Section 704, Targeted Allocations, and the Distribution Waterfall: Overcoming Challenges Absent IRS Guidance

Understanding the Economic Effect Test and How to Allocate Income or Loss Using Targeted Allocations

TUESDAY, JUNE 3, 2014, 1:00-2:50 pm Eastern

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Section 704, Targeted Allocations, and the Distribution Waterfall

June 3, 2014

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Partner Allocations

Agenda

• Review of basic rules governing partner allocations
  — Level set: sections 704(a) - 704(d)
  — Tests for economic effect
• Determining “layer cake” allocations
• Determining “targeted” allocations
  — Definition and computation of targeted allocations
  — Targeted allocations and preferred returns
  — Other considerations
PARTNERSHIP ALLOCATIONS

SECTION 704
Partnership Income, Gain, Loss, and Deduction
Each partner’s distributive share of the partnership’s items of income, gain, loss, deduction, and credit is determined by the partnership agreement, provided that the allocations in the agreement have “substantial economic effect”

If the allocations do not have substantial economic effect, the partnership must allocate its items in accordance with the “partners’ interests in the partnership”
Sections 704(c) and (d) – Distributive Share

- Income, gain, loss, and deduction with respect to contributed property to the partnership by a partner shall be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution.

- A partner’s distributive share of partnership loss shall be allowed only to the extent of the adjusted basis of such partner’s interest in the partnership.
Determining a Partner’s Distributive Share

1. Compute partnership taxable income
2. Convert partnership taxable income to section 704(b) income
3. Allocate section 704(b) income among the partners
4. Allocate taxable income among the partners taking into account section 704(c)
Allocations – Fundamental Principle

• Allocation of tax items must be consistent with the “underlying economic arrangement of the partners”
  — If there is a an economic benefit or economic burden that corresponds to an allocation, the partner to whom the allocation is made must receive the economic benefit or bear the economic burden
Substantial Economic Effect Safe Harbor

- Two-part test for substantial economic effect:
  - Economic Effect
  - Substantiality

- When do you test a partnership’s allocations?
  - Economic effect
  - Substantiality
Economic Effect Safe Harbor

1. Compliance with Capital Account Maintenance Rules

2. Liquidation in Accordance with Partner’s Capital Accounts

3. Unlimited Deficit Restoration Obligation “U-DRO”

or

Qualified Income Offset “QIO”

“General Test”

“Alternate Test”
Deemed Economic Effect

- Economic Effect Equivalence
  - At the end of each year, a liquidation of the partnership at the end of such year or at the end of any future year would produce the same economic results to the partners as if the safe harbor had been satisfied, regardless of economic performance of the partnership.
Partner’s Interest in the Partnership (“PIP”)

• If allocations do not have substantial economic effect then:
  – Allocations are made based on PIP taking into account all facts and circumstances relating to the partners’ economic arrangement
    – Relative contributions
    – Sharing of economic profits and losses
    – Interests in cash flow and other non-liquidating distributions
    – Distribution rights of capital upon liquidation

• Allocations deemed to be in accordance with PIP
  – Allocations in accordance with regulatory “minimum gain” provisions
  – Allocations in accordance with creditable foreign tax expenditure safe harbor
Testing Allocations Under Section 704(b) – Schematic

Begin with the Partnership Agreement

Do allocations have economic effect?

No

Yes

Are allocations deemed to have economic effect?

No

Yes

Are allocations substantial?

No

Yes

Allocations are respected under section 704(b)

Allocations must be in accordance with PIP (or deemed PIP)
Allocation of Tax Items – The Leap from 704(b) Allocations to Tax Allocations

• Capital accounts track the partners’ economic agreement and are adjusted by section 704(b) “book” income and loss, *not* taxable income and loss
  – Includes tax-exempt income and nondeductible expenses
  – Section 704(b) income generally differs from taxable income due to basis differences in assets and liabilities

• This “book-tax” disparity can be created by:
  – Contribution of property with built-in gain or loss
  – Distribution of property with built-in gain or loss
  – Change in economic arrangement of the partners
Partnership Agreement Review – Discussion

- Section 704(b) Safe Harbor Agreement - Typical Key Provisions
  - Liquidation provision
  - Deficit Capital Account Restoration
  - Capital Account Maintenance Provisions
  - Profit and Loss Allocation Provision
  - Regulatory Allocation Provisions
  - Curative Allocation Provision
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ALLOCATION DRIVEN
(SECTION 704(b) SAFE HARBOR)
EXAMPLE

“LAYER CAKE ALLOCATIONS”
Allocation Driven – Example

• A, B, & C each contribute $100 to LLC
• LLC is an investment partnership
• The partnership agreement satisfies the alternate test for economic effect
• LLC allocates Net Profits as follows:
  — 1st: To A until to the extent of a 10% simple return on A’s unreturned capital
  — 2nd: 1/3 each to A, B and C
• LLC has $340 of Income in Year 1

How is the $340 allocated in Year 1?
Example (cont.) – Net Profit Allocations

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>A</th>
<th>B</th>
<th>C</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1 Net Profits</td>
<td>340</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>1 To A until A receives a 10% simple return on A’s unreturned capital</td>
<td>10</td>
<td>10</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2 1/3 each to A, B, and C.</td>
<td>330</td>
<td>110</td>
<td>110</td>
<td>110</td>
</tr>
<tr>
<td>Year 1 Allocations:</td>
<td>340</td>
<td>120</td>
<td>110</td>
<td>110</td>
</tr>
</tbody>
</table>
Example (cont.) – Net Profit Allocations

• Assume the Net Profits in the prior examples consisted of:
  – Capital gains $300
  – Interest income 100
  – Management fee expense (60)
  – Total Profits 340

• Allocation to partners would typically consist of a proportionate share of each item:
  – Partner A: 120/340 = 36%
  – Partner B: 110/340 = 32%
  – Partner C: 110/340 = 32%
Example (cont.) – Roll Capital Accounts

<table>
<thead>
<tr>
<th></th>
<th>P-SHIP</th>
<th>A</th>
<th>B</th>
<th>C</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Beginning of Year Capital</td>
<td>-0-</td>
<td>-0-</td>
<td>-0-</td>
</tr>
<tr>
<td>2</td>
<td>Plus Contributions</td>
<td>300</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>3</td>
<td>Net Profits</td>
<td>340</td>
<td>120</td>
<td>110</td>
</tr>
<tr>
<td>4</td>
<td>Less Distributions</td>
<td>-0-</td>
<td>-0-</td>
<td>-0-</td>
</tr>
<tr>
<td>3</td>
<td>End of Year Capital Accounts</td>
<td>640</td>
<td>220</td>
<td>210</td>
</tr>
</tbody>
</table>
Allocation Driven Allocations Recap

- Income allocations determine the cash entitlements for each partner

- Allocations satisfying economic effect safe harbor provisions will be respected (assuming allocations are also substantial)

- Other allocations may look to an allocation meeting the substantial economic effect safe harbor
  - For example, the fractions rule (section 514(c)(9)(E)) requires allocations that have substantial economic effect
DEFINITION AND COMPUTATION OF TARGETED ALLOCATIONS
What Are Targeted Allocations?

- Targeted allocations are found in partnership agreements that do not liquidate based on positive capital accounts
  - These agreements liquidate based on cash distribution entitlements
- Targeted allocations generally tie all allocations of income/loss to the distribution provisions of the partnership agreement
- Thus, targeted allocations are “distribution-driven” or “cash-driven” allocations that have the following characteristics:
  - Liquidation in accordance with distribution provision
  - “Allocate” income so that capital accounts equal what a partner would receive upon a hypothetical liquidation if the assets of the partnership were sold for their “Section 704(b) Book Value”
Cash Driven Agreements – Typical Key Provisions

Sample Excerpts -

Section 4.1(a) “Profit and Loss Allocations”:
Net Profits and Net Losses of the Company for each Fiscal Year shall be allocated to the Members in a manner that causes each Member’s Adjusted Capital Account to equal the amount that would be distributed to such Member pursuant to Section 9.3(c) upon a hypothetical liquidation of the Company for Book Value.

Section 9.3 “Winding Up”:
(c) Upon dissolution and winding up....The proceeds from liquidation of the Company’s property shall be applied and distributed in the following order:
  • To the payment and discharge of all the Company’s debts and liabilities, including those to Members who are creditors, including the establishment of any reserves;
  • To the Members in accordance with Section 3.1.
Cash Driven Agreements (cont.)

Section 3.1 “Available Cash will be distributed”:

• First, 100% to the Class A Members to extent of the Class A Preferred Return;
• Second, 100% to the Class A Members until the Class A Members receive their undistributed capital;
• Thereafter, 20% to the Class B Members and 80% to the Class A Members.
Cash Driven Agreements – Other Provisions

• Targeted capital account agreements typically retain a great deal of the “boilerplate” language found in layer-cake allocation agreements.

• This language includes the usual provisions on how to establish and maintain section 704(b) capital accounts and how to calculate partnership section 704(b) Profits and Losses
  — Regulatory allocation provisions such as minimum gain, nonrecourse deductions, and the qualified income offset.
Cash Driven Agreements – Other Provisions

- These provisions are retained for several reasons:
  - Practitioners have grown comfortable with the traditional provisions and are reluctant to abandon them;
  - Allows for easier determination of section 704(c) allocations; and
  - Increases the possibility that the targeted capital account approach satisfies the “economic effect equivalence” test in the section 704(b) regulations
Targeted Allocations - Net Income vs. Gross Items

In allocating income to a partner’s capital account to reach the desired targeted capital account, the partners have a choice. Allocations can be made out of net income or gross items.

**Net Income Approach**
- The targeted capital account language would read, “Net Profits and Net Losses for any Fiscal Year shall be allocated among the Members in such a manner that...the targeted capital account is achieved.”

**Gross Income Approach**
- The targeted capital account language would read, “Net Profits and Net Losses (and to the extent necessary, items thereof) for any Fiscal Year shall be allocated among the Members in such a manner that...the targeted capital account is achieved.”
A and B form AB Partnership by contributing $100 each. A has a 10% preferred return and income is then shared 50-50.

### Net Income Approach

<table>
<thead>
<tr>
<th>Gross Income</th>
<th>Expenses</th>
<th>Net Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Partner A</td>
<td>10</td>
<td>(9)</td>
</tr>
<tr>
<td>Partner B</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Partnership</td>
<td>10</td>
<td>(9)</td>
</tr>
</tbody>
</table>

### Gross Items Approach

<table>
<thead>
<tr>
<th>Gross Income</th>
<th>Expenses</th>
<th>Net Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Partner A</td>
<td>10</td>
<td>-</td>
</tr>
<tr>
<td>Partner B</td>
<td>-</td>
<td>(9)</td>
</tr>
<tr>
<td>Partnership</td>
<td>10</td>
<td>(9)</td>
</tr>
</tbody>
</table>
Traditional and Targeted Allocation Formulas

Historically, partner capital accounts are liquidated based on positive capital accounts in accordance with the following formula:

\[
\text{beginning} + \text{contributions} + \text{income} = \text{ending capital} - \text{distributions} - \text{loss capital}
\]

Targeted allocations “plug” income under the following formula:

\[
\text{ending capital} - \text{beginning capital} - \text{contributions} = \text{income capital} + \text{distributions or loss}
\]
Targeted Allocations – Basic Computation

One way to compute targeted allocations may be under a 6-step process:

Step 1. Determine beginning capital for each partner
Step 2. Allocate contributions and distributions by partner
Step 3. Add Steps 1 and 2 to determine the “adjusted beginning capital” account for each partner
Step 4. Determine aggregate ending partnership capital
Step 5. Allocate aggregate ending capital to the partners in accordance with the cash distribution provision
Step 6. Subtract Step 3 from Step 5 to determine income for each partner
Targeted Allocations – Basic Net Profits Allocation Example

• A, B, & C each contribute $100 to LLC
• LLC liquidates as follows:
  — 1st: To A until A receives a return of its contributed capital
  — 2nd: to A until A receives a 10% simple return on A’s unreturned capital
  — 3rd: to B and C to the extent of their unreturned capital
  — 4th: 1/3 each to A, B, and C
• LLC has $340 of Income in Year 1

How is the $340 allocated in Year 1?
### Basic Net Profits Example (cont.) – Steps 1-3

<table>
<thead>
<tr>
<th>Step</th>
<th>Description</th>
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<th>A</th>
<th>B</th>
<th>C</th>
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<tbody>
<tr>
<td>1</td>
<td>Determine Beginning Capital</td>
<td>-0-</td>
<td>-0-</td>
<td>-0-</td>
<td>-0-</td>
</tr>
<tr>
<td>2</td>
<td>Plus Contributions, Less Distributions</td>
<td>300</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>3</td>
<td>Equals Adjusted Beginning Capital Account</td>
<td>300</td>
<td>100</td>
<td>100</td>
<td>100</td>
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</table>
Basic Net Profits Example (cont.) – Step 4: Determine Aggregate Capital

<table>
<thead>
<tr>
<th>Step 4: Determine Aggregate Capital</th>
<th>Partnership Total</th>
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<tbody>
<tr>
<td>Beginning Partnership Capital</td>
<td>-0-</td>
</tr>
<tr>
<td>Plus Contributions / Less Distributions</td>
<td>300</td>
</tr>
<tr>
<td>Current Year Income</td>
<td>340</td>
</tr>
<tr>
<td>Current Year Loss</td>
<td>-0-</td>
</tr>
<tr>
<td>Ending “Distributable Capital”</td>
<td>640</td>
</tr>
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### Basic Net Profits Example (cont.) – Step 5: Determine Capital Entitlements

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<th>Total</th>
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<th>B</th>
<th>C</th>
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<tbody>
<tr>
<td>EOY Distributable Capital:</td>
<td>640</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>1 to A until A receives a return of its contributed capital</td>
<td>100</td>
<td>100</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>2 to A until A receives a 10% simple return on A’s unreturned capital</td>
<td>10</td>
<td>10</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>3 to B and C to the extent of their unreturned capital.</td>
<td>200</td>
<td>-</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>4 1/3 each to A, B, and C.</td>
<td>330</td>
<td>110</td>
<td>110</td>
<td>110</td>
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<tr>
<td>Ending Entitlements to Capital</td>
<td>640</td>
<td>220</td>
<td>210</td>
<td>210</td>
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Basic Net Profits Example (cont.) –

Step 6: Determine Income Allocation

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
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<th>B</th>
<th>C</th>
</tr>
</thead>
<tbody>
<tr>
<td>EOY Distributable Capital:</td>
<td>640</td>
<td>220</td>
<td>210</td>
<td>210</td>
</tr>
<tr>
<td>Less Adjusted Beginning Capital:</td>
<td>(300)</td>
<td>(100)</td>
<td>(100)</td>
<td>(100)</td>
</tr>
<tr>
<td>Equals Income Allocation</td>
<td>340</td>
<td>120</td>
<td>110</td>
<td>110</td>
</tr>
</tbody>
</table>
HITTING THE TARGET WITH PREFERRED RETURNS
Targeted Allocations – Preferred Return with Losses Example

Same Facts as Example 1, except LLC has a ($50) Net Loss:

• A, B, & C each contribute $100 to LLC.

• LLC liquidates as follows:
  — 1st: To A until A receives a return of its contributed capital.
  — 2nd: to A until A receives a 10% simple return on A’s unreturned capital.
  — 3rd: to B and C to the extent of their unreturned capital.
  — 4th: 1/3 each to A, B, and C.

• LLC has ($50) Loss in Year 1

How is the ($50) Net Loss allocated in Year 1?
## Preferred Return with Losses Example

### Steps 1-3

<table>
<thead>
<tr>
<th>Steps 1-3</th>
<th>P-SHIP</th>
<th>A</th>
<th>B</th>
<th>C</th>
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<tbody>
<tr>
<td>1 Determine Beginning Capital</td>
<td>-0-</td>
<td>-0-</td>
<td>-0-</td>
<td>-0-</td>
</tr>
<tr>
<td>2 Plus Contributions, Less Distributions</td>
<td>300</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>3 Equals Adjusted Beginning Capital Account</td>
<td>300</td>
<td>100</td>
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Preferred Return with Losses Example (cont.) – Step 4: Determine Aggregate Capital

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<tr>
<th>Step 4: Determine Aggregate Capital</th>
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<tbody>
<tr>
<td>Beginning Partnership Capital</td>
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<tr>
<td>Plus Contributions / Less Distributions</td>
<td>300</td>
</tr>
<tr>
<td>Current Year Income</td>
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<tr>
<td>Current Year Loss</td>
<td>(50)</td>
</tr>
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<td>Ending “Distributable Capital”</td>
<td>250</td>
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### Preferred Return with Losses Example (cont.) – Step 5: Determine Capital Entitlements

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<th>Step</th>
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<tr>
<td>1</td>
<td>to A until A receives a return of its contributed capital</td>
<td>100</td>
</tr>
<tr>
<td></td>
<td></td>
<td>100</td>
</tr>
<tr>
<td>2</td>
<td>to A until A receives a 10% simple return on A’s unreturned capital</td>
<td>10</td>
</tr>
<tr>
<td></td>
<td></td>
<td>10</td>
</tr>
<tr>
<td>3</td>
<td>to B and C to the extent of their unreturned capital.</td>
<td>140</td>
</tr>
<tr>
<td></td>
<td></td>
<td>-</td>
</tr>
<tr>
<td>4</td>
<td>1/3 each to A, B, and C.</td>
<td>-0-</td>
</tr>
<tr>
<td></td>
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<td>-0-</td>
</tr>
<tr>
<td></td>
<td>Ending Entitlements to Capital</td>
<td>250</td>
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<tr>
<td></td>
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<td>110</td>
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<td></td>
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<td>70</td>
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<td></td>
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EOY Distributable Capital: 250
Preferred Return with Losses Example (cont.) –
Step 6: Determine Income Allocation

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<th>C</th>
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</thead>
<tbody>
<tr>
<td>(Step 5)</td>
<td>EOY Entitlement to Distributable Capital:</td>
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<td>70</td>
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<tr>
<td>(Step 3)</td>
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<td>(100)</td>
<td>(100)</td>
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<tr>
<td></td>
<td>Equals Profits (Loss) Allocation</td>
<td>(50 )</td>
<td>10</td>
<td>(30 )</td>
</tr>
</tbody>
</table>
Preferred Returns with Losses – Considerations

• If the agreement allocates “Net Profits and Net Losses,” does this result in an allocation of zero to the preferred return partner, and all of the Net Loss to the other partners?
  – If so, the capital accounts following the allocation will not equal their ending economic entitlement

• The most important step is determining the underlying economics of the preferred return
  – Is it payable only out of net income?
  – Payable out of gross income?, or
  – Payable in all events?
Preferred Returns – Considerations

Compare

• Layer-Cake Allocations:
  — Drafting the preferred return is generally quite easy and obvious
  — The preferred return is created by a specific allocation of income
  — For example, a preferred return of 10% to Partner A on its $100 of contributed capital can be achieved by simply allocating the first $10 of gross or net income to A

• Targeted Allocations
  — Drafting the preferred return is achieved by including a specific distribution in the cash waterfall section
  — Income allocations are then made in the manner necessary to reduce the differences between the partners’ beginning and ending capital accounts
Preferred Returns – Considerations (con’t)

- Contrast the economics of two possible cash distribution provisions:
  - Cash is distributed:
    1. to A until A receives its contributed capital;
    2. to B until B receives its contributed capital;
    3. to A until A receives its 10% preferred return; and
    4. to A and B equally.
  - Cash is distributed:
    1. to A until A receives its 10% preferred return;
    2. to A until A receives its contributed capital;
    3. to B until B receives its contributed capital; and
    4. to A and B equally.
Preferred Return with Losses – Example Revisited

(Step 5) EOY Entitlement to Distributable Capital:

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>A</th>
<th>B</th>
<th>C</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>250</td>
<td>110</td>
<td>70</td>
<td>70</td>
</tr>
</tbody>
</table>

(Step 3) Less Adjusted Beginning Capital:

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>A</th>
<th>B</th>
<th>C</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(300)</td>
<td>(100)</td>
<td>(100)</td>
<td>(100)</td>
</tr>
</tbody>
</table>

Equals Profits (Loss) Allocation

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>A</th>
<th>B</th>
<th>C</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(50)</td>
<td>10</td>
<td>(30)</td>
<td>(30)</td>
</tr>
</tbody>
</table>

Assume the partnership has $10 of gross income and $60 of deductions in Year 1 but the agreement provides for allocations of Net Profits and Net Losses (i.e., net income). How is income or loss allocated?
Preferred Return with Losses – Example Revisited

Option 1 - Net Profits

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>A</th>
<th>B</th>
<th>C</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adjusted Capital</td>
<td>300</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Allocation of net income</td>
<td>(50)</td>
<td>-</td>
<td>(25)</td>
<td>(25)</td>
</tr>
<tr>
<td>Ending Capital</td>
<td>250</td>
<td>100</td>
<td>75</td>
<td>75</td>
</tr>
<tr>
<td>Targeted Capital</td>
<td>250</td>
<td>110</td>
<td>70</td>
<td>70</td>
</tr>
<tr>
<td>Difference</td>
<td>-</td>
<td>(10)</td>
<td>5</td>
<td>5</td>
</tr>
</tbody>
</table>
## Preferred Return with Losses – Example Revisited

### Option 2 - Gross Income

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>A</th>
<th>B</th>
<th>C</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adjusted Capital</td>
<td>300</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Allocation of gross items</td>
<td>(50)</td>
<td>10</td>
<td>(30)</td>
<td>(30)</td>
</tr>
<tr>
<td>Ending Capital</td>
<td>250</td>
<td>110</td>
<td>70</td>
<td>70</td>
</tr>
<tr>
<td>Targeted Capital</td>
<td>250</td>
<td>110</td>
<td>70</td>
<td>70</td>
</tr>
<tr>
<td>Difference</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>
## Preferred Return with Losses – Example Revisited

### Option 3 - Guaranteed Payment

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>A</th>
<th>B</th>
<th>C</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adjusted Capital</td>
<td>300</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Allocation of net income</td>
<td>(50)</td>
<td>-</td>
<td>(25)</td>
<td>(25)</td>
</tr>
<tr>
<td>Guaranteed Payment Expense</td>
<td>(10)</td>
<td>-</td>
<td>(5)</td>
<td>(5)</td>
</tr>
<tr>
<td>Guaranteed Payment Contribution</td>
<td>10</td>
<td>10</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Ending Capital</td>
<td>250</td>
<td>110</td>
<td>70</td>
<td>70</td>
</tr>
<tr>
<td>Targeted Capital</td>
<td>250</td>
<td>110</td>
<td>70</td>
<td>70</td>
</tr>
<tr>
<td>Difference</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>
## Preferred Return with Losses – Example Revisited

### Option 4 - Capital Shift

<table>
<thead>
<tr>
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<th>A</th>
<th>B</th>
<th>C</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adjusted Capital</td>
<td>300</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Allocation of net income</td>
<td>(50)</td>
<td>-</td>
<td>(25)</td>
<td>(25)</td>
</tr>
<tr>
<td>Capital Shift – Taxable?</td>
<td></td>
<td>10</td>
<td>(5)</td>
<td>(5)</td>
</tr>
<tr>
<td>Ending Capital</td>
<td>250</td>
<td>110</td>
<td>70</td>
<td>70</td>
</tr>
<tr>
<td>Targeted Capital</td>
<td>250</td>
<td>110</td>
<td>70</td>
<td>70</td>
</tr>
<tr>
<td>Difference</td>
<td></td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>
Sample Targeted Allocation Language – Example 2

Some targeted allocations are written to mitigate the shortfall in Capital Accounts:

Net Profits and Net Losses, or items thereof, of the Company for each Fiscal Year shall be allocated to the Members in such a manner that, as of the end of such Fiscal Year and to the extent possible, each Member’s Adjusted Capital Account shall be equal to the amount that would be distributed to such Member if the Company were to (i) liquidate the assets of the Company for an amount equal to the Book Value of such property and (ii) distribute the proceeds in liquidation in accordance with Section 3.1 of this Agreement.
Targeted Allocations Using Gross Items

• A well drafted targeted allocation provision will provide guidance on how the gross allocation is supposed to be done

• There are two common approaches:
  – One-step approach - Allocate using gross items only if necessary
  – Two-step approach - Allocations are always made using gross items, allocating all income items first, then allocating deduction/loss items second

• There can be drastically different tax results when choosing how to allocate gross items
Targeted Allocations Using Gross Items - Example of One-Step and Two-Step Approaches

• Assume the same cash waterfall as in the previous example ($10 preferred return to A, and then residual split evenly).

• Assume that the investment partnership instead has Net Profits:
  – There is $10 of “net income” comprised of:
    – Capital Gain $110
    – Section 212 management fee expense ($100)
  – The targeted allocation would result in all net $10 being allocated to Partner A, and nothing to B and C.

<table>
<thead>
<tr>
<th>Income (Loss)</th>
<th>Allocation</th>
<th>“Net Profit”</th>
<th>A</th>
<th>B</th>
<th>C</th>
</tr>
</thead>
<tbody>
<tr>
<td>$10</td>
<td>10</td>
<td>10</td>
<td>-0-</td>
<td>-0-</td>
<td></td>
</tr>
</tbody>
</table>

What do the allocations look like under a targeted provision with gross allocations?
Example of One-Step and Two-Step Approaches

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>C</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>One-Step Method</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. Cap Gain</td>
<td>110</td>
<td>-0-</td>
<td>-0-</td>
</tr>
<tr>
<td>2. Fees</td>
<td>(100)</td>
<td>-0-</td>
<td>-0-</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>10</td>
<td>-0-</td>
<td>-0-</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>C</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Two-Step Method</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. Cap Gain</td>
<td>44</td>
<td>33</td>
<td>33</td>
</tr>
<tr>
<td>2. Fees</td>
<td>(34)</td>
<td>(33)</td>
<td>(33)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>10</td>
<td>-0-</td>
<td>-0-</td>
</tr>
</tbody>
</table>

- Under these facts, there are drastically different tax results for the partners
- If A, B, and C are all high-wealth individual taxpayers, which method do you think each partner would want?
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OTHER CONSIDERATIONS
Targeted Allocations – Special Allocations

• Special allocations
  – As a general matter, targeted capital account agreements do not contain special allocations of income or loss
    – Why?
  – Is it possible to have special allocations in targeted capital account agreements?
  – A special allocation in a targeted capital account agreement may be respected
    – Is the special allocation based on a corresponding special allocation of cash or funding of a specific item?
    – Consider general substantiality principles
Targeted Allocations – Tax Distributions

• Consider how the tax distribution is treated
  – In an Allocation Driven deal
    – Reduction in capital account
  – In a Cash Driven deal two possible approaches
    – Advance
    – Nonadvance

• How does each approach impact each partner’s economic entitlement?
Targeted Allocations – Respected?

• Validity of Targeted Capital Account Allocations
  - The targeted capital account approach does not fit the standard of the section 704(b) regulatory safe harbor for several reasons, the most obvious of which is that under the safe harbor, liquidating distributions must be made in accordance with positive ending capital account balances while targeted capital account allocations are based on the distribution waterfall
  - There are two potential arguments why targeted capital account allocations are valid under section 704(b)
Targeted Allocations – Respected?

  - Under this argument, targeted capital account allocations should be respected as valid as long as they result in the same income and loss allocations as allocations made under the safe harbor regulations.
  - What if you have a net profit agreement, a preferred return partner with priority over another partner’s capital, and the partnership doesn’t generate sufficient profit in a year to satisfy the preferred return?

- **Partners-Interest-in-the-Partnership ("PIP")** - Treas. Reg. 1.704-1(b)(3)
  - Under this argument, the targeted capital account allocations should be valid as long as they are consistent with the partners’ interest in the partnership as defined by section 704(b).
Targeted Allocations – Other Considerations

- Other allocations that look to an allocation meeting the substantial economic effect safe harbor?

- The fractions rule (section 514(c)(9)(E)) requires allocations that have substantial economic effect
  - Use of targeted allocation agreements in real estate partnerships that have tax-exempt partners?
Targeted Allocations – Guidance

• There is no official guidance from the government on the use of targeted allocations

• AICPA’s recent proposed revenue ruling

• Recent comments by government officials
Targeted Allocations – Recap

- What type of agreement do you have?
- What is the process to determine allocations of income?
- Does a partner have a preferred return?
- Does the partnership agreement provide for tax distributions?
- Comfort level on validity of annual allocations?
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