

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

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Tax Distribution Provisions In Partnership Agreements

October 1, 2020

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Partnership Taxation - The Good and the Bad

- ▶ Good news! 😊
 - ▶ No entity level of taxation (except under BBA)
 - ▶ Easy in, easy out
- ▶ Bad news! ☹️
 - ▶ Partnership income is currently taxed to the partners even if the partnership does not make any distributions.
 - ▶ A partner is generally unable to demand distributions unless provided for in the partnership agreement.
- ▶ The time to ask for tax distributions is at formation!
 - ▶ If a partner has no control over distributions generally, the partner should negotiate for tax distributions at the time of entering into the partnership agreement.



Circumstances Necessitating a Need For Tax Distributions

- ▶ Why might there be a need for tax distributions?
 - ▶ Most common reason is phantom income:
 - ▶ The partnership is using its taxable profits to fund nondeductible expenditures (such as capital expenditures or principal payments due under a loan).
 - ▶ The partnership is applying its taxable profits to increase cash reserves.
 - ▶ The partnership is reinvesting proceeds from an asset sale to purchase replacement assets.

Circumstances Necessitating a Need For Tax Distributions

- ▶ Other situations that may create phantom income:
 - ▶ The partnership owns REIT stock that makes a consent dividend.
 - ▶ The partnership distributes cash from taxable income to the preferred partner to return its capital, but the carried interest partner is still subject to tax on its share of taxable income.

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).

Circumstances Necessitating a Need For Tax Distributions

- ▶ Other circumstances:
 - ▶ Third-party limitations on distributions:
 - ▶ For example, a lender restricts partnership distributions.
 - ▶ Review loan document tax distribution provision for consistency with partnership agreement tax distribution provision.
 - ▶ Consider the limitations on interest deductions at the partner level.

Circumstances In Which a Partner May Prefer No Tax Distributions

- ▶ The partner prefers to keep the cash in the partnership for operations and/or expansion, and:
 - ▶ The partner has cash from other sources to pay the tax on partnership income.
 - ▶ The partner anticipates having sufficient losses from other sources to offset partnership income.
 - ▶ The partner is tax-exempt.
 - ▶ The partner is a carried Interest partner and would rather have the cash to pay down high cost preferred returns.
 - ▶ Typically, the carried interest partner will negotiate the option to make tax distributions or defer tax distributions to the carried interest partner.

How Are Tax Distributions Treated?

- ▶ Tax distributions are typically documented as an advance on the partner's rights to other distributions and reduce the other distributions on a dollar-for-dollar basis.
 - ▶ The impact is that tax distributions result in interest free use of capital to the partners who receive them, like an interest free loan.
 - ▶ For the carried interest partner, the interest rate is effectively any applicable hurdle or preferred return rate. If the carried interest can borrow money to pay taxes on partnership income at a lower rate, the carried interest partner will prefer it receive no tax distributions.
- ▶ If it is intended that tax distributions are treated as advances, the partnership agreement should clearly state so.

How Are Tax Distributions Treated?

- ▶ If it is intended that tax distributions are treated as advances, what happens if there is not enough cash over the life of the partnership to offset the advances?
- ▶ Example 2: A is the capital partner and contributes \$2M to the partnership. B is the carried interest partner and contributes no capital. Subject to any tax distributions, the capital partner is entitled to all other distributions until its capital contributions have been repaid and any distributions thereafter are shared 50/50 by A and B. The partnership purchases two investment properties for \$1M each. The partnership sells the first property for \$2M, makes a tax distribution of \$250K to A and B, and distributes the remaining \$1.5M to A. The second property has substantial environmental issues not covered by insurance and is sold in a subsequent year for \$0.

How Are Tax Distributions Treated?

- ▶ Does the partnership agreement include a deficit restoration clause or provide for a clawback of the tax distributions?
 - ▶ If so, what if B is a shell entity and does not hold any assets?
 - ▶ Consider tax distribution clawback guarantees by B's members.
- ▶ What is the impact to B?
 - ▶ 50% (\$500K) of the capital gain from the sale of the first property is allocated to B, and 50% (\$500K) of the capital loss from the second property is allocated to B.
 - ▶ B cannot carry back the capital loss. Can B use those losses to offset other capital gains?
- ▶ If B is not required to repay the excess tax distribution, only \$250K of the loss from the second property will be allocated to B (so as to avoid a negative capital account balance).

How Are Tax Distributions Treated?

- ▶ Sometimes tax distributions are treated as a loan to the partner:
 - ▶ Does the loan bear interest?
 - ▶ A tax distribution treated as a loan has similar tax consequences as a tax distribution with a clawback.

How Are Tax Distributions Treated?

- ▶ Sometimes tax distributions are in addition to other distributions received by the partners and do not offset such other distributions (i.e., not an advance).
 - ▶ Impact is that the preferred return to the capital partner is paid on an after-tax basis and reduces capital available to pay a promote to the carried interest partner:

How Are Tax Distributions Treated?

- ▶ Example 3: A contributes \$10M and is entitled to an annual preferred return of 10% and any remaining profits are split between A and B. The assumed tax rate for tax distributions is 50% and the partnership makes \$2M of taxable profits each year.
 - ▶ Because the \$1M preferred return is on an after-tax basis, A is entitled to the full \$2M, because \$1M (50% tax rate) is paid by A in taxes and thus at a 50% tax rate doubles the amount of the nominal distribution.

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.
- ▶ Another compromise is to charge an interest rate on tax distributions for those who want them.

Ordering of Cash Flow

- ▶ Tax distribution should say “notwithstanding any other provision in this Agreement” to make clear it overrides regular waterfall.
- ▶ However, tax distribution should only apply if the partners otherwise do not have sufficient distributions elsewhere in the document, including deemed distributions via tax withholding. Thus, in the tax distribution provision, any other distributions made with respect to the same taxable year should count toward, and reduce, a partner’s tax distributions.
- ▶ Tax distributions are typically intended to be timing benefits only and therefore this intent should be clearly documented by treating the tax distribution as an “advance” on other distributions.
- ▶ Similar issues arise with the “withholding taxes” paragraph to make sure it is an advance.

Can We Make The Baseline Tax Distribution Provision Better?

- ▶ To extent of available cash
 - ▶ Reserves
 - ▶ Capital expenditures
 - ▶ Determined by the general partner/manager?
 - ▶ Can the partnership borrow funds or sell assets to fund?
- ▶ Without violation of applicable law
 - ▶ Lender or fraudulent conveyance act restrictions
- ▶ How to deal with shortfalls (pro rata, priority to certain partners, carry forward shortfall distribution obligation to future year).

Can We Make The Baseline Tax Distribution Provision Better?

- ▶ Measuring need for tax distributions based on annual income/distributions or based on income/distributions over the life of the partnership? Reset if there is a transfer of partnership interest?
- ▶ Annual or aggregate?
- ▶ Net of prior losses or not?
 - ▶ Only to the extent the losses are available (need partner-level info to determine that?)
 - ▶ [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.

Can We Make The Baseline Tax Distribution Provision Better?

- ▶ Character of income?
 - ▶ Ordinary, capital, dividends,
- ▶ Kind of income?
 - ▶ 1411?
 - ▶ Self-employment taxes?
 - ▶ Franchise taxes?

Can We Make The Baseline Tax Distribution Provision Better?

- ▶ Pro rata based on ownership or based on taxable income?
 - ▶ If based on taxable income, what if tax-exempt partner?
- ▶ Highest applicable tax rate:
 - ▶ To that partner?
 - ▶ To any partner?
 - ▶ Special types of investors, such as corporate versus individual (character doesn't matter for some). Wide gap between individual tax rates and corporate tax rates starting in 2018
- ▶ Some tax distributions assume all partners are taxable, or assume a rate based on the highest tax rate owed by any partner and apply it to everyone.
- ▶ Some look to the specific taxable income of a partner, but make some simplifying assumptions. Other items not typically addressed:
 - ▶ Is a partner in AMT
 - ▶ Partner NOLs
 - ▶ Potential non-deductibility of partnership interest expense when loan funded debt-financed distribution

Can We Make The Baseline Tax Distribution Provision Better?

- ▶ Take into account § 199A?
- ▶ Take into account § 163(j)?
- ▶ Take into account other limitations on deductibility of expenses at the partner level?

Can We Make The Baseline Tax Distribution Provision Better?

- ▶ How is income on which tax is distributed determined?
 - ▶ § 704(b) book or taxable?
 - ▶ State versus federal taxable income
 - ▶ Forward vs. Reverse § 704(c)
 - ▶ § 704(c)(1)(B) and § 737 relating to the “mixing bowl” rules
 - ▶ § 754 (§ 734/§ 743 adjustments)
 - ▶ § 751(b) relating to “hot asset” exchanges
 - ▶ § 731(a) gain relating to distributions in excess of basis
 - ▶ § 707(a) relating to payments to partners in non-partner capacities such as “disguised sales”

Can We Make The Baseline Tax Distribution Provision Better?

- ▶ Quarterly or annual?
 - ▶ How to determine quarterly income?
 - ▶ Good faith
 - ▶ Full year divided by 4
 - ▶ End of year true ups?
- ▶ State - which state?
- ▶ Highest Corporate tax rate? Highest Individual?
- ▶ How does manager determine?
 - ▶ Pass-through partners
- ▶ Deduction of state for federal?

Can We Make The Baseline Tax Distribution Provision Better?

- ▶ In respect of capital transactions or not?
 - ▶ Especially if not an advance
- ▶ Exclude guaranteed payments or not?
- ▶ Payable to holders of restricted profits interest?
- ▶ Subject to clawback or not?
- ▶ Potential carried interest taxes
- ▶ FIRPTA taxes or special international partner considerations

Can We Make The Baseline Tax Distribution Provision Better?

- ▶ Partnership audits? Increase or not?
- ▶ Interplay between withholding and tax distributions
- ▶ At time of put/call/redemption?
- ▶ Special types of partners - tax-exempt/foreign/etc.
- ▶ So long as the Company is a partnership for tax purposes.
- ▶ When new partner is admitted, going forward or no?

Special Considerations

Post-TEFRA BBA Audit Rules

Post TCJA Considerations



Coordinating With the BBA

- ▶ Under the BBA centralized partnership audit procedures, the partnership must pay the tax liability resulting from an audit, unless the partnership representative makes an election to “push out” the underpayment.
 - ▶ If a push out election is made, should the partnership make a tax distribution to cover the resulting tax liability?
 - ▶ Consider whether the tax distribution should in this case include applicable interest and penalties?
 - ▶ Is this addressed at all in the current tax distribution provision?

Coordinating With the BBA

- ▶ If no push out election is made and partnership pays the tax, many partnership agreements now provide that partners must contribute their share of the underpayment.
 - ▶ Can a partner demand a corresponding tax distribution?
 - ▶ How about a redeemed partner?
 - ▶ How would the redemption price have been affected had there been more taxable income on the books (and less cash on the books due to the tax distribution).

Coordinating with the TCJA

- ▶ The TCJA provides for a 20% deduction for pass-through income.
 - ▶ Should partnership agreements be revisited to determine whether the 20% is taken into account?
- ▶ In many partnerships, the 20% deduction does not universally apply to all partners:
 - ▶ In some professional services businesses, only partners that meet certain requirements are entitled to the deduction.
 - ▶ In partnerships with little or no employees, and little or no depreciable assets, only partners that meet certain requirements are entitled to the deduction.
 - ▶ The deduction does not apply to reasonable compensation or guaranteed payments for services.

Coordinating with the TCJA

- ▶ To what extent should a partner's individual circumstances be taken into account?
- ▶ Example: GP receives a 20% carried interest but no fee. Partnership acquires 2-3 commercial buildings and the GP is active in performing rental management services. The partnership sells building 1 in year 2 and, except for tax distributions, reinvests the proceeds in another building.
 - ▶ Under the TCJA, GP's tax rate from the sale is short-term cap gain. LPs' tax rate is LTCG

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.

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 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 clearly 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 a 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.

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?

Deficit Restoration for Excess

- ▶ Distributions made pursuant to this Section 5.4 with respect to a Fiscal Year shall be credited against (and, therefore, reduce) succeeding amounts otherwise distributable to the Members pursuant to Section 5.2. Distributions pursuant to this Section 5.4 are not intended to change the aggregate distribution amount which each Member is entitled to receive pursuant to Section 5.2 and Section 5.3 over the term of the Company. Accordingly, in the event that (i) the Company is dissolved and its assets liquidated, and (ii) a Member has received one or more prior Tax Distributions that have not been credited against distributions that would have otherwise been made to such Member pursuant to Section 5.2 (“**Excess Tax Distributions**”), then such Member shall contribute to the capital of the Company an amount equal to such Excess Tax Distributions and such contribution amount shall be distributed among the Members in accordance with Section 11.1.

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.
- ▶ . . . provided, that the Managing Member Giveback shall not exceed an amount equal to the excess of Carried Interest Distributions over the Deemed Cumulative Tax Liability with respect to Carried Interest Distributions.

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].

Tax Distributions in Loans

- ▶ **“Permitted Tax Distribution”** means, with respect to any period, distributions to the holders of the Equity Interests in the applicable Borrower in an aggregate amount not to exceed the Income Tax Liabilities relating to such period.
- ▶ **“Tax Distributions”** means Tax Distributions (as defined in the LLC Agreement) made by Holdings to its members in accordance with Section 5.1(a) of the LLC Agreement, as in effect on the date hereof and delivered to the Administrative Agent.
- ▶ **Restricted Payments**»
- ▶ No Group Member shall directly or indirectly declare, order, pay, make or set apart any sum for any Restricted Payment except for the following (and Holdings shall not use the proceeds of any Restricted Payment permitted hereunder in reliance upon clause (c) below other than as set forth in such clause (c)):
 - ▶ unlimited cash dividends on the Stock of Subsidiaries of the Borrower to the Borrower, and cash dividends on the Stock of the Borrower to Holdings paid and declared solely for the purpose of funding the following:
 - ▶ Tax Distributions (which Holdings shall be permitted to make to its members); provided, that the rates applicable to Tax Distributions shall be calculated in accordance with Section 5.1(a) of the LLC Agreement;

Tax Distributions in Loans

- ▶ “**Income Tax Liabilities**” means, for each equity holder of a Borrower that is treated as a partnership for Federal and state income tax purposes (including without limitation a limited liability company, a partnership, or any corporation that has filed an election under Subchapter S of the Code) for any fiscal year, an amount equal to (a) such equity holder’s allocable share of the taxable income and gains of such Borrower for such fiscal year multiplied by (b) a percentage equal to the combined federal and state maximum marginal income tax rate (determined taking into account the deductibility of state income taxes for Federal income tax purposes), as determined by [designated CPA firm] or other independent public accounting firm reasonably acceptable to the Administrative Agent.

Thank You

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