Structuring (and Drafting) Joint Venture Agreements (PowerPoint)

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I. Introduction

Learning how to structure and draft Joint Venture (JV) agreements is a never-ending process, constantly evolving with corresponding changes in business and legal requirements. This article is designed to provide an overview of those agreements for lawyers, accountants, and business professionals, with an emphasis on tax-related provisions. Starting with an overview of a typical partnership agreement structure, the article then discusses the most commonly negotiated tax provisions in a partnership agreement, then ends with a detailed discussion of the important concept of partnership tax distributions.

II. Structure of a Typical Partnership Agreement

A partnership agreement typically is broken down into various articles or sections and will include one or more exhibits and schedules. The following explanation describes typical sections of most partnership agreements in the order commonly found in agreements. Many partnership agreements will contain additional sections covering specialized deal considerations such as compliance with regulatory restrictions that may be unique to that type of partnership agreement.

A. Prefatory Language

The typical agreement begins with prefatory language such as an effective date, a preamble, recitals, "whereas" clauses, or explanatory statements that put the agreement into context. This section will explain fundamental questions such as when the agreement becomes effective, who the partners are, whether it is a new or amended partnership agreement, and the purpose of the partnership (for example, to own a particular property or business). Often these provisions also outline a history of the agreement and any amendments.
B. General Provisions

This section will include general information such as the name of the partnership, the principal and registered offices, the term, and the general purpose and powers (for example, buying real estate, borrowing or lending money, the ability to operate in a particular manner or through particular types of entities). Either this section or a section at the end of the agreement will typically include a lengthy alphabetical list of definitions. Many definitions will simply be a cross-reference to the section in which a term is defined in the main body of the agreement. Many of the definitions relate to federal income tax terminology a partnership must use if it intends to satisfy the tax allocation safe harbors found under the tax code. If these safe harbors are satisfied, the IRS will respect the income or loss allocations among the partners.

C. Capital Contributions

The capital contribution section is short but very important. It answers questions such as what the partners are contributing and when the contributions are being made. Capital contributions are typically broken down into original contributions of cash or property and subsequent contributions, including additional capital contributions a partnership may be able to require from the partners (capital calls). Whether a capital contribution is required may be determined by reference to the penalties and remedies provided in this section to deal with situations in which capital is called and not provided. This section will also dictate whether a partner has the option to make an in-kind contribution (to contribute property in lieu of cash), whether a partner has the right to withdraw its capital before liquidation of the partnership (a lockup), and whether a partner is entitled to interest on its capital account. Finally, this section typically requires that a partnership maintain capital accounts for each partner, consistent with the regulatory safe harbors for income and loss allocations. The definition of a capital account is included either in this section or in the general definition section.\(^3\) In essence, a partner’s capital account is the fair market value (FMV) of partner contributions (net of any related debt assumed by the partnership), increased or decreased by the partner’s share of income or loss and decreased by the FMV of partner distributions (net of any related debt assumed by the partner). For this purpose, income and loss refers to the economic or book definitions under the tax rules of section 704(b). It may not be the same as income or loss determined for income tax or for generally accepted accounting principles.

Interest on capital is unusual and is generally classified as a guaranteed payment for federal tax purposes.\(^4\) A guaranteed payment is used for some preferred partners that wish to be treated more akin to lenders. This goal is often satisfied with a preferred allocation of partnership income in lieu of stated interest or a guaranteed payment. A preferred return allows some of the advantages of a debt-like investment without putting

\(^3\) In some cases an agreement may avoid the detailed definition of a capital account and simply state that the partnership must maintain capital accounts in accordance with the specified tax regulations.

\(^4\) A guaranteed payment is a payment to a partner that is determined without regard to the income of the partnership and in many ways is treated similarly to an interest payment. See generally section 707(c) and Reg. § 1.707-1(c).
undue economic obligations on the partnership to pay even if there is no income to support the payment. A preferred return also has the advantage of carrying out the tax character of the underlying income used to satisfy the payment, potentially allowing the recipient the benefit of capital gains tax rates.\(^5\)

**Example 1: Capital account basics.** A contributes Building with $100 gross FMV, subject to $30 of debt. In year 1 the partnership allocates $10 of section 704(b) book income to A and distributes $4 of cash to A. A's ending capital account is $76, computed as follows:

<table>
<thead>
<tr>
<th>Effect on Capital Account</th>
<th>Ending Capital Account</th>
</tr>
</thead>
<tbody>
<tr>
<td>Increase by net FMV of property contributed</td>
<td>+$70</td>
</tr>
<tr>
<td>Increase by income allocation</td>
<td>+$10</td>
</tr>
<tr>
<td>Decrease by distributions</td>
<td>-$4</td>
</tr>
</tbody>
</table>

**D. Tax Allocations -- Section 704(b) and (c)**

This section of the agreement describes how taxable income and loss should be shared among the partners. Most of the allocation language relates to the economic/book allocations, and in general the taxable income will follow these book allocations.\(^6\) However, if a partner contributed an asset with built-in appreciation or depreciation, special rules require that the built-in tax gain or loss be allocated back to the contributing partner.\(^7\) Note that the term "allocation" is a tax-only term and should not be confused with "distribution," which is an economic term. These two terms interrelate because if a partnership liquidates in accordance with the book capital accounts, the income or loss allocations will directly affect each partner's share of distributions. For example, an allocation of income increases a partner's capital account, which means that the partner is entitled to more distributions because of the larger capital account.

Partnership agreements typically break the book allocations down into two sections. The primary allocation section describes the general business deal, such as allocating

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\(^6\) For example, $100 of net book income may be composed of $120 of gross capital gain and $20 of depreciation deductions. An equal allocation of this $100 of income between the two partners results in each partner receiving $60 of capital gain and $10 of depreciation deductions for net taxable income of $50 each. However, if $30 of the gross income were tax exempt, the net taxable income to each partner would be only $35 ($45 of capital gain, $15 of tax-exempt income, and $10 of depreciation deductions). *See Reg. § 1.704-1(b)(1)(vii)* (net book allocations carry out a proportionate share of underlying tax items).

\(^7\) *Section 704(c).*
profits in accordance with relative capital or profit percentages (percentage interests). The second section overrides the first section and is designed to comply with the book income tax regulatory safe harbors to dictate things like making sure partners generally do not receive deductions in excess of their capital accounts and how to allocate deductions funded by nonrecourse debt. This second section is often called the "boilerplate" or "regulatory allocations" section. The typical agreement first allocates income and loss under the regulatory allocation provisions, if applicable, and then allocates any remaining book income or loss (usually defined as profit and loss in the agreement) in the primary allocation section.

The book allocations section is important because it describes how the taxable income and loss are allocated among the partners. Further, if the partnership liquidates in accordance with capital accounts, those allocations drive the economics of the deal. If the partnership does not liquidate in accordance with capital accounts but instead liquidates according to a defined ordering of cash or property distributions (i.e., a cash or liquidation waterfall), the book allocations have no effect on the economics and relate solely to tax. Because liquidating in accordance with capital accounts means that the complicated regulatory allocations can have a meaningful effect on the business deal, agreements often liquidate with a waterfall and avoid the need for the business persons to understand the tax boilerplate.

The tax allocations will not be respected if the agreement liquidates with a waterfall and the partners' economic rights under the waterfall are different from the rights based on their capital accounts. In that case, the taxable income or loss will be reallocated so that the capital accounts and the waterfall rights are consistent. For example, assume the tax allocations send all $100 of section 704(b) income to Partner A and none to Partner B, causing A's capital account to increase by all $100 and B's capital account to remain constant. If the waterfall provides that the cash corresponding to that profit is shared $50 each by A and B, the IRS will not respect the tax allocation and will reallocate $50 of income to B. To avoid inconsistencies between the tax allocations and the partners' rights under the waterfall, many partnership agreements simply use a target/fill-up allocation under which the agreement allocates book income or loss among the partners using a formula that causes the partners' capital accounts to equal the amounts the partners would receive under the waterfall.

Example 2: Target allocations. Limited partner, LP, and general partner, GP, contribute $90 and $10, respectively, to the partnership and set beginning capital accounts in the same amount. The distribution waterfall provides that cash is paid first

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6 A partner can receive deductions in excess of its capital account if the partner is at risk for the negative amount (that is, the partner has to fund deficit capital accounts) or if the partner is deemed at risk for the amount (that is, the negative amount is funded from nonrecourse debt that the partner is actually or deemed to be at risk for).

9 For a more complete discussion of whether to liquidate with capital accounts or with a waterfall, see Brian J. O'Connor and Steven R. Schneider, "Capital-Account-Based Liquidations: Gone With the Wind or Here to Stay?" 102 J. Tax'n 21 (2005).

10 See generally Todd D. Golub, "How to Hit Your Mark Using Target Allocations in a Real Estate Partnership," 50Tax Mgmt. Memo. 403 (Sept. 28, 2009).
to return contributed capital plus a 10 percent annual preferred return and is then paid 80-20 to LP and GP. The partnership earns $20 of income in year 1, and under the waterfall the $120 of total partnership cash would be distributed as follows:

<table>
<thead>
<tr>
<th></th>
<th>LP</th>
<th>GP</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Return of capital</td>
<td>$90</td>
<td>$10</td>
<td>$100</td>
</tr>
<tr>
<td>Preferred return</td>
<td>$9</td>
<td>$1</td>
<td>$10</td>
</tr>
<tr>
<td>Residual return</td>
<td>$8</td>
<td>$2</td>
<td>$10</td>
</tr>
<tr>
<td>Total</td>
<td>$107</td>
<td>$13</td>
<td>$120</td>
</tr>
</tbody>
</table>

A typical target allocation provision would allocate the $20 of year 1 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). Thus, the $20 of income is allocated $17 to LP and $3 to GP.

For a partnership in which there will be contributions of appreciated or depreciated property, the section allocating those items to the contributing partner should be covered in some detail (section 704(c)). Partnership agreements typically include only a single paragraph to cover section 704(c) allocations and often simply repeat the general statutory requirement that tax allocations take into account a partner’s potential built-in tax gain or loss on contributed property. However, for many partnerships, including many real estate partnerships, the section 704(c) provision is highly negotiated and includes much more detail relating to which of several alternative methods is chosen to allocate noneconomic taxable income or loss.

**Example 3: Section 704(c).** Partner A contributes property with a tax basis of $20 and a value of $100, and the partnership later sells the property for $110. The partnership must allocate the first $80 of tax gain to Partner A because that represents the inherent built-in gain A had in the property when it contributed the property to the partnership. The remaining $10 of post-contribution economic gain is allocated according to the section 704(b) book allocation provisions in the agreement. Further, when the built-in gain property is depreciated, the partnership must first allocate tax depreciation on the property to the noncontributing partner up to the amount of its book depreciation, with any residual tax depreciation going to the contributing partner. This ensures that the tax basis shortfall is first borne by the contributing partner through both dispositions and

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11 Typically the general partner would receive the 20 percent residual profit sharing for its services plus a share of the 80 percent return based on its relative capital contribution. However, for simplicity, the example shows the general partner as receiving only a 20 percent residual profit sharing after the preferred return.

12 If the partners had other contributions or distributions during the year, the partnership should adjust the beginning-of-the-year capital accounts to reflect this. Partnership agreements frequently use the term “partially adjusted capital account” to refer to the beginning-of-the-year capital accounts adjusted for intra-year contributions and distributions.
depreciation. However, to the extent there is insufficient tax basis for the noncontributing partner to receive its full share of book depreciation, there may still be a tax shortfall to the noncontributing partner depending on the section 704(c) method chosen.

E. Distributions

The distribution section describes the partners' rights to cash or property distributions. These distribution rights are typically subject to the partners' overall distribution rights on liquidation, which may appear in a later section of the agreement. Sometimes the two distribution sections are referred to as the current distribution section and the liquidation distribution section. Often in a partnership that liquidates with a cash waterfall, the liquidation distribution section simply refers to the partners' rights under the current distribution section (after specified reserves). For partnerships that follow the book allocation safe harbor tests, the liquidation section will simply liquidate in accordance with positive section 704(b) book capital accounts after all allocations have been made to partner capital accounts.

The distribution section typically addresses important details such as when distributions are made and in what amount. For example, an agreement may provide that there will be quarterly distributions of operating income and larger distributions of capital on defined capital transactions or capital events (such as significant asset sales or refinancings). Most agreements limit operating income distributions to a defined net cash flow to ensure that the partnership has sufficient cash remaining for operations and necessary reserves.

This section will often specifically address taxes. Many agreements provide for minimum distributions to a partner (so-called tax distributions) to ensure that each partner has sufficient funds to satisfy its personal tax obligations on its share of partnership income. Tax distributions are generally documented as an advance on the partner's rights under the more general distribution provisions. Sometimes the distributions are treated as a loan to the partner. Further, taxes paid by the partnership on behalf of a partner are typically treated as a deemed distribution to the partner whose income is requiring the withholding. This is common when the partnership is required to withhold on distributions to a foreign partner.

F. Management

Partnerships will typically designate a board or a single partner as the managing partner. If the partnership designates a single partner as managing partner, this is usually the person classified under state law as the manager of an LLC or the general manager.

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13 It is also common to see the operating income waterfall differ from the liquidation waterfall. For example, if the partnership has an entrepreneurial partner and an investor partner, the operating income waterfall may make current cash distributions to both partners, but on liquidation (or some capital events) the liquidating or capital event waterfall will first use funds to repay the investor partner’s contributions (that is, return of capital) before making distributions to both partners.
partner of a limited partnership. The agreement typically vests significant discretion and control in the board or the managing partner, often allowing the passive partners to vote only on more major matters such as acts in contravention of the agreement, the filing of bankruptcy, the admission of additional members not contemplated by the original agreement, and merger or sale of substantially all the partnership assets. The level of detail in the management section varies greatly among partnership agreements. This section also articulates when a partner has liability to the partnership or other partners, and any related indemnifications. This section will also often refer to any related affiliate service agreements, such as a property or asset management agreement with an affiliate of the managing partner.

G. Accounting, Books, and Records

This section covers the more mundane information about keeping books and records and providing tax statements to partners. Items usually described in this section include (1) annual and quarterly reporting of financial information to the partners; (2) who prepares the tax returns and the deadline for providing this information to the partners; (3) who will serve as the tax matters partner or partnership representative (TMP) and represent the partnership in an IRS audit; and (4) what tax decision-making power the TMP will have, such as the ability to extend the statute of limitations, elect in or out of the special unified partnership audit rules, or make other tax elections. Although the identity and authority of the TMP may sound boring, they are often critical questions when controversy later arises. These details are often overlooked in the drafting process.

H. Transfers of Partnership Interests

This section will dictate when a partner can or must transfer its partnership interest. Typically, partnership interest transfers are strictly regulated in the agreement and often have no ready market even if a partner wanted to sell its interest. If a partner is allowed to transfer its interest, the agreement will usually allow the partnership or existing partners to have a right of first offer or right of first refusal to acquire the interest or an option to acquire the interest subject to pre-agreed pricing formulations. There is typically an exception for some transfers (so-called permitted transfers) that often include estate planning transfers to family trusts or family partnerships. If the parties anticipate a potential sale of partnership interests by some or all of the partners, the agreement may include a right by a majority of the partners to force minority partners to also sell (a drag-along right) or a right by the minority partners to join in a sale by the majority partners (a tag-along right).

If a sale occurs midyear, the agreement will commonly include a provision explaining how the taxable income or loss for the year is allocated between the buying and selling partners. Many agreements simply allow the managing partner discretion on how to reasonably allocate income, while others are much more specific and may require a first-of-the-month convention or a closing of the books for significant items and a proration for smaller items like operating income.
I. Dissolution and Winding Up

This section describes when and how a partnership will be wound up and whether there will be any reserves retained for potential obligations. As noted above, from a tax perspective this section may be the key to learning whether the agreement intends to follow the regulatory book allocation safe harbors. The agreement likely intends to follow the safe harbors if, after paying creditors and setting up reserves, the agreement distributes the remaining proceeds according to the partners' section 704(b) book capital accounts. Although there are other requirements to satisfy the safe harbors, this is the primary requirement that puts an agreement either in or out of those safe harbors. If the agreement instead liquidates with a cash waterfall, the agreement must rely on a more limited tax safe harbor for comfort that the IRS will respect the income and loss allocations. That safe harbor applies only if, in all events, the partners would receive the same economic distributions had they liquidated in accordance with each partner's section 704(b) capital account. This would occur, for example, in a simple 50-50 partnership in which all capital is contributed equally and all profits, losses, and distributions are shared equally.

J. Miscellaneous

Finally, the miscellaneous section is a repository for items that do not readily fit within the other sections. This includes things like delivery of notices to the partners or partnership, application of the agreement to successors or assigns, waiver of jury trial, restrictions on disclosure of terms, and representations and warranties.

III. Key Areas of Negotiation

A. Overview

As a practical matter, the person who creates the first draft of the partnership agreement yields significant power. It is this very reason that the "money" partner tends to produce the first draft -- money talks! The first draft includes the framework and starting point of any negotiations. The first draft also means that the primary drafter's negotiating points are more masked because details are more likely overlooked as compared to the redline comments from the second partner. Because redline comments are read under a microscope the person commenting on a prior draft will need to have a strong justification for every change and will thus tend to minimize changes to only the most essential. Further, the commenter will typically be given guidance from the business side such as whether it must be a "light markup" or not. In this context, there will be areas that the drafter will particularly need to focus on to make sure that nothing important slips through the cracks. The following is a list of such topics of primary negotiation and why. Although these negotiation areas are written roughly in the order of general importance, the ultimate level of relative importance will vary by deal.

B. Section 704(c) Methods and Built-in Tax Gain
Section 704(c) is a fundamental item of negotiation because the tax rules provide three very different choices that demonstrate the zero-sum game nature of these tax allocations. Assuming none of the partners are tax-indifferent, what benefits one partner harms the other. The practical difference between the traditional, curative, and remedial allocations methods requires an understanding of the interaction of the built in gain (or loss) in the contributed (or booked up) property and the tax allocations. For example, a property may have a value 40% higher than tax basis but the non-section 704(c) partner may only receive 20% of the economic allocations such that all section 704(c) methods would result in the non-section 704(c) partner having its full share of tax depreciation. In contrast, there may only be a 10% built-in gain but the non-section 704(c) partner may have a preferred return that effectively draws 100% of the net income and depreciation deductions in most years – thus creating a tax-deduction shortfall to such partner under the traditional method’s ceiling rule.

As a practical matter, the document should state the section 704(c) method if there is a known section 704(c) built-in gain (including “reverse” section 704(c) when a partner joins an existing partnership). It is best to set the section 704(c) method in the term sheet since it is a business item as much as a tax item, but unfortunately only a minority of term sheets address section 704(c). Partnership agreements that do not designate a specific section 704(c) method for a known built-in gain ignore the elephant in the room -- although sometimes that is done intentionally by a partner who otherwise has general tax decision making authority in the document.

In its most fundamental sense, the traditional method can only benefit the section 704(c) partner as compared to the other methods and thus is nearly always the starting point in the document if the section 704(c) partner has drafted it. However, the remedial method is the inverse and is always the most fair to the non-section 704(c) partner because this method will always put such partner in the same place it would have been had the property been newly purchased property with a full tax basis. The curative method must be modeled out in more detail to determine its exact effects, but can sometimes close the gap between the two methods if a partial cure is used (for example, curing a depreciation shortfall only with depreciation deductions available from a second property).

In choosing a method, absent unusual facts such as expiring net operating losses, a partner with a built-in gain will undoubtedly start with the traditional method. If there is no material foreseen depreciation shortfall to the non-section 704(c) partner (e.g., the “money partner”), this may very well be acceptable. However, if the money partner wants certainty that they will never be shorted on deductions, they will insist on the remedial method. In reality it is very rare that the curative method is used as there is often no extra available tax depreciation to cure with and partners generally do not like to cure with operating income. Further, the curative method has the distortive affect of curing any depreciation shortfall over the shorter remaining tax life of the asset, rather than the newly placed in service life used in the remedial method.

C. Discretion over Tax Elections and Major Decisions
Partnership agreements are getting more sophisticated in the way they address the collective decision making process relating to tax elections and other tax-related decisions. In older agreements it was quite common to view this as an administrative point and cede such power to the general partner or managing member. In modern agreements this topic is more often highly negotiated and often directly addressed in the term sheet at a high level. There is no single default way to address this issue. Some agreements address it item by item (such as spelling out section 754 elections, section 706 elections, and the like). Other agreements simply include a general conceptual approach in the major decisions section, usually either making it a board decision or a unanimous consent decision. Most will take a hybrid approach and specifically address a pre-agreement of certain fundamental points such as section 704(c) and section 754 in the document, and leave any unaddressed items to either a major decision or delegate it to the manager with a certain level of consent rights by the other partner.

As a practical matter a hybrid approach to tax decisions is best, giving the manager some practical decision making authority over minor items. In addition, if representing the non-manager, it is good to also have the opportunity for a reasonable review period for draft tax returns. The following are two samples of ways to handle the tax major decisions.

### Major Decision Sample Language - Tax

<table>
<thead>
<tr>
<th>Simple with materiality qualifier</th>
<th>make any material tax election or tax filing on behalf of the Company</th>
</tr>
</thead>
<tbody>
<tr>
<td>Comprehensive with material adverse effect qualifier</td>
<td>All decisions with respect to legal or tax matters (including any tax elections of the Company or any subsidiaries, any change to or adoption of any method of accounting, of allocation of profit and loss or of depreciating property of the Company or any subsidiaries not specifically provided for herein, any other tax return preparation decisions and any decisions to settle contests of real estate taxes) which matters in the reasonable judgment of [either Member] could have a material adverse effect upon the Company, and subsidiaries, or such Member.</td>
</tr>
<tr>
<td>Simple and comprehensive with no materiality threshold</td>
<td>Approve all matters concerning the allocation of Profit or Loss (and items of taxable income, gain, loss or deduction) among the Members, tax elections, and the accounting procedures to be used by the Company.</td>
</tr>
<tr>
<td>Detailed with materiality qualifier</td>
<td>Take any action to make, change or revoke any material tax election, elect classification as a corporation for federal income tax purposes, amend any tax return in any material respect, or agree to any material tax audit adjustment by, or enter into any material agreement with, any taxing authority.</td>
</tr>
<tr>
<td>Limited to items having</td>
<td>All income or other tax elections, tax returns and tax audits involving the Company or a Company Subsidiary to the</td>
</tr>
</tbody>
</table>
D. Tax distributions

No tax advisor wants to have to tell his or her clients that they owe a tax without receiving a corresponding amount of cash to pay it. Such cashless income is often referred to as “phantom” or “dry” income. Unfortunately for taxpayers investing in tax partnerships, phantom income issues frequently arise, because partners must recognize their shares of partnership taxable income regardless of whether they receive any distributions.

Taxpayers who control their partnerships (such as general partners or LLC managers) can sometimes limit the impact of phantom income by simply causing their partnerships to make sufficient cash distributions under their general distribution provisions. The partnership would, of course, need to have cash available to distribute. The situation is harder for non-controlling partners, who typically have no power to force partnership distributions beyond what is required in the partnership agreement. For them, protection from phantom income is achieved primarily through negotiated partnership tax distribution provisions described in more detail in Part IV of this article.

E. General Tax Allocation and Boilerplate Decisions

The tax allocation provisions include a number of discretionary provisions related to capital accounts and section 704(b) allocations (i.e., section 704(b) "boilerplate decisions"). These provisions cover decisions such as (i) how to value assets for section 704(b) purposes when they are contributed or distributed, (ii) discretion on when to revalue (book up) assets on events such as contributions and issuances of profits interests, (iii) discretion under section 706 on methods of allocating income between partners when there has been a change in partner ownership during the tax year, and (iv) discretion to make future section 704(b) allocations to “cure” any economic distortions created by the mandatory section 704(b) “regulatory” allocations.

The manager or general partner tends to have the primary authority on day to day section 704(b) boilerplate decisions. Despite the default power given, many agreements carve back on this power in one or more ways. The non-manager will often ask for a specific consent right each time such decision making power is referenced in the partnership agreement. As a practical matter giving the non-manager full consent rights makes the agreement harder to administer and may give the non-manager too much power. Other agreements will deal with this not through a specific consent right but through a general tax reference in the major decision powers discussed in Part III.C. above. Finally, it is common to insert a reasonableness qualifier as a compromise. For example, if the non-manager has a consent right, that consent would be limited to “reasonable” consent. Furthermore, the manager’s original authority can also be limited to a “reasonable” exercise of such power. At the end of the day these types of qualifiers...
are designed to prevent partners from using tax decisions as leverage if the partners ever have a falling out later.

F. Audit related decisions

Partnership audit decisions have risen in prominence with the passage of the new entity-level audit rules in 2015, mandatorily effective starting in 2018. At this point all new agreements should address the new statutory changes and soon there will be a wider effort to amend older agreements once the government publishes more guidance on the many open questions. In the meantime, it is important that the audit provisions address the following negotiated points:

Who will be the partnership representative and is there a backup plan?

The new audit rules allow any person to be the partnership representative, even a non-member. However, under the historical audit rules the equivalent “tax matters partner” must be a partner that is also a manager or general partner (or if non-member managed, then it need not be a manager). This begs the question of whether the partnership wants to elect a non-member to be the partnership representative starting in 2018 (or earlier if the partnership elects early application of the new rules). In general most partnerships are going to stick with using the historical managing partner approach, but for non-member managed partnerships, the partnerships should consider having the non-member manager be the partnership representative since that is the person who will know the underlying facts the best. However, as a non-member, it is likely that a specific key partner, or a board of directors appointed by the members, will want to retain ultimate authority such that the non-member representative would report to this partner/board, and the partner/board will have the ability to replace the non-member representative as partnership representative in the future.

Specific partner approval rights on key issues

Under both the historical audit rules and the new roles, a critical topic will be individual partner approval rights on key issues. This issue is heightened under the new rules because the partnership representative will have more binding authority than before, including the ability to bind the partnership to settlements and the ability to elect to “push out” audit adjustments to the partners vs. pay the adjusted tax at the partnership level. Although much of this decision making power will be covered in the major decision language discussed in Part III.C above, it is best to also clearly spell out specific critical issues in this section of the agreement for clarity. It is typical for the person who is not the partnership representative to have reasonable consent rights to settlements, choice of court on litigation matters, and the extension of the statute of limitations. Going forward it is expected that this list will grow to include the election under section 6226 to push audit adjustments out to the partners and potentially other decisions. Some agreements also allow key partners a right to review and possibly comment on significant IRS correspondence and court filings.

Rights and obligations to give and receive information between the partnership and the partners
Partners often negotiate for rights to information regarding the audit from the partnership representative. Historically this included making such partners "notice partners" that the IRS sends information to (which usually happened as a matter of law anyway), and sometimes providing such partners the right to review proposed answers to IRS's Information Document Requests and other IRS correspondence. Under the new audit rules the concept of a notice partner is eliminated so a partner should negotiate even further information from the partnership as to notice of key events since the IRS will no longer reach out. The partnership in turn also needs key information from partners under the new rules, particular with regard to determining whether the partner is a taxpayer so that the partnership can make the decision whether to "push out" audit adjustments to the partners or use the partner's tax rate information for purposes of calculating tax in a partnership-level adjustment. Thus the need for information sharing is greater than it ever was in both directions and the document should clearly provide the rights to this information.

G. Allocation of nonrecourse debt deductions

Although traditionally overlooked boilerplate, the regulations provide important discretion in allocating non-recourse deductions. Non-recourse deductions are the deductions where no partner is treated as at personal risk, and they generally follow the partners' interests in the partnership. For a partnership with a single "straight up" sharing regime, these deductions will always be allocated in those same fixed sharing ratios. However, if a partnership has multiple "tranches" of sharing (such as 100% to the preferred up to an 8% return and then 80% to the preferred and 20% to the "carried interest" partner), then there is discretion to allocate these deductions in accordance with a single or a combination of these tranches. Agreements vary between allocating with the residual tranche (including the carry) and the original ratio of contributed capital. A tax-paying capital partner would prefer to use the capital contribution ratios.

H. Allocation of non-recourse debt basis

Similar to non-recourse deductions, the regulations also include discretion to allocate so-called "third tier" nonrecourse debt basis. The most significant discretion is to allocate debt disproportionately to a single partner to the extent of that partner's section 704(c) gain that is not already attracting nonrecourse debt. Although this special allocation cannot be used for disguised sale planning, this attracting of additional debt basis can be critical for a historical partner with very low tax basis, such as can often be the case when a new partner joins a historical partnership. Thus, the low-basis partner may negotiate that the agreement allocates them as much debt as possible under the nonrecourse debt allocation rules.

IV. Tax Distributions

14 Reg. § 1.704-2.
15 Reg. § 1.752-3(a)(3).
16 Reg. § 1.752-3(a)(2) attracts debt to the extent the non-recourse debt exceeds tax basis and the gain from a sale of such property for the non-recourse debt would cause gain allocable to such partner under section 704(c) principles (so-called "section 704(c) minimum gain").
A. Arguments For and Against Tax Distributions

Partners are responsible for their share of partnership taxable income. Tax distributions provide cash to pay the tax that may be due on such income. Partners may recognize taxable income on allocations in excess of their partnership distributions for various reasons. The partnership, for example, may use its taxable profits to fund nondeductible expenditures (such as capital expenditures or principal payments due under a loan), or, alternatively, the partnership might apply its taxable profits to increase cash reserves.\(^\text{17}\) In these circumstances, the partners must look to other sources of cash to fund the taxes payable on undistributed partnership profits.

Tax distribution provisions become particularly important for non-preferred partners, a term used to cover minority partners with little control, or even managing partners whose profit sharing begins only after the “money” partners are repaid. In many of these partnerships, the partnership agreement returns contributed capital to preferred partners before residual profits are shared by all partners. As a result, the partnership uses cash flow from taxable profits to repay capital contributions to preferred partners, while the tax allocations related to such profits (and the accompanying tax obligations) are spread among all partners. In effect, this is very similar to what occurs when partnerships apply taxable profits to repay principal under a loan. In each case, the partnerships use cash flow that could pay taxes to repay contributed capital or borrowings.

Tax distributions, however, are not treated the same under all partnership agreements for a variety of reasons. In some cases, the partnerships already distribute all available cash flow quarterly or more frequently, and all partners share profits and cash in the same ratio. In those cases, if the tax distribution is limited to available cash flow, the tax distribution would not change the manner in which cash would otherwise be distributed. In other cases, a significant percentage of the partnership is owned by tax-exempt persons who do not need or want tax distributions and do not want the partnership to use its precious cash to make unnecessary distributions. Although the taxable partner could negotiate for non-pro rata tax distributions only to the taxable partners, the non-receiving partners may view such non-pro rata distributions as imprudent or simply unfair. Further, a tax distribution provision may affect the business plan of the partnership if the partnership is required to use reserves, borrow, or reapportion cash distributions to pay partner taxes or to avoid events giving rise to phantom income. Alternatively, a partner who is entitled to a disproportionately large share of profits (i.e., a “carried interest”) only after the money partners achieve a minimum rate of return may wish to forgo tax distributions if such money could otherwise be used to pay the preferred equity, and ultimately increase the return under the carried interest.\(^\text{18}\) Partners

\(^{17}\) If the controlling partner has significant discretion regarding the distribution of cash or holding of reserves, a minority partner can be at the mercy of a controlling partner unless the applicable partnership agreement includes a mandatory tax distribution provision. However, independent of the phantom income issue, most sophisticated partnership agreements set forth specific standards for when cash can be accumulated or must be distributed, with the degree of specificity being a negotiated point in the drafting process.

\(^{18}\) It may be more cost-effective for a carried interest partner to use other funds to pay taxes, with a cheaper cost-of-funds rate than the preferred return rate. Further, the carried interest partner may prefer
in certain types of businesses, such as real estate or a start-up business, also may have significant depreciation or start-up losses from this or other unrelated investments that substantially reduce the likelihood of aggregate net phantom income.

If a partnership agreement does not have a tax distribution provision, taxable partners should generally review cash flow and tax projections to determine whether they will receive any phantom taxable income. In the case of a partner with a carried interest, taxable income often will not exceed any applicable "interest-like" preferred return payable to preferred partners until liquidation, in which case a tax distribution may not be necessary, assuming there are no other phantom income concerns. However, if the taxable income will exceed the preferred return, many non-preferred partners may find themselves facing phantom income from the partnership and should determine whether they have net deductions from other investments to offset the phantom income or if they have sufficient liquidity outside the partnership to pay the taxes.

The following example illustrates how phantom income can occur when the cash waterfall first distributes taxable operating profits in excess of the preferred return to repay partner capital contributions (instead of distributing in accordance with residual sharing percentages). Under these circumstances, a non-preferred partner with a carried interest will receive taxable income based on its higher residual sharing percentage, but will receive distributions based on its lower share of contributed capital.

**Example.** LP and GP, respectively contribute $99 million and $1 million in cash to PRS, which PRS uses to buy Building. The distribution waterfall in the partnership agreement returns capital plus a 10% annual preferred return in the same 99:1 ratio in which capital was contributed, and then distributes profits 79:21 to LP and GP, recognizing GP's additional 20% "promote" share of profits.\(^{19}\)

GP's phantom income is illustrated in Exhibit 1. In this example, GP finds itself with phantom income because, once the taxable income exceeds the 10% preferred return, GP receives only 1% of the distributions but is taxed on 21% of the related income (until all of the capital is returned).

**Exhibit 1. Phantom GP Income**

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\(^{19}\) Note GP is given a full 21% of profits in this example for simplicity, although most transactions would provide GP with a total of only 20.8% of the profits, recognizing that GP's 20% promote should also dilute the return on GP's 1% of capital (20% of 1% reduces GP's capital return by 0.2%).
### Phantom GP Income When GP Has Promote and Cash Returns Contributed Capital

<table>
<thead>
<tr>
<th>Pre-Tax Cash Flow</th>
<th>LP</th>
<th>GP</th>
<th>Total</th>
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</thead>
<tbody>
<tr>
<td>Capital Contributions</td>
<td>$99,000,000</td>
<td>$1,000,000</td>
<td>$100,000,000</td>
</tr>
<tr>
<td>Year 1 Distributable Cash</td>
<td></td>
<td></td>
<td>$12,000,000</td>
</tr>
<tr>
<td>Distributions of 10% preferred return</td>
<td>$9,900,000</td>
<td>$100,000</td>
<td>$10,000,000</td>
</tr>
<tr>
<td>Distributions – return of capital</td>
<td>$1,980,000</td>
<td>$20,000</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>Total Distributions</td>
<td>$11,880,000</td>
<td>$120,000</td>
<td>$12,000,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Taxable Income</th>
<th>LP</th>
<th>GP</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1 taxable income</td>
<td></td>
<td></td>
<td>$12,000,000</td>
</tr>
<tr>
<td>First to preferred return</td>
<td>$9,900,000</td>
<td>$100,000</td>
<td>$10,000,000</td>
</tr>
<tr>
<td>Second with residual sharing (79:21)</td>
<td>$1,580,000</td>
<td>$420,000</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>Total taxable income</td>
<td>$11,480,000</td>
<td>$520,000</td>
<td>$12,000,000</td>
</tr>
<tr>
<td>Tax liability (40%)</td>
<td>$4,592,000</td>
<td>$208,000</td>
<td>$4,800,000</td>
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</table>

<table>
<thead>
<tr>
<th>Post-Tax Cash Flow</th>
<th>LP</th>
<th>GP</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Distribution surplus/shortfall</td>
<td>$7,288,000</td>
<td>($88,000)</td>
<td>$7,200,000</td>
</tr>
</tbody>
</table>

### B. Negotiating for Tax Distribution Provisions

A non-preferred partner who believes tax distributions are needed can sometimes encounter resistance from a preferred partner. An often effective response by a non-preferred partner is to argue that, if the entity was taxed as a Subchapter C corporation, the entity would be similarly required to pay income taxes at the entity level. Indeed, the use of a partnership model is simply shifting this entity-level tax obligation to the partner level. As a result, a non-preferred partner could persuasively argue that, like cash flow of a C corporation, partnership cash flow should cover taxes on partnership income. After all, to allow otherwise would cause the non-preferred partner to bear much of the tax burden on partnership income when the partnership, if incorporated, would fully shoulder that burden. In practice, this argument often convinces resistant preferred partners to accept at least some form of a tax distribution provision that benefits the non-preferred partner.

Despite this “corporate analogy” argument, a partner may continue to resist tax distributions, particularly if such partner is either tax-exempt or taxed at a much lower rate (such as an alternative minimum tax taxpayer). A partner who does not need tax distributions, for example, may prefer to leave that cash in the partnership to generate
additional profits, and in any event will not typically want the partnership to incur debt and interest expense to make tax distributions. Ultimately, if the partners cannot agree on a tax distribution, they may decide that the partnership will make tax loans to partners with insufficient cash to pay their taxes. In these cases, the negotiation then turns to such issues as interest rates and repayment terms.

C. Baseline Tax Distribution Provision

A review of the following "baseline" provision is a helpful start to analyzing particular tax distribution provisions:

**Tax Distributions.** To the extent that the amount distributed to (or withheld on behalf of) any Member in respect of a fiscal year of the Company is less than such Member's Assumed Tax Liability, the Manager shall distribute cash equal to such shortfall to such Member, at such times as to permit the Member to timely satisfy estimated tax or other tax payment requirements. Each Member's "Assumed Tax Liability" shall equal the expected aggregate federal, state, and local tax liability of such Member attributable to items of income, gain, loss, and deduction allocated to such Member for income tax purposes (excluding allocations under Section 704(c) principles), assuming [the highest marginal income tax rates applicable to any Member] or [that such Member is an (individual/corporation) subject to tax at the highest marginal rate of income tax applicable to a resident in (Name of State and/or City)], taking into account the character of the relevant income or loss to such member and the deductibility, if any, of any state or local tax in computing any state or federal tax liability. Any amounts paid to Members under this section [] shall be treated as advances on distributions otherwise payable under this Agreement and are limited to available Net Cash Flow, with any shortfall prorated according to each Member's relative Assumed Tax Liability for such fiscal year.

In short, the above baseline tax distribution provision instructs the manager to distribute cash to the members to pay their assumed tax liabilities to the extent that the members have not already directly received sufficient distributions from the company (or indirectly received distributions through tax withholdings) to pay their taxes. The provision contemplates multiple distributions within a single year in order to fund estimated taxes. The provision also defines taxes broadly to include federal, state, and local income taxes.

The broad definition of taxes, however, excludes taxes on income allocations under Section 704(c). This approach is logical because Section 704(c) gain allocations, when triggered, generally will relate to unrealized gains that accrued outside of the partnership. As a result, the rationale for imposing an obligation to pay taxes on such gains on the partnership is not particularly compelling. This does not mean that a

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20 The need for cash reserves depends largely on the nature of the partnership's business (e.g., a technology partnership with significant research and development is likely to need more cash than a non-development real estate partnership).
partner potentially subject to income allocations under Section 704(c) cannot negotiate to include such income allocations in a tax distribution provision. On the contrary, tax distribution provisions sometimes, either intentionally or inadvertently, treat Section 704(c) gain allocations no differently than other allocations of gain. Most tax professionals, however, would view extending the definition of taxes in a tax distribution provision to include Section 704(c) income allocations as outside customary practice.

By assuming that all members are either individuals or corporations subject to tax at the highest effective rate in a particular jurisdiction, the baseline provision allows the manager to calculate tax distribution amounts without having to undertake multiple calculations or review the tax returns of the members to ascertain their actual tax situations. Thus, if a partnership has individual partners in multiple state jurisdictions such as Florida (top state rate 0%), Virginia (top state rate 5.75%), and California (top state rate 13.3%), the agreement would specify California. This provision prudently trades precision for relative simplicity in determining tax distribution amounts. The provision also avoids potential disputes among partners by maintaining proportionate distributions and helping to keep partner information confidential.

The tax distribution provision above also includes language designed to avoid excessive tax distributions. For example, the provision takes into account the tax character of partnership income in determining tax distributions. The partnership, therefore, will not assume a higher ordinary-income tax rate for items that may qualify for reduced tax rates, such as long-term capital gains or certain dividends. Further, the provision follows the common practice of limiting potential tax distributions to available cash flow. In so doing, the tax distribution provision will not force the manager to borrow in order to make tax distributions and will allow the partnership to keep reserves.

Finally, and even more importantly, the provision treats tax distributions as advances on distributions otherwise payable to members. Tax distributions, as a result, are not intended to have an impact on the amount of partnership distributions ultimately received. Instead, such distributions are intended to affect only the timing of partnership distributions. This "advance" language is critical for preventing tax distributions from changing the economic arrangement of the partners (beyond the timing benefit). Without such language, tax distributions become "permanent" distributions that can dramatically affect the economics of the partnership.21

21 Tax distributions inherently change the economics in that they effectively provide a time value of money benefit, since most do not require an interest charge for this cash advance. However, without the "advance" language a tax distribution can mean that the partnership is effectively paying the partner's taxes. For an example of this issue see Interactivecorp (f/k/a USA Interactive) and USANI Sub LLC v. Vivendi Universal, S.A., USI Entertainment Inc., and Vivendi Universal Entertainment LLLP, 30 Del J Corp L 251, 2004 WL 1516149 (Del. Ch. 6/30/04).

22 Even this baseline provision can make tax distributions permanent to the extent that the partnership does not have a clawback provision to require the return of the prior tax distribution. This can occur when a service partner with no capital receives an allocation of taxable income, and a tax distribution, but there are offsetting economic losses in a later year that fully reverse the prior income. For example, an allocation to a service partner of $1 million of ordinary income in year one may entitle the partner to a $400,000 tax distribution. If the partnership later loses that same $1 million, absent a clawback obligation
V. Conclusion

Drafting partnership agreements is a combination of art and science and is an ever evolving exercise as the underlying law keeps changing. The article provides an overview of the typical structure of a sophisticated partnership agreement and the key items of negotiation. To fully cover the topic takes a lifetime of experience, but short of that, we hope this article is a practical overview learned from the school of hard knocks attended by your authors.