704(c) Minimum Gain on the property.
  - The Section 704(c) provisions require that the gain inherent in property contributed to the LLC must be allocated back to the Member who contributed it.
  - The rationale behind this is that it prevents a shifting of pre-contribution gain to another taxpayer (which could be used to shift the rate at which the gain would be taxed, if it was taxed at all).
Common Allocation Provisions.

- **Member Nonrecourse Deduction**

  - “Nonrecourse Deductions” are deductions that result from basis created by nonrecourse debt on the property giving rise to the deductions (e.g., $800,000 of the $1,000,000 basis in depreciable property is the result of nonrecourse borrowings to acquire the property, thus depreciation deductions resulting from the $800,000 are nonrecourse deductions).

  - This provision is used to make sure that such deductions will be allocated to the member who bears the economic risk of loss with respect to the deductions. If more than one member bears the economic risk of loss, deductions are allocated according to the ratio in which the members share the risk.
Company Nonrecourse Deduction.

- Company Nonrecourse Deductions are depreciation and other items on property that has nonrecourse financing.
- Special rules apply to how these deductions are allocated, and they are tied back to Minimum Gain, which is the amount by which nonrecourse financing exceeds the tax basis in the property (which would result in gain if the property was transferred in satisfaction of the debt, and for no other consideration).
- In determining the amount of the nonrecourse deduction, the increase in Minimum Gain for the year (which could be the result of depreciation lowering the basis of the property) is reduced by the distributions of proceeds of any nonrecourse borrowing during the year.
- Example. Property is acquired by the LLC for $1,000,000, 100% of which is financed with a mortgage on the property. The property is depreciated to $800,000 in the first year. In the second year it is depreciated to $600,000. There is $400,000 of Minimum Gain in year 2 and a $200,000 Nonrecourse Deduction. The rules require that the deduction is allocated to the Members who have the risk of loss. Note, if this had been an LP, the allocation would be to the GP, who bears the risk of loss.
Common Allocation Provisions.

- **Catch-all Reference to 704(b) and Often to the “Fractions Rule”**

  - It is generally prudent to include in the Allocations Section of the Agreement a provision that all allocations are intended to comply with the requirements under Section 704(b) (that is, all allocations are intended to have “substantial economic effect” and shall be interpreted accordingly. This can save any unanticipated problem from occurring.

  - If there are tax-exempt investors involved (such as pension funds), they are concerned with having “Unrelated Business Taxable Income” because this can cause them to be subject to tax. Unrelated Business Taxable Income does not result from rents that are not tied to profits of a business. If the company participates in an active business (e.g. operating a parking lot), this raises the issue.

  - The “Fractions Rule” minimizes this problem. Therefore, if such tax-exempt Members are anticipated, it is generally prudent for this catch-all to also indicate that all allocations are intended to comply with the fractions rule.
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Hedge Fund Tax Allocations Discussion Topics

- The basics of book and tax allocations
- Examples of book/tax differences
- Tax allocation methods
- The aggregate method and break periods
- Stuffing/fill-up
Hedge Fund Tax Allocations
The Basics of Book and Tax Allocations

• Two broad categories of income:
  – Ordinary items (interest, dividends, operating expenses)
  – Capital items (realized gain/loss, change in unrealized appreciation (depreciation))
  – Book Allocations – all items generally allocated pro rata
Hedge Fund Tax Allocations
The Basics of Book and Tax Allocations (cont.)

- Tax allocations – ordinary items generally allocated pro rata
- Capital items allocated IN CONCEPT so that partners who are allocated unrealized gain/loss are allocated the realized gain/loss associated with the sale of such securities
- TIMING generally drives book/tax differences associated with allocation of capital items
Hedge Fund Tax Allocations

Examples of Book/Tax Differences

- Unrealized gain/loss
- Tax realization before book realization
  - Constructive sales, 1256 positions, OID
- Tax realization after book realization
  - Wash sales, straddles
- Tax recharacterizations
  - Foreign currency, market discount
Hedge Fund Tax Allocations
Tax Allocation Methods

• Layering
• Aggregate
• Full netting vs. partial netting
• Layering:
  – Involves allocating unrealized gain (loss) to each partner on a security-by-security basis
  – Very precise, can be cumbersome
  – Best done by a tax allocation software package
Hedge Fund Tax Allocations
Tax Allocation Methods (cont.)

• Aggregate:
  – Allocates unrealized gain(loss) for all investments together (hence the name), rather than on a security-by-security basis
  – Introduces judgment, flexibility, subjectivity into the allocation process
  – Must meet criteria for use of aggregate method
Hedge Fund Tax Allocations
Tax Allocation Methods (cont.)

• Qualifications for aggregate method
  – Management company, or investment partnership
    • 90% are qualified financial assets
    • Revaluations made annually
    • Allocations in accordance with capital accounts
Break Period

- General definition
- Impact on allocations
- For capital allocations:
  - Each break period stands alone?
  - Can the taxable year override break periods?
Hedge Fund Tax Allocations
Stuffing/Fill-Up

• To stuff or not to stuff?
• Stuff both gains and losses?
• Stuff partial withdrawals?
• Stuff long-term investors with short-term gains?
• Stuff short-term investors with long-term gains?
• Impact of ceiling rule?
• Impact of American Job Creation Act of 2004 on stuffing losses
Hedge Fund Tax Allocations
Stuffing/Fill-Up (cont.)

• Distributions in kind as a solution to stuffing issues
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PARTNERSHIP TARGETED (FORCED) ALLOCATIONS

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Partnership Agreement Provisions - Allocations and Distributions

- **Allocation Driven (Layered)**
  - 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 (Targeted/Forced)**
  - 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
Layered and Targeted (Forced) Allocations
The Formulae

**Layered allocations** compute ending capital under the following formula:

\[
\text{beginning capital} + \text{contributions} + \text{income} - \text{distributions} - \text{loss} = \text{ending capital}
\]

**Targeted allocations** plug income under the following formula:

\[
\text{target ending capital} - \left(\text{beginning capital} + \text{contributions} - \text{distributions} - \text{loss}\right) = \text{income}
\]

or

\[
\text{target ending capital} - \left(\text{beginning capital} + \text{contributions} - \text{distributions} - \text{loss}\right) = \text{loss}
\]
Allocations and Distributions - Pros and Cons

- **Allocation Driven (Safe Harbor)**
  - **Advantages**
    - Safe harbor, Treas. Reg. § 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

- **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
Partner’s Interest in the Partnership (“PIP”)

If allocation fails to satisfy SEE safe harbor, partners’ distributive shares of partnership items determined in accordance with PIP.

- PIP signifies the manner in which the partners have agreed to share the economic benefit or burden (if any) corresponding to the item being allocated. Reg. § 1.704-1(b)(3).

- 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
Targeted (Forced) 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 (Forced) 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
- Who is the “preparer” of the allocations?
Layered and Targeted Allocations – Classic 80/20 Example

- 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
Layered 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.
## Layered Allocations – Capital Accounts

<table>
<thead>
<tr>
<th></th>
<th>LP</th>
<th>GP</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Book</td>
<td>Tax</td>
</tr>
<tr>
<td>Contribution</td>
<td>200</td>
<td>200</td>
</tr>
<tr>
<td>Gain</td>
<td>80</td>
<td>80</td>
</tr>
<tr>
<td>Distribution</td>
<td>(200)</td>
<td>(200)</td>
</tr>
<tr>
<td>Total</td>
<td>80</td>
<td>80</td>
</tr>
</tbody>
</table>
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 10.3.

- 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
Targeted Allocations

Targeted allocations are computed under a 6-step process:

**Step 1.** Determine beginning capital for each partner

**Step 2.** Allocate contributions and distributions by 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
### Targeted Allocation – Capital Accounts

<table>
<thead>
<tr>
<th>Step</th>
<th>Description</th>
<th>LP</th>
<th>GP</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Determine Beg. Capital</td>
<td>200</td>
<td>0</td>
<td>200</td>
</tr>
<tr>
<td>2</td>
<td>Determine Contrib. and Dist.</td>
<td>(200)</td>
<td>0</td>
<td>(200)</td>
</tr>
<tr>
<td>3</td>
<td>Adjusted Capital</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>4</td>
<td>Determine Aggregate End. Capital</td>
<td>0</td>
<td>0</td>
<td>100</td>
</tr>
<tr>
<td>5.</td>
<td>Allocate Ending Capital</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>1st – Return Cap. to LP</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td></td>
<td>2nd – Return remainder 80/20</td>
<td>80</td>
<td>20</td>
<td>100</td>
</tr>
<tr>
<td></td>
<td>Total Ending Cap.</td>
<td>80</td>
<td>20</td>
<td>100</td>
</tr>
<tr>
<td>6</td>
<td>Taxable Income by Partner</td>
<td>80</td>
<td>20</td>
<td>100</td>
</tr>
</tbody>
</table>

(subtract Step 3 from Step 5)
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