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Understanding Targeted Allocations (PowerPoint)

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Speaker Biography

BRIAN J. O'CONNOR co-chairs the Tax and Wealth Planning Group for the Washington, D.C. based law firm of Venable LLP. Mr. O'Connor practices in the areas of partnership, corporate, real estate and international taxation. Mr. O'Connor also teaches an advanced course on partnership taxation and the drafting of partnership agreements as an adjunct professor at Georgetown University Law Center. He regularly speaks across the country to professional groups on topics relating to business entities and taxation and is the author or co-author of numerous articles relating to business entities and taxation in professional journals and trade publications, including *The Journal of Taxation, The Journal of Pass-through Entities, Tax Notes, Tax Management Real Estate Journal* and *Business Entities*. Mr. O'Connor also has acted as a primary participant in the publication of the nationally recognized treatise *Tax Planning for Real Estate Transactions.*
has been regularly selected for The Best Lawyers in America for both Tax Law and Tax Litigation and Controversy and has been regularly included in Maryland Super Lawyers. Further, Mr. O'Connor was recently named a "Tax Lawyer of the Year" for Maryland. Before joining Venable, Mr. O'Connor was an attorney advisor for the Office of Chief Counsel for the Internal Revenue Service where he participated in high profile legislative projects and drafted regulations and other published guidance relating to pass-through entities.
received his J.D. degree, magna cum laude, from Washington & Lee University and his LL.M. degree in Taxation, with distinction and the program's highest possible grade point average, from Georgetown University Law Center. Mr. O'Connor is a member of the Virginia, Maryland and District of Columbia Bars as well as the Tax Sections for the Virginia, Maryland and American Bar Associations.

Target vs. Layer Cake Allocations

Basic Concepts

- Layer Cake Allocation
  - Basic concept is to allocate section 704(b) book profit/loss first and use this allocation to determine the cash distributions.
- Targeted Allocations
  - Basic concept is to allocate 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.

Satisfaction of Section 704(b) Safe Harbors

- Both Layer Cake and Target Allocations COULD satisfy the safe harbors, if liquidated with capital accounts.
- The practical reality is
  - <u>Most</u> Target Allocations instead liquidate with the cash waterfall in which they target the income and do not satisfy the safe harbors.
  - <u>Most</u> Layer Cake liquidate with positive section 704(b) capital accounts and otherwise meet the safe harbors.
  - <u>Sometimes</u> Target agreements also liquidate with capital accounts or Layer Cake agreements liquidate with cash waterfalls.

Example 1: Basic Target Allocations

Basic Facts

- LP and GP contribute $90 and $10, respectively.
- The distribution Waterfall
  - Cash is paid first to return contributed capital plus a 10% annual preferred return.
  - Cash paid 80:20 to LP and GP, respectively.
- The partnership earns $20 of income in year one.

Waterfall

	LP	GP	Total
Return of capital	90	10	
Preferred return	9	1	
Residual return	8	2	
Total	107	13	

•For simplicity, the example shows the GP as only receiving a 20% residual profit sharing after the preferred return and no return on it's capital at the residual return level.

Target Allocation

- A typical target allocation provision would allocate the $20 of year one earnings to "fill up" the LP and GP opening capital accounts ($90 and $10, respectively) to equal their Target rights under the Waterfall ($107 and $13, respectively).

	LP	GP	Total
Beginning	90	10	100
Ending	107	13	120
Target	17	3	20

Basic Steps - Layer Cake Allocations

- Profit allocations
  - Reverse prior losses
  - Preferred return
  - Residual sharing ratio
- Loss allocations
  - Reverse prior profits (in reverse order)
  - Relative contributed capital (adjusted capital accounts)
  - Residual sharing ratio
- Adjust capital accounts for contributions, distributions, and allocations
- Liquidate with positive capital accounts

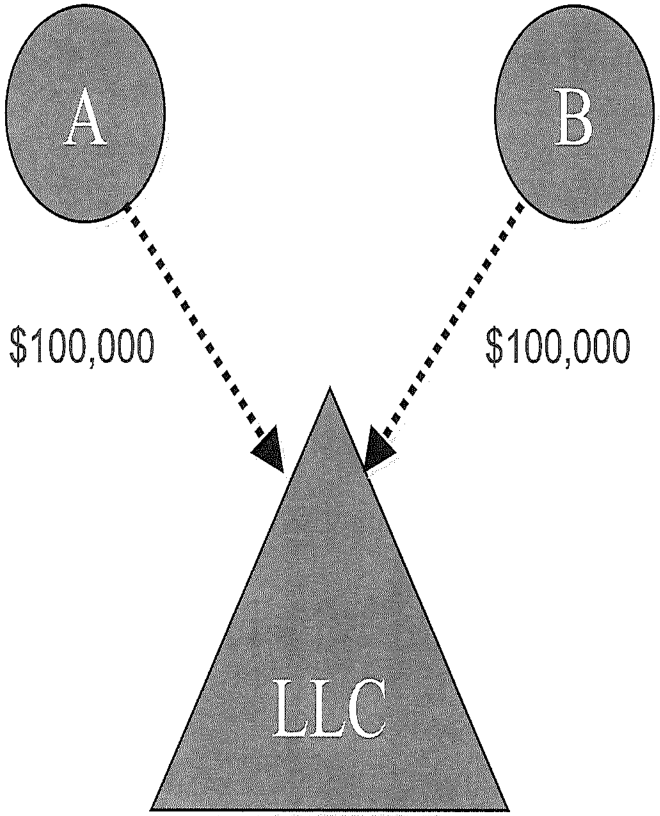
Basic Steps - Targeted Allocations

- Calculate Cash Waterfall Target
  - Preferred return
  - Preferred capital
  - Common capital
  - Residual sharing
- Profit/Loss allocations to bring adjusted capital account to equal Target
- Adjust the capital accounts for distributions
- Generally liquidate with cash waterfall, but can liquidate with positive capital accounts

3 Steps to Target Allocations

- Step 1 - Determine Partially Adjusted Capital Account (adjust beginning of year capital for current year contributions and distributions)
- Step 2 - Determine Target Capital Account (based on distribution waterfall at book value less minimum gain amounts)
- (a) Net value in partnership upon deemed liquidation:
- (b) Run value through distribution waterfall
- (c) Adjust for partner and partnership minimum gain
- Step 3 - Allocate Profit or Loss to bring Partially Adjusted Capital Accounts to Target Capital Account.

Example 2 – Net Income in Excess of Preference



Beginning Balance Sheet

Assets		Liabilities	
Cash:	$200,000		$0
		Capital	
		A:	$100,000
		B:	$100,000
Total	$200,000	Total:	$200,000

Year 1 Income = $50,000

10% preferred to A, residual A=40%, B=60%

Layer Cake Allocations

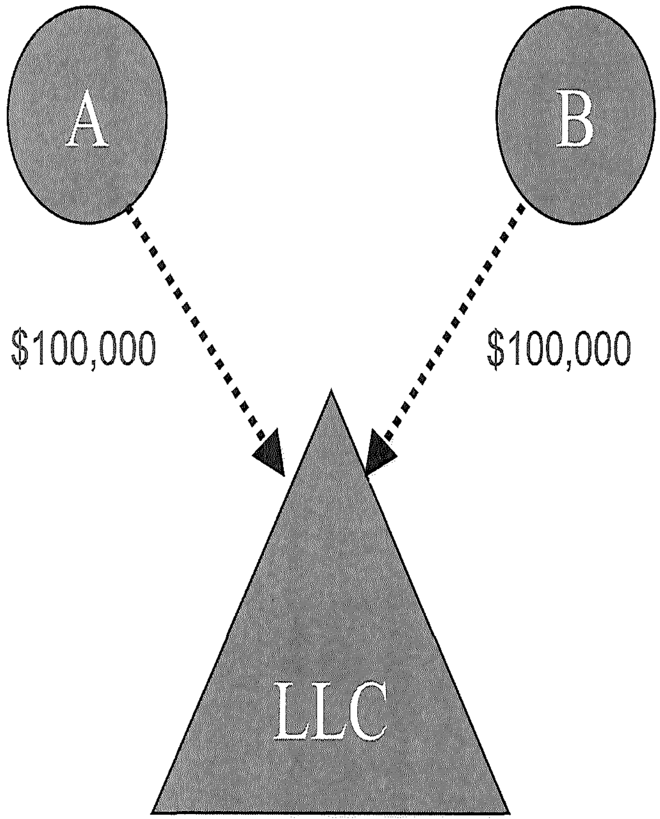
Section 704(b) Income Allocations

	A	B
Opening Capital	$100,000	$100,000
$50,000 Income		
1. 10% pref to A.	$ 10,000	$ 0
2. 40:60 A and B	$ 16,000	$ 24,000
Total Income	$ 26,000	$ 24,000
Ending Capital	$126,000	$124,000

Targeted Allocations

	A	B
Opening Capital	$100,000	$100,000
Adjustments during year	0	0
Partially adjusted cap acct	**$100,000**	**$100,000**
Determine Cash Waterfall		
$250,000 Cash		
1. 10% pref to A.	$ 10,000	$ 0
2. Return original capital	$100,000	$100,000
3. 40:60 A and B	$ 16,000	$ 24,000
Ending Target Capital	**$126,000**	**$124,000**
Income Allocation	$ 26,000	$ 24,000

Example 3 – Net Income Less than Preference



Beginning Balance Sheet

Assets		Liabilities
Cash:	$200,000	$0
		Capital
		A: $100,000
		B: $100,000
Total	$200,000	Total: $200,000

Year 1 Income = $8,000

10% preferred to A, residual A=40%, B=60%

Targeted Allocations

	A	B
Opening Capital	$100,000	$100,000
Adjustments during year	0	0
Partially adjusted cap acct	**$100,000**	**$100,000**
Determine Cash Waterfall		
$208,000 Cash		
1. 10% pref to A.	$ 10,000	$ 0
2. Return original capital	$ 99,000	$ 99,000
3. 40:60 A and B	$	$
Ending Target Capital	**$109,000**	**$ 99,000**
Target Income Allocation	$ 9,000	($ 1,000)
Net Income Allocation	$ 8,000	$ 0
Shortfall (Gpmt?)	$ 1,000	($ 1,000)

Layer Cake Allocations

Section 704(b) Income Allocations

	A	B
Opening Capital	$100,000	$100,000
$ 8,000 Income		
1. 10% pref to A.	$ 8,000	$ 0
2. 40:60 A and B	$	$
Total Income	$ 8,000	$ 0
Ending Capital	$108,000	$100,000

Comparison of Examples 2 and 3

Ending Cash Received by A and B

	A	B
Example 2		
Target/waterfall	$126,000	$124,000
Layer Cake/cap acct	$126,000	$124,000
Example 3		
Target/waterfall	$109,000	$ 99,000
Layer Cake/cap acct	$108,000	$100,000

Where Do We Go From Here?

- Targeted Allocations are and presumably will continue to be the norm.
- Still, in some cases, targeted allocations will not work or will not fit your business deal.
- Most tax return preparers have become at least somewhat comfortable with targeted allocations – but some confusion persists.
- In light of the proposed fee waiver regulations, guidance from the service may be forthcoming. This guidance may or may not be helpful to taxpayers.