Negotiating Tax Provisions in Partnership and LLC Agreements

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Brian J. O'Connor

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Case Study

S Corp, an S corporation engaged in the government contracting business, has entered into a sale/joint venture transaction with Fund, a private equity fund. Under the terms of the overall deal, S Corp will directly or indirectly transfer all of its assets to LLC in exchange for $70 million in cash and common LLC “rollover units” representing 30% of the LLC. For its part, Fund will transfer cash in exchange for preferred LLC units representing 70% of the LLC.
Case Study (cont.)

Fund prepares the draft Operating Agreement for the LLC and provides the Operating Agreement to S Corp for review and comment. Both parties agree that the LLC will issue "profits interests" to certain key executives both at closing and throughout the term of the LLC. Finally, LLC will borrow on its assets from Bank to fund a portion of the $70 million cash payment to S Corp.
First Provision – Cash Waterfall

“Distributions: The Company shall make all distributions of Net Cash Flow and Capital Proceeds to the Members as follows:

(a) First, to Fund, until Fund has received an IRR on its Capital Contributions of twelve percent (12%).

(b) Second, to Fund, until Fund receives a return of its Capital Contributions.

(c) Third, to S Corp, until S Corp receives a return of its Capital Contributions.

(d) Fourth, to the Members, in accordance with their Percentages.”
First Provision – Cash Waterfall

Primary Issues

• Does cash waterfall match the business deal?

• IRR already includes a built-in return of capital contributions

• No IRR on common capital?

• Common capital subordinate to preferred capital. Does subordination create a guaranteed payment on the preferred capital?

• What about tax distributions?
First Provision – Cash Waterfall

Tax Distributions -- Issues

• Cash flow limitation?

• Annual or quarterly?

• What tax rate? What about Section 1411?

• What if different state tax rates apply to different members?

• How to handle Section 704(c) items and Section 743(b) adjustments?

• Cumulative or non-cumulative?
First Provision – Revised

“Distributions: The Company shall make all distributions of Net Cash Flow and Capital Proceeds to the Members as follows:

(a) First, to Fund, until Fund has received an IRR on its Capital Contributions of twelve percent (12%).

(b) Second, to S Corp, until S Corp has received an IRR on its Capital Contributions of twelve percent (12%).

(c) Third, to the Members, in accordance with their Percentages.”
First Provision – Revised

“Tax Distributions: Notwithstanding Sec. ___ above, if the amount distributed to any Member for a year 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 satisfy estimated tax or other tax payment requirements. Each Member’s “Assumed Tax Liability” shall equal the aggregate federal, state, and local income and Medicare tax liability of such Member on items of income, gain, loss, and deduction allocated to such Member for income tax purposes (excluding allocations under Section 704(c) principles), assuming that such Member is an individual subject to tax at the highest marginal rate of income tax applicable to a resident in the Commonwealth of Virginia, 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.”
Second Provision -- Allocations

“Allocations: For each taxable year, after adjusting each Member’s Capital Account for all Capital Contributions and distributions during such year and all special allocations for such year, all Profits and Losses shall be allocated to the Members’ Capital Accounts in a manner such that, as of the end of such year, the Capital Account of each Member (which may have either a positive or negative balance) shall equal, as nearly as possible, (a) the amount of distributions that would be received by each such Member if the Company were liquidated and all its assets were sold for their Gross Asset Values, taking into account any adjustments thereto for such period, all liabilities of the Company were satisfied in full in cash according to their terms ......................
Second Provision – Allocations (cont.)

... and all remaining amounts (after satisfaction of such liabilities) were distributed in full pursuant to Section ____ [the Capital Proceeds distribution section], minus (b) the sum of such Member’s share of Minimum Gain and partner nonrecourse debt minimum gain (as determined according to Treasury Regulation Section 1.704-2(i)) and the amount, if any, such Member is obligated to contribute to the capital of the Company as of the last day of such taxable year or other relevant period.”
Second Provision – Allocations (cont.)

- Targeted Allocations vs. Layer Cake Allocations

- Layer cake allocations
  - Allocate Section 704(b) book profit/loss first and use this allocation to determine the cash distributions.
  - Cash effectively follows tax.

- Targeted allocations
  - 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.
    - Tax effectively follows cash.
Basic Concepts

- Layer cake vs. target and Section 704(b) safe harbors
  - As a technical matter, liquidation with Section 704(b) capital accounts (often referred to as a “safe harbor” agreement) can occur with either a layer cake or a target allocation.
  - As a matter of practice, most target allocations instead liquidate with the cash waterfall in which they target the income, and most layer cake liquidate with positive Section 704(b) capital accounts.
  - It is possible to use target allocations to target capital accounts to equal the cash waterfall, but instead liquidate with capital accounts. The risk is that if the capital accounts do not equal the waterfall; the capital accounts govern the economics.
Basic Steps: Layer Cake Allocations

- Profit allocations
  - Reverse prior losses
  - Preferred return
  - Residual sharing ratio

- Loss allocations
  - Reverse prior profits (in reverse order)
  - 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
- 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
Three 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)
  - Net value in partnership upon deemed liquidation
  - Run value through distribution waterfall
- Step 3: Allocate profit or loss, to bring partially adjusted capital accounts to target capital account
Example 1: Net Income In Excess Of Preference

Year 1 income = $50,000
10% preferred to A, residual A=40%, B=60%
## Layer Cake Allocations

**Section 704(b) income allocations**

<table>
<thead>
<tr>
<th>Description</th>
<th>A</th>
<th>B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening capital</td>
<td>$100,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>$50,000 income</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. 10% pref to A.</td>
<td>$10,000</td>
<td>$0</td>
</tr>
<tr>
<td>2. 40:60 A and B</td>
<td>$16,000</td>
<td>$24,000</td>
</tr>
<tr>
<td>Total income</td>
<td>$26,000</td>
<td>$24,000</td>
</tr>
<tr>
<td>Ending capital</td>
<td>$126,000</td>
<td>$124,000</td>
</tr>
</tbody>
</table>
## Targeted Allocations

### Section 704(b) income allocations

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening capital</td>
<td>$100,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Adjustments during year</td>
<td>0</td>
<td>0</td>
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<tr>
<td>Partially adjusted cap</td>
<td>$100,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>acct</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Determine cash waterfall

$250,000 cash

1. 10% pref to A.       $10,000   
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   

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Example 2: Net Income Less Than Preference

Beginning balance sheet

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
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</thead>
<tbody>
<tr>
<td>Cash: $200,000</td>
<td>$0</td>
</tr>
<tr>
<td>Capital</td>
<td></td>
</tr>
<tr>
<td>A: $100,000</td>
<td></td>
</tr>
<tr>
<td>B: $100,000</td>
<td></td>
</tr>
<tr>
<td>Total $200,000</td>
<td>Total: $200,000</td>
</tr>
</tbody>
</table>

Year 1 income = $8,000
10% preferred to A, residual A=40%, B=60%
# Layer Cake Allocations

## Section 704(b) income allocations

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening capital</td>
<td>$100,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>$8,000 income</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. 10% pref to A.</td>
<td>$8,000</td>
<td>$0</td>
</tr>
<tr>
<td>2. 40:60 A and B</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>Total income</td>
<td>$8,000</td>
<td>$0</td>
</tr>
<tr>
<td>Ending capital</td>
<td>$108,000</td>
<td>$100,000</td>
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</table>
Targeted Allocations

Section 704(b) income allocations

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening capital</td>
<td>$100,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Adjustments during year</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Partially adjusted cap acct</td>
<td>$100,000</td>
<td>$100,000</td>
</tr>
</tbody>
</table>

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 $0 $0

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)
Comparison Of Examples 1 And 2

<table>
<thead>
<tr>
<th>Example 1</th>
<th>A</th>
<th>B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Target/waterfall</td>
<td>$126,000</td>
<td>$124,000</td>
</tr>
<tr>
<td>Layer cake/cap acct</td>
<td>$126,000</td>
<td>$124,000</td>
</tr>
<tr>
<td>Example 2</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Target/waterfall</td>
<td>$109,000</td>
<td>$99,000</td>
</tr>
<tr>
<td>Layer cake/cap acct</td>
<td>$108,000</td>
<td>$100,000</td>
</tr>
</tbody>
</table>

Ending cash received by A and B
Second Provision -- Allocations

Primary Issues

• Target vs. Layer Cake
• Loss allocations
• Special allocations
• Guaranteed payment issue
Third Provision – Section 704(c)

"Contributed Property: In accordance with Code Section 704(c) and the Regulations thereunder, income, gain, loss and deduction with respect to any property contributed (or deemed contributed) to the Company shall, solely for tax purposes, be allocated among the Members so as to take account of any variation between the adjusted basis of the property to the Company for federal income tax purposes and its initial Gross Asset Value (computed in accordance with the definition of Gross Asset Value). In making its allocations under Section 704(c), the Company shall apply the remedial method within the meaning of Regulations Section 1.704-3(d)."
Third Provision – Section 704(c)

**Primary Issue** - What Section 704(c) Method Should Apply?

- Traditional Method
  - Favors contributor of built-in gain property

- Traditional Method with Curative Allocations
  - Favors non-contributing partners by correcting ceiling rule limitations as quickly as possible but limited to available items

- Remedial Method
  - Favors non-contributing partners without regard to available items but may correct ceiling rule limitations over a longer period of time
Five Step Approach To Determine Impact of Section 704(c)

- Step One: Compute tax item
- Step Two: Compute book item
- Step Three: Allocate book item
- Step Four: Allocate tax to non-contributing partner to the extent of its share of the book item
- Step Five: Allocate residual tax, if any, to contributing/Section 704(c) partner
Section 704(c) – Available Methods

- “Ceiling Rule” - if not enough tax items to match book items allocable to non-contributing partners, analysis stops if the “traditional method” applies.
- If the “traditional method with curative allocations” applies, look to see if other appropriate items exist and, if so, use those items to correct ceiling rule distortions.
- If the “remedial method” applies, apply notional or “made up” items to correct ceiling rule distortions.
Third Provision -- Revised

• "Contributed Property: In accordance with Code Section 704(c) and the Regulations thereunder, income, gain, loss and deduction with respect to any property contributed (or deemed contributed) to the Company shall, solely for tax purposes, be allocated among the Members so as to take account of any variation between the adjusted basis of the property to the Company for federal income tax purposes and its initial Gross Asset Value (computed in accordance with the definition of Gross Asset Value). In making its allocations under Section 704(c), the Company shall apply the traditional method within the meaning of Regulations Section 1.704-3(b)."
Fourth Provision – Disguised Sales

“Disguised Sale: The parties acknowledge and agree that the agreed upon distribution to S Corp upon the formation of LLC shall cause S Corp to be treated as having entered into a disguised sale for federal income tax purposes under Code Section 707(a)(2)(B).”
Disguised Sales of Property – Section 707(a)(2)(B)

- Partner transfers money or property to the partnership.
- Partnership transfers money or property to the partner (or another partner).
- The transfers, taken together, can be recharacterized as a sale or exchange.
Disguised Sales of Property – Section 707(a)(2)(B)

• Transfer to partnership preceded or followed by transfer from partnership to partner.
  – If within 2 years, presumed to be a sale.
  – If not within 2 years, presumed not to be a sale.

• Presumptions can be overcome.
  – If facts and circumstances “clearly establish” transfer is not a sale, or is a sale.

• Contributions of encumbered property can give rise to a disguised sale.
Fourth Provision – Disguised Sales

Issues:

• Can the exception for Pre-Formation Expenditures Apply?

• Can the exception for Debt-Financed Distributions Apply?

• Other exceptions?
Reimbursement of Preformation Expenses – Reg. §1.707-4(d)

- Transfer of money or property by partnership to partner not treated as part of sale to extent that transfer to partner is made to reimburse the partner for, and does not exceed amount of capital expenditures that:
  - Are incurred during two-year period preceding transfer by partner to partnership; and
  - Are incurred by partner with respect to:
    • Partnership organization and syndication costs; or
    • Property, contributed to the partnership by the partner, reimbursement not to exceed 20 percent of FMV at contribution if FMV of property at contribution is 120 percent or greater of partner’s adjusted basis in property.
Debt-Financed Distributions – Reg. §1.707-5(b)(1)

- If partner transfers property to partnership, and

- Partnership incurs a liability and the proceeds of that liability are allocable under Reg. Section 1.163-8T to transfer of money or property to the partner made within 90 days of incurring the liability, then

- Transfer of money or property treated as sales proceeds only to extent that amount of money transferred exceeds partner’s share of partnership liability.
“Disguised Sale: The parties acknowledge and agree that the agreed upon distribution to S Corp upon the formation of LLC shall cause S Corp to be treated as having entered into a disguised sale for federal income tax purposes under Code Section 707(a)(2)(B). However, the parties agree to apply the exceptions in the disguised sale rules for reimbursements of preformation expenditures in Regulations Section 1.707-4(d) and debt-financed transfers in Regulations Section 1.707-5(b) to the greatest extent possible in calculating any disguised sale gain recognized by S Corp.”
Fifth Provision – Nonrecourse Deductions

“Nonrecourse Deductions: The parties acknowledge and agree that all Nonrecourse Deductions shall be allocated entirely to Fund.”
Fifth Provision – Nonrecourse Deductions

Issues:

- Everyone loves Nonrecourse Deductions!
- Allocations of nonrecourse deductions cannot have substantial economic effect – but can be in accordance with PIP.
- Provided certain requirements are met, partnerships can freely allocate nonrecourse deductions as long as such allocations are reasonably consistent with allocations that have substantial economic effect of some other significant partnership item attributable to the property securing the nonrecourse liabilities.
- Requirements include satisfying one of the Section 704(b) safe harbors and having a minimum gain chargeback.
Fifth Provision – Revised

“Nonrecourse Deductions: The parties acknowledge and agree that all Nonrecourse Deductions shall be allocated to the Members in proportion with their Percentage Interests.”
Sixth Provision – TMP

“Tax Matters Partner: Fund shall be the Company’s tax matters partner as defined in Section 6231(a)(7) of the Code ("TMP"). The TMP shall make all tax elections and shall approve and file the Company’s tax returns. The TMP also shall have all powers and responsibilities provided in Code Section 6221, et seq. The TMP shall keep all Members informed of all notices from government taxing authorities which may come to the attention of the TMP. The Company shall pay and be responsible for all reasonable third-party costs and expenses incurred by the TMP in performing those duties.”

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Sixth Provision – TMP

Issues:

• Who should be the TMP?
• What about tax elections?
• Who blesses the final partnership tax return?
• Who can settle audits/appeals?
• Who can select a forum for litigation?
Sixth Provision – Revised

“Tax Matters Partner: Fund shall be the Company’s tax matters partner as defined in Section 6231(a)(7) of the Code ("TMP"). The TMP shall have all powers and responsibilities provided in Code Section 6221, et seq. The TMP shall keep all Members informed of all notices from government taxing authorities which may come to the attention of the TMP. The Company shall pay and be responsible for all reasonable third-party costs and expenses incurred by the TMP in performing those duties. The TMP shall not settle any dispute with a taxing authority or select a forum for such a dispute without the Consent of the Members.”
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