
Drafting Tax Distribution Provisions in Partnership Agreements: Protecting Against Tax on "Phantom" Income

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Partnership and LLC Tax Distributions

Understanding and Avoiding
Phantom Income from Partnerships

Tax Distributions

- Typically documented as an advance on the partner's rights under the more general distribution provisions. Sometimes distributions are treated as a loan to the partner.
- Think of distribution as a tax loan. For GP, interest rate is the hurdle rate. More often requested by GP who is more likely to have phantom income on promote, especially if an IRR waterfall.
- Generally equal to share of net income multiplied by maximum applicable rate for type of income.
 - Variables: actual versus assumed rates, partners subject to different tax rates, losses followed by profits, quarterly versus annual distributions.

Partnership Taxation – The Good and the Bad

- Good news! 😊
 - No entity level of taxation
 - Easy in, easy out
- Bad news! ☹️
 - Current taxation even if no distributions
 - Ability to demand distributions limited by partnership agreement
- Time to ask for tax distributions is at formation!

Arguments For and Against Tax Distributions

- Why needed? Phantom income!
 - Partnership uses its taxable profits to fund nondeductible expenditures (such as capital expenditures or principal payments due under a loan)
 - Partnership might apply its taxable profits to increase cash reserves
 - Partnership reinvests taxable gain in replacement asset

Arguments For and Against Tax Distributions

- Why needed? Phantom income!
 - Partnership owns REIT stock that makes a consent dividend
 - Partnership distributes cash from taxable income to preferred partner to return its capital but carried interest partner still subject to tax on its share of taxable income
 - If no control over distributions generally, more need for up-front negotiated tax distributions

Arguments For and Against Tax Distributions

- When you might not want a tax distribution
 - Partner has other losses to offset phantom income and it makes more business sense to keep the cash in the partnership
 - All distributions are pro rata but most partners are tax-exempt and don't need them
 - Carried Interest partner would rather have the cash repay high cost preferred returns
 - No phantom income is predicted and partner does not want to use up its asks when it does not need it
 - Partner has sufficient distribution control that it can get the distributions anyway (assumes pro rata distributions)

Special Considerations – Promotes

- A “Carried Interest” or “promote” is a disproportionate sharing of profit by a service partner. If distributions repay capital first, the promote partner (often called “the GP”) can easily have phantom income.
- In a fund context it is common for the GP to have a right to a tax distribution, but at its election. This way if the GP does not need the tax distribution or has cheaper sources of capital (i.e., an interest rate lower than the preferred return “hurdle rate”), the GP can decide to decline the tax distribution.

Special Considerations – Promotes

- Sometimes a promote is not borne by all partners, creating the question of whether the time-value-of-money cost of the tax distribution should be borne only by the partners bearing the promote. Options include:
 - Change tax distribution to an interest-free tax loan just by the partners bearing the promote
 - Keep as a tax distribution but only reduce the corresponding capital partner distribution dollars for the capital partners bearing the promote (with backend reversal consistent with the treatment of the tax distribution as only an advance on future distributions).

Example 1 – Phantom Promote Income

- 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.
- 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).

Phantom GP Income When GP Has Promote and Cash Returns Contributed Capital

Pre-Tax Cash Flow	LP	GP	Total
Capital Contributions	\$99,000,000	\$1,000,000	\$100,000,000
Year 1 Distributable Cash			\$12,000,000
Distributions of 10% preferred return	\$9,900,000	\$100,000	\$10,000,000
Distributions – return of capital	\$1,980,000	\$20,000	\$2,000,000
Total Distributions	\$11,880,000	\$120,000	\$12,000,000

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

Post-Tax Cash Flow	LP	GP	Total
Distribution surplus/shortfall	\$7,288,000	(\$88,000)	\$7,200,000

Negotiating for Tax Distribution Provisions

- Explain that if the partnership were a C corporation, the taxes would be due by the entity anyway.
- Counter-argument is that if many of the partners are tax-exempt, there would not be a corporate-level tax for them.
- A possible compromise is instead of pro rata tax distributions, distributions can be to only the taxable partners – although some may feel this to be unfair.

Tax Distribution Sample

- **Section 9.2** **Tax Distribution**. Notwithstanding anything to the contrary in this Article ___, to the extent that the amount distributed to (or withheld on behalf of) any Member in respect of a fiscal year of the Company (other than in a year of liquidation) 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.
 - “in respect of” because it may be paid in January
 - “shall distribute” – sometimes “reasonably endeavor” or “commercially reasonable efforts”
 - Sometimes estimated tax dates listed – note different for corporations and individuals

Tax Distribution Sample (continued)

- 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)), assuming the highest marginal federal, state, and local income or similar tax rate applicable to any Member, 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.
 - Liability attributable to income vs. "income tax liability"
 - Sometimes a specific locality is noted
 - Problems with assuming a fixed tax rate
 - Forward vs. reverse § 704(c)
 - Character of income and deductibility considerations – what about deductibility limitations?

Tax Distributions Sample (continued)

- *[For simplicity the Company shall be able to assume that the highest rate applicable to any Member for ordinary income is [], for Unrecaptured Section 1250 gain is [] and for long-term capital gain is [] absent a specific Member clearing demonstrating to the reasonable satisfaction of the Company that a higher rate is applicable.]*
- In calculating the state and local tax rate for any Member, the rate will be the greater of the rate of state and local tax in the state where the property that generated the income was located and the state where such Member (including any direct or indirect owner who is responsible for paying taxes on such income) is resident. Any amounts paid to Members under this Section _____ shall be treated as advances on distributions otherwise payable under this Agreement, and are limited to Net Cash Flow.

Can We Make The Baseline Provision Better?

- (1) Cash flow limitations
- (2) Distribution timing and estimated taxes
- (3) Determination of the applicable tax rate
- (4) Coverage of non-income taxes
- (5) Turning off tax distributions in liquidation
- (6) Non-Section 704(b) income items
- (7) Section 743(b) adjustments
- (8) Cumulative net income concepts
- (9) Other special provisions

Cash Flow Limitations

- To the extent of available cash as reasonably determined by the Manager in good faith.
- Pre-defined “Cash Flow”.
- Subject to loan or reserve restrictions.
- Can the partnership borrow funds or sell assets to fund?
- How to deal with shortfalls (pro rata, priority to certain partners, carry forward shortfall distribution obligation to future year).

Distribution Timing and Estimated Taxes

- Tax Distributions shall be made on or before each date prescribed by the Code for an [individual/corporation] to pay a quarterly installment of estimated federal income tax for a fiscal year.
- . . . not less than [five] days prior to the date on which such Member would be obligated to make estimated tax payments
- . . . will be made in installments four times a year (applying year-to-date estimates or projections of net taxable income as reasonably determined by the Board of Directors)
- End of year true ups?

Determination of Applicable Tax Rate

- Specifying fixed rates for ordinary and capital gain income
- Highest applicable tax rate:
 - To that partner?
 - To any partner?
 - Considering tax based on source of income?
 - Look through flow-through partners?
- Picking a specific jurisdiction

Coverage of Non-Income Taxes—Self-Employment and Medicare Taxes

- 3.8% Medicare taxes – § 1402 and § 1411
- Potential carried interest taxes
- FIRPTA taxes or special international partner considerations

Turning Off Tax Distributions in a Liquidation or Capital Event

- Makes sense if everything is liquidated and distributed in the same year
- What if liquidation crosses year end and tax liability is before cash distributions
- Capital event vs. true liquidation – not all capital events produce cash distributions

Non-Section 704(b) Income Items.

- Forward vs. Reverse § 704(c)
- § 704(c)(1)(B) and 737 relating to the “mixing bowl” rules
- § 751(b) relating to “hot asset” exchanges
- § 731(a) gain relating to distributions in excess of basis.
- § 707(c) guaranteed payments
- § 707(a) relating to payments to partners in non-partner capacities such as “disguised sales”

Section 743(b) Adjustments

- Although as a policy matter most would agree that it makes sense to take into account both positive and negative § 743(b) adjustments, very few tax distribution provisions address this point.
- The practical reality, however, is that events that give rise to positive or negative § 743(b) adjustments result from sales or distributions generally well after partnership formation.

Cumulative Income Concepts

- [A]n amount equal to the product of the cumulative historic taxable income allocated to a Member pursuant to this Agreement (after reducing such taxable income by any taxable loss so allocated to such Member for all Fiscal Years, or portions thereof, ending on or before or which includes such current Fiscal Year) multiplied by the Tax Rate.
- The determination of a Member's taxable income for the current year shall be reduced by any cumulative taxable loss previously allocated to each Member (including Losses allocated to a predecessor of a Member) in prior fiscal years which have not been offset by subsequent allocations of taxable income.

Other Special Considerations

(1) Clawbacks

(2) Adjustments and income reallocations

(3) Discretionary refusal of a tax distribution

Tax Adjusted Clawback

- The obligation of the General Partner to make such payment to the Partnership will be limited to the cumulative amounts actually received by the General Partner from the Partnership on account of its Carried Interest with respect to such Limited Partner, net of taxes payable by the General Partner and its partners in respect of such amounts, based on the highest marginal rates applicable to an individual resident in New York City.
- [CLAWBACK REDUCED BY] the aggregate amount of Tax Distributions for each fiscal period since the Partnership's inception to which the General Partner would have been entitled with respect to that portion of its Carried Interest attributable to such Limited Partner if all such Tax Distributions had been made.

Income Reallocation Sample

- **Income reallocations.** In the event that there is a reallocation of income or loss among the Members or any other person (the “Reallocated Items”), to the extent that tax distributions were originally made to any person with respect to such Reallocated Items, such persons who received distributions pursuant to paragraph [tax distribution paragraph] with respect to such Reallocated Items, shall return such distributions to the Company. The persons which received an allocation of the Reallocated Items described immediately above shall be entitled to tax distributions pursuant to this paragraph in an amount equal to the distributions that would have otherwise been distributed to such person or persons under paragraph [tax distribution paragraph] had such amounts been originally allocated to such person or persons.

Discretion to Receive Tax Distribution

- **Discretionary refusal of a tax distribution.**
Notwithstanding anything to the contrary in this [Article], if, with respect to taxable income allocated to the Manager that is attributable to Manager Incentive Distributions (current or future), the Manager's Tax Liability with respect to the taxable year to which any such income allocation relates exceeds the Manager Incentive Distributions paid to the Manager for such taxable year, then the Company shall, at the option of the Manager, distribute an amount equal to the shortfall to the Manager (a "Special Tax Distribution"), [subject to cash flow limitation].

Conclusions

- In most partnerships, a simple one or two paragraph tax distribution is used.
- In more sophisticated deals, more nuanced concepts are included.
- Almost no partnership includes every concept discussed herein.
- Often the practical compliance issues force tax distributions to be more simple.

For further information

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