Partnership Allocations: What You Don't Know Can Hurt You

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Why are we talking about this?

- The partnership allocation rules have been around for more than 30 years – why are we talking about this?
- The application of technical rules evolve.
- Business models evolve.
- Practitioners get comfortable and – sometimes – perhaps lose their normal laser-like focus.
- So, in the spirit of “an ounce of prevention is worth a pound of cure . . . .”
What we’ll cover today

- A refresher of the partnership allocation rules.
- Some key decisions in melding the business deal to the governing agreement.
- Highlights of some things that can go wrong.
- Questions and (hopefully) answers.
Starting point: The partnership “agreement”

- Includes *all* agreements
- Between partners.
- Among partners.
- Need not be called a “partnership agreement”
- Can consist of more than one document
- May be oral or written (evidentiary issues)
- Includes relevant non-tax law provisions
- For hybrid entities, it should include any shareholders’ agreement
Background: The Section 704(b) Regulations

“These regulations are designed to insure that items of partnership income, gain, loss, deduction or credit are allocated among the partners in the same manner in which the partners share the economic benefits and burdens associated with these items.”
The statutory framework

- General rule: Partner’s share of income, gain, loss, deduction or credit determined in accordance with the partnership agreement.

- Exception 1: If the partnership agreement lacks “substantial economic effect,” items of income, gain, loss, deduction or credit will be allocated to the partners based on the “partners’ interest in the partnership.”

- Exception 2: If the agreement contains no allocation provisions, the allocation of income, gain, loss, deduction or credit similarly is allocated to the partners based on the “partners’ interest in the partnership.”
"Substantial economic effect"

- Substantial economic effect (SEE) is a safe harbor.
- If the allocations meet the test, they will be respected.
- The test imposes two requirements.
  - The allocation must have "economic effect" and
  - That economic effect must be "substantial."
“Economic effect”

- Three requirements.
  - Maintain capital accounts in accordance with the rules contained in the Regulations.
  - Liquidating distributions, in all instances, must be made in accordance with positive capital accounts.
  - Provide for one of the following:
    - Basic test: Partners with a capital account deficit have an obligation to restore that deficit, generally within 90 days – the dreaded deficit restoration obligation (DRO)
    - Alternate test: A further two-pronged test.
      - The partnership agreement precludes a partner from an impermissible negative capital account, and
      - The partnership agreement contains a qualified income offset provision.
Structure of the Regulations

- The Regulations provide for 2 different methods to determine whether an allocation has SEE.
  - The alternate economic effect test.
  - A safe harbor.
- If an allocation lacks SEE, the Regulations require the allocation be based on PIP.
  - Caveat: Even if an allocation is respected under one of these methods under section 704(b), the amount may be reallocated under another provision of federal tax law
  - Example: Transfer pricing rules of section 482.
Alternate test of economic effect – in general

- This is the most common method by which partnerships assure their allocations meet the SEE safe harbor

Why?
- General aversion to deficit restoration obligations.
- Increasing use of limited liability companies.
- Sometime legal question under varying state laws of whether or not third party creditors can enforce a DRO.
The alternate test for economic effect has four basic requirements.

- Capital account must be maintained in accordance with the rules in the Regulations.
- Liquidating distributions must be made in accordance with positive capital account balances.
- A loss allocation may not cause or increase a deficit in capital.
- The partnership agreement contains a QIO.
Types of capital accounts

- The capital account maintenance rules effectively means there are 3 different types of capital accounts.
  - Section 704(b), or "book" capital – essentially fair market value.
  - Tax basis capital – adjusted tax basis.
  - Capital under generally accepted accounting principles (GAAP).
- Each partner has only one capital account under the allocation regulations, even if the agreement creates disparate classes of partnership interest held by a single partner.
Capital account maintenance

- Contributions (at fair market value, net of liabilities).
- Distributions (at fair market value, net of liabilities).
- Income:
  - Increase for taxable income items.
  - Increase for nontaxable income items (example: tax-exempt bond interest).
- Deductions and losses:
  - Decrease for deductible losses and expenditures.
  - Decrease for nondeductible, noncapitalized expenditures.
- Depreciation and gain (or loss) on sale of property is computed using book basis.
Capital account maintenance

- Reg §1.704-1(b)(2)(iv)(f).
- Optional revaluation events ("book up" or "book down").
- Contributions of property or money by a new or existing partner.
- Distributions of property or money to an existing partner.
- Issuance of profits interest.
- Securities partnerships.
Capital account maintenance

- Reg §1.704-1(b)(2)(iv)(h).
- What is fair market value for purposes of the capital account revaluation?
  - The partnership can determine FMV if:
    - The partners agree at arm’s-length, and
    - The partners have “substantially adverse interests.”
Capital account maintenance

- Reg §1.704-1(b)(iv)(q).
- What happens if the Regulations don’t provide guidance on a capital account bookkeeping issue?
- Allocations are accepted if consistent with the underlying economic arrangement.
- The allocations should be based, if practicable, on federal income tax accounting principles.
Liquidating distributions

- The partnership agreement must provide that liquidating distributions will be made in accordance with the positive capital account balances of the partners.

- Determined after taking into account all capital adjustments for the taxable year of the liquidation.

- Timing: Generally must be made by the earlier of:
  - The end of the year of liquidation; or
  - 90 days after the date of liquidation.
Liquidating v. current distributions

- The requirement that liquidating distributions follow capital account balances does not apply to current distributions.
- But current distributions reduce capital accounts, so ultimately they will affect liquidating distributions.
Deficit restoration obligation

- Rule: A partner with a deficit capital account balance upon liquidation is unconditionally obligated to restore the amount of that deficit.
- DROs can be actual or deemed.
  - Actual: DRO provision in the partnership agreement.
  - Deemed: State law obligation.
  - Differences between state law and the regulatory DRO?
  - Partner (or related party) promissory notes contributed to the partnership.
  - Unconditional obligation to contribute.
  - Ultimate payer on partnership recourse debt.
  - Minimum gain.
Deficit restoration obligation

- Does a DRO create amounts at-risk for section 465?
- Hubert Enterprises, Inc.
  - 6th Cir. test: “Does the taxpayer have a fixed and definite obligation to use personal funds to pay a debt in a worst case scenario?”
  - Who, really, is the payor of last resort?
  - Taxpayer is not at risk if the obligation to repay borrowed funds is contingent.
Deficit capital accounts

- Under the alternate test, no partner may be allocated a loss if it would cause or increase a deficit in the partner’s *adjusted capital account*.
- Huh?
- Adjusted capital account is the capital account reduced by certain expected future decreases, including all future distributions, unless matched with income.
Qualified income offset provision

- In lieu of a DRO under the primary test for economic effect.
- The alternate test requires the partnership agreement contain a QIO.
- The partnership agreement must provide that *unexpected distributions* which cause or increase a deficit balance in a partner’s capital account will be eliminate as quickly as possible through special allocations of income and gain.
- Partnership allocations may not cause or increase a deficit balance in a partner’s capital account in excess of any obligation to restore that deficit.
Protective gross income allocations

- Many sophisticated partnership agreements contain a protective allocation provision which prevents future deficit capital accounts by requiring the allocation of gross income to a partner with a deficit capital account balance at the end of the year.

- This means that the *adjusted capital account* balance can never be negative, and allocations of current year losses can be based on *actual capital account* balances.
Special allocations

- A "special allocation" is an allocation which is not made based on a partner's interest in the partnership.
  - Example: An allocation of 90 percent of depreciation to one partner in a 50/50 partnership.

- Special allocations generally are not possible in a partnership that requires liquidating distributions to be based on ownership percentages.
Substantiality

- Second prong of the “substantial economic effect” test.
- Substantiality is separate from – and in addition to – the basic or alternate economic effect test.
- Reg §1.704-1(b)(2)(iii): “... an allocation (or allocations) is substantial if there is a reasonable possibility that the allocation (or allocations) will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences.”
Substantiality – general rules

- Three key rules to keep in mind.
- Intra-year shifting.
- Transitory allocations.
- Overall tax effect.
Intra-year shifting

- Taxable v. tax-exempt income.
- Ordinary income v. capital gain.
- Ordinary loss v. capital loss.
- Domestic source v. foreign source income.
- Active income (or loss) v. passive income (or loss).
- Passive income (or loss) v. portfolio income (or loss).
Transitory allocations

- Testing period: All years in which allocations may occur.
- Hallmarks: Does anybody lose, other than the fisc?
  - Aggregate tax reduction.
  - Minimal capital impact.
- Exceptions:
  - 5-year waiting period.
  - Value = basis rule.
Overall tax effect rule

- An allocation will not be respected if the after-tax economic consequences of at least one partner may, in present value terms, be enhanced, and a strong likelihood exists that the after-tax consequences of no partner will, in present value terms, be substantially diminished (taking into account the partners’ non-partnership tax attributes).

- Projected after-tax economic results to each partner under prescribed allocation scheme be compared to same after-tax economics that would result under allocation scheme if the allocations being tested were not in the agreement.

- Virtually no guidance as to factors that should be considered in arriving at “base-line” allocations.
Substantiability Proposed regulations

- Primary purpose: Clarify that “look-through entities” are looked through to apply the substantiability rules.
- Apply substantiability tests by looking through to the owners of look through entities.
- Look through entities are partnerships and S corporations.
- Exception for RICs and REITs.
- Similar rules for:
  - CFC Subpart F income.
  - Consolidated return group members.
Substantiality proposed regulations (cont’d)

- “Clarification” that substantiality baseline is PIP.
- Eliminate per capita presumption.
- Confirm that section 482 can override section 704(b).
- Disregard of small interests absent actual knowledge or reason to know to the contrary.
- Timing and procedural matters.
Partners’ interest in the partnership

- What if the partnership’s allocations are outside the safe harbor and the alternate test?
- An allocation that fails both the general rule and the alternate effect tests may nevertheless be respected in the allocation is based on the partner’s interest in the partnership (PIP).
- This is a facts and circumstances determination.
Partners’ interest in the partnership (cont’d)

- Relative contributions of the partners.
- Relative interests in distributions upon liquidation.
- Relative interests in cash flow.
- Relative interests in economic profit and loss sharing ratios.
- Planning based on PIP can be problematic – potential lack of certainty.
Allocations based on the partners’ interest

- The partnership agreement is silent.
- The allocations lack substantial economic effect.
- The allocations cannot have economic effect.
Nonrecourse deductions

- Definition: No partner bears economic risk.
- The regulations provide a “safe harbor” under the partners’ interest in the partnership.
- Failure to satisfy the special rules means the allocation defaults to a facts and circumstances test.
- There is another set of special rules when the partner or an affiliate is the nonrecourse lender.
Section 704(b) recap...

- To be respected, partnership allocations must:
  - Have substantial economic effect,
  - Be in accordance with the partners’ interests in the partnership, or
  - Be deemed to be in accordance with the partners’ interests in the partnership.

- If the partnership’s allocations are not respected, income, loss, etc. will be allocated in accordance with the rules for the partners’ interest in the partnership.
The debate

- Fundamental choice: Liquidating by capital accounts or by distribution formula.

- Many clients simply do not understand capital accounts or the significance of income and loss allocations.

- Although clients often do not understand capital accounts, they are generally comfortable with the economic arrangements associated with multiple classes of corporate stock.

- Clients and tax advisors alike typically do not want mistakes or unexpected interpretations of the allocation regulations to alter the economic arrangements between partners.
Reviewing partnership agreements – things to consider

- Definitions: Clarity, necessity, sample calculations (example: “preferred return”).
- Standard tax language: Loss limitations, nonrecourse deductions, DROs and QIOs.
- Allocations: Safe harbor or distribution-based agreements.
- Contributed property and section 704(c) method: Key negotiation point.
- Liquidation: Should a partner have a DRO?
  - Debt allocations.
  - Loss allocations.
  - Risks and alternatives.
Reviewing partnership agreements – things to consider (cont’d)

- Initial capital and percentages.
  - Initial built-in gain or loss.
  - Equity value.
- Tax distributions?
  - Rates? Federal and state?
  - Partner tax attributes, including section 704(c)?
  - Optional or mandatory?
  - Cumulative or current income?
- Preferred returns: Guaranteed payment or preferred allocation?
- Tax preparer and law firm coordination during drafting process.
Reviewing partnership agreements – things to consider (cont’d)

- Make sure the partnership models its allocation and distribution provisions!
- And make sure you understand those allocation and distribution provisions!
Most common mistakes

- The form book is your friend.
- Don’t think about the nature of the partners – a partner is a partner . . .
- It doesn’t matter where the partnership does business.
- The allocation appendix from the last deal should work.
- Put the “pedal to the metal” – get the deal done!
- Save your client’s money – let the other guy draft the documents.
- Don’t involve the accountants – they’ll slow things down and just confuse things with a lot of questions.
- Don’t ask questions about the business.
Most common mistakes

- Don’t read the business plan – it really doesn’t matter.
- If you do decide to read the business plan, assume its accurate.
- The partners will work things out.
- Don’t ask about the long-term plan for the business or the partners’ exit strategy.
Thank you!