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**Structuring Tax Provisions in Partnership and LLC Operating Agreements**

Effective Allocations With Flow-Through Entities

TUESDAY, JANUARY 11, 2011

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today’s faculty features:

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Structuring Tax Provisions in Partnership and LLC Operating Agreements

by Carolyn Turnbull, CPA, MST
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January 11, 2011

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Capital Contributions
Capital Contribution - Introduction

- Relationship to distributions and allocations of profits and losses
- Partnership agreement should define the meaning of “capital contribution”
  - Amount of money and fair market value of property (other than money) contributed to the partnership with respect to the interest held by the contributing partner
    - Partnership agreement should describe, in detail, the property contributed to the partnership and list any encumbrances that the partnership is assuming or that the contributed property is subject to.
  - Items which may require special treatment
    - Contribution of a promissory note or other obligation to contribute cash or property to the partnership
    - Contribution of services by a partner to the partnership
Other nontax items to consider

- Is a partner obligated to make additional capital contributions?
- Can a partner make an optional capital contribution to the partnership?
  - If so, under what circumstances?
  - What impact will an optional capital contribution have on the partnership, the contributing partner, and the noncontributing partners?
- Is a partner entitled to a specified rate of return on their capital contribution?
Example 1
All Partners Contributing Property

5.01 Initial Contributions.

(a) Simultaneously with the execution hereof, and pursuant to that certain Assignment, Bill of Sale and Assumption Agreement executed concurrently herewith by and between the General Partner and the Partnership (the “Transfer Agreement”), the Partners have contributed to the capital of the Partnership the portions of the Operating Assets set forth opposite their respective names below under the heading “Capital Contributions.” The Partners’ capital percentages (the “Capital Percentages”) shall be as set forth opposite their respective names below under the heading “Capital Percentages”:

<table>
<thead>
<tr>
<th>Capital Percentages</th>
<th>Capital Contributions</th>
</tr>
</thead>
<tbody>
<tr>
<td>General Partner</td>
<td>1%</td>
</tr>
<tr>
<td>Limited Partner</td>
<td>99%</td>
</tr>
</tbody>
</table>

(b) Simultaneously with the execution hereof, and pursuant to the Transfer Agreement, the Partnership shall also assume the Operating Liabilities. 99% of the Operating Liabilities shall be assumed by the Partnership on behalf of the Limited Partner, and 1% of the Operating Liabilities shall be assumed by the Partnership on behalf of the General Partner.

(c) For convenience, the General Partner and the Partnership agreed in the Transfer Agreement to the direct transfer of the Operating Assets from the General Partner to the Partnership and to the direct assumption of the Operating Liabilities by the Partnership on behalf of the General Partner. The Transfer Agreement further provides, and the Partners hereby agree, that (i) in accordance with Section 4.1 of the Limited Liability Company Agreement of the Limited Partner, the General Partner shall be deemed to have transferred to the Limited Partner a 99% interest in the Operating Assets, and the Limited Partner shall be deemed to have assumed on behalf of the General Partner 99% of the Operating Liabilities, and (ii) in accordance with Section 5.01(a) and 5.01(b) of this Agreement, the Limited Partner shall immediately thereafter be deemed to have transferred to the Partnership such 99% interest in the Operating Assets, and the Partnership shall be deemed to have assumed such 99% of the Operating Liabilities on behalf of the Limited Partner.
Example 2
Contributions of Cash and Property

Section 6.1 Initial Capital Contributions. As contemplated in the Contribution Agreement:

(a) prior to the making by Partner 2 of the contribution referred to in Section 6.1(b), Partner 1 shall contribute, convey, assign, transfer and deliver all of its legal and beneficial interest in Operating Company and all other Contributed Assets, based on which, the Company shall be deemed to have an initial equity value of $150,000,000; and

(b) Partner 2 shall contribute the Initial Investor Contribution Amount to the Company.
**Example 3**

**Straightforward Property Contribution**

Section 3.1  **Initial Contributions.** On the Closing Date, each Member made those contributions to the Company that are provided for in Section ____ of the Contribution Agreement and the amounts set forth in Exhibit “A” (the “Initial Contributions”). As a result of such Initial Contributions, each Member shall have the Member Interest set forth opposite such Member’s name on Exhibit “A”.
Capital Contribution – Basic Tax Implications

- §721 – No gain or loss to partner or partnership on contribution of property for an interest in partnership capital
  - Exceptions
    - Partner contributes property to an investment company (§721(b))
    - Liabilities assumed by the partnership or liabilities securing property contributed to the partnership exceed the adjusted tax basis of property contributed to the partnership
    - Disguised sales (§707(a)(2))

- §722 – Partner takes a substitute basis in partnership interest equal to her basis in contributed property(ies) and cash

- §723 – Partnership takes carryover basis in contributed property equal to partner’s basis in such property prior to contribution
  - Partnership may increase its basis in the contributed property for any gain recognized by the partner upon the contribution.
Capital Contribution – Other Tax Considerations

- Impact of liabilities assumed by a partnership or transfer of property subject to a liability to the partnership on the partnership, the contributing partners and the noncontributing partner
- Deferred contributions
  - Impact on a partner’s ability to deduct partnership tax losses under the basis and at-risk limitations
  - Whether interest is required to be imputed under §§483 and 1274
  - Whether the partners’ capital accounts should be permitted to be revalued in connection with deferred contributions
Capital Contribution – Contribution of Services

● Background
  - Capital interest vs. profits-only interest
  - *Sol Diamond, Campbell, and Mark IV Pictures, Inc.*

● Rev. Proc. 93-27
  - General rule
    - Receipt of profits-only interest in exchange for service to or for the benefits of the partnership, either in a partner capacity or in anticipation of becoming a partner, is not a taxable event to either the partner or the partnership
  - Exceptions
    - Profits interest relates to a substantially certain and predictable stream of income from partnership assets;
    - The partner disposes of the profits interest within two years or receipt; or
    - Profits interest is a limited partnership interest in a “publicly traded partnership”.
Capital Contribution – Contribution of Services

- Notice 2005-43
- Proposed regulations under §83
  - General rule
    - Transfer of a partnership interest (whether a profits or capital interest) in connection with the performance of services is subject to §83.
    - Treatment as a guaranteed payment
  - §83(b) election
    - Section 83(b) election is made
    - Section 83(b) election is not made
      - Forfeiture allocations upon forfeiture of partnership interest subject to the §83(b) election
Capital Contribution – Contribution of Services

- Proposed regulations under §83
  - Valuing the partnership interest
    - Liquidation value election
      - Requires the partnership agreement to contain provisions that are legally binding on all of the partners stating that:
        - The partnership is authorized and directed to elect the safe harbor, and
        - The partnership and each of its partners (including any person to whom a partnership interest is transferred in connection with the performance of services) agrees to comply with all the requirements of the safe harbor with respect to all partnership interests transferred in connection with the performance of services while the election remains effective.
      - Exception
        - Each partner in the partnership executes a legally binding document authorizing and directing the partnership to adopt the safe harbor and agreeing to comply with all of the requirements of the safe harbor.
Proposed legislation for “carried interests”

- Would apply to holders of an “investment services partnership interest”
- Would provide that, for purposes of §83, where a partnership interest is transferred in connection with the performance of services provided for (or on behalf of) the partnership:
  - Liquidation value would be treated as the FMV of the partnership interest, and
  - The person receiving the partnership interest would be treated as having made a §83(b) election unless the person elects not to have the §83(b) election apply.
Allocations (Regulatory)
Example

Section 9.2 Special Allocations. Notwithstanding anything in this Agreement to the contrary, the following special allocations shall be made:

(a) Nonrecourse Deductions. Nonrecourse Deductions for any taxable year shall be allocated to the Members in proportion to their relative Membership Interests.

(b) Member Nonrecourse Deductions. Member Nonrecourse Deductions for any taxable year shall be allocated 100% to the Member that bears the Economic Risk of Loss with respect to the Member Nonrecourse Debt to which such Member Nonrecourse Deductions are attributable in accordance with Treasury Regulation Section 1.704-2(i). If more than one Member bears the Economic Risk of Loss with respect to a Member Nonrecourse Debt, Member Nonrecourse Deductions attributable thereto shall be allocated between or among such Members in accordance with the ratios in which they share such Economic Risk of Loss. This Section 9.2(b) is intended to comply with the provisions of Treasury Regulation Section 1.704-2(i) and shall be interpreted consistently therewith.

(c) Company Minimum Gain Chargeback. Notwithstanding any other provision of this Agreement, if there is a net decrease in Minimum Gain during any taxable year, each Member shall be allocated items of Company income and gain for such year (and, if necessary, subsequent taxable years) in the manner and amounts provided in Treasury Regulation Sections 1.704-2(f)(6), (g)(2) and (j)(2)(i). For purposes of this Section 9.2, each Member’s Capital Account shall be determined, and the allocation of income or gain required hereunder shall be effected, prior to the application of any other allocations pursuant to this Article 9 with respect to such taxable year. This Section 9.2(c) is intended to comply with the partner minimum gain chargeback requirement in Treasury Regulation Section 1.704-2(f) and shall be interpreted consistently therewith.

(d) Member Nonrecourse Debt Minimum Gain Chargeback. Notwithstanding the other provisions of this Agreement (other than Section 9.2(c) above), if there is a net decrease in Member Nonrecourse Debt Minimum Gain during any taxable year, any Member with a share of Member Nonrecourse Debt Minimum Gain at the beginning of such taxable year shall be allocated items of Company income and gain for such year (and, if necessary, subsequent taxable years) in the manner and amounts provided in Treasury Regulation Section 1.704-2(i)(4) and (j)(2)(ii). For purposes of this Section 9.2, each Member’s Adjusted Capital Account balance shall be determined, and the allocation of income and gain required hereunder shall be effected, prior to the application of any other allocations pursuant to this Article 9, other than Section 9.2(c) above, with respect to such taxable year. This Section 9.2(d) is intended to comply with the partner nonrecourse debt minimum gain chargeback requirement in Treasury Regulation Section 1.704-2(i)(4) and shall be interpreted consistently therewith.
(e) **Qualified Income Offset.** Except as provided in Sections 9.2(c) and 9.2(d) above, in the event any Member unexpectedly receives an adjustment, allocation or distribution described in Treasury Regulation Sections 1.704-1(b)(2)(ii)(d)(4), (5) or (6), items of Company income and gain shall be allocated to such Member in an amount and manner sufficient to eliminate, to the extent required by such Treasury Regulation, the deficit balance, if any, in its Adjusted Capital Account created by such adjustment, allocation or distribution as quickly as possible unless such deficit balance is otherwise eliminated pursuant to Sections 9.2(c) or 9.2(d). This Section 9.2(e) is intended to constitute a qualified income offset described in Treasury Regulation Section 1.704-1(b)(2)(ii)(d) and shall be interpreted consistently therewith.

(f) **Gross Income Allocation.** In the event any Member has a deficit balance in its Adjusted Capital Account at the end of any taxable year, such Member shall be allocated items of Company gross income and gain in the amount of such excess as quickly as possible; provided, however, that an allocation pursuant to this Section 9.2(f) shall be made only if and to the extent that such Member would have a deficit balance in its Adjusted Capital Account after all other allocations provided in this Section 9.2 (other than Section 9.2(e)) have been tentatively made as if Section 9.2(e) and this Section 9.2(f) were not in this Agreement.

**Section 9.3 Curative Allocations.** The allocations set forth in Section 9.2 (the “Regulatory Allocations”) are intended to comply with certain requirements of the Treasury Regulations. It is the intent of the Members that, to the extent possible, all Regulatory Allocations shall be offset either with other Regulatory Allocations or with special allocations of other items of Company income, gain, loss or deduction pursuant to this Section 9.3. Therefore, notwithstanding any other provision of this Article 9 (other than the Regulatory Allocations), but subject to the Code and the Treasury Regulations, the Board shall make such offsetting special allocations of Company income, gain, loss or deduction in whatever manner it determines appropriate so that, after such offsetting allocations are made, each Member’s Capital Account balance is, to the extent possible, equal to the Capital Account balance such Member would have had if the Regulatory Allocations were not part of this Agreement. In exercising its discretion under this Section 9.3, the Board shall take into account future Regulatory Allocations that, although not yet made, are likely to offset other Regulatory Allocations previously made.

...“Adjusted Capital Account” means the Capital Account maintained for each Member (a) increased by any amounts the Member is obligated to contribute or restore to the Company pursuant to the penultimate sentences of Treasury Regulations Sections 1.704-2(g)(1) and 1.704-2(i)(5), and (b) decreased by any amounts described in Treasury Regulations Sections 1.704-1(b)(2)(ii)(d)(4), (5), or (6) with respect to such Member.
Capital Accounts
Partners’ capital accounts play a key role in determining whether partnership allocations have substantial economic effect or are deemed to be in accordance with the partners’ interests in the partnership under §704(b) and the regulations thereunder.
Example 1

Section 4.6  *Capital Account Mechanics.*

(a) A separate Capital Account shall be established and maintained for each Member in accordance with the requirements of Treasury Regulations Section 1.704-1(b)(2)(iv). The original Capital Account established for any Member who acquires Membership Interests by virtue of an assignment in accordance with the terms of this Agreement shall be in the same amount as and shall replace the Capital Account of the assignor of such Interest. To the extent such Member acquires less than all of the Membership Interests of the assignor of the Membership Interests so acquired by such Member, the original Capital Account of such Member and its Capital Contributions shall be in proportion to the Membership Interests it acquires, and the Capital Account of the assignor who retains any Membership Interests shall be reduced in proportion to the Interest it retains.

(b) The Capital Account of each Member shall be maintained in accordance with the following provisions:

(i) to such Member’s Capital Account there shall be credited such Member’s Capital Contributions, such Member’s distributive share of Profits, special allocations of income and gain, and the net amount of any Company liabilities that are assumed by such Member or that are secured by any Company assets distributed to such Member;

(ii) to such Member’s Capital Account there shall be debited the amount of cash and the Gross Asset Value of any Company assets distributed to such Member pursuant to any provision of this Agreement, such Member’s distributive share of Losses, special allocations of loss and deduction, and the net amount of any liabilities of such Member that are assumed by the Company or that are secured by any property contributed by such Member to the Company;

(iii) in determining the amount of any liability for purposes of this Section 4.6(b), there shall be taken into account Section 752(c) of the Code and any other applicable provisions of the Code and the Treasury Regulations; and

(iv) the Capital Accounts shall be increased or decreased upon a revaluation of Company property pursuant to clause (b) of the definition of Gross Asset Value in the manner prescribed in Treasury Regulation Section 1.704-1(b)(2)(iv)(f).
Example 2
“Gross Asset Value” and “Depreciation”

“Gross Asset Value” means, with respect to any asset, such asset’s adjusted basis for federal income tax purposes, except as follows:

(a) the initial Gross Asset Value of any asset contributed by a Member to the Company shall be the gross fair market value of such asset, as agreed to by the contributing Member and the Board;

(b) the Gross Asset Value of all Company assets shall be adjusted to equal their respective gross fair market values, as determined by the Board, in connection with: (i) the acquisition of an additional interest in the Company by any new or existing Member in exchange for more than a de minimis Capital Contribution or in exchange for the performance of services to or for the benefit of the Company; (ii) the distribution by the Company to a Member of more than a de minimis amount of Company assets as consideration for an interest in the Company; (iii) the liquidation of the Company within the meaning of Treasury Regulations Section 1.704-1(b)(2)(ii)(g) (other than pursuant to Section 708(b)(1)(B) of the Code); and (iv) the grant of an interest in the Company (other than a de minimis interest) in consideration for the provision of services to or for the benefit of the Company or any other event to the extent determined by the Board to be necessary to properly reflect the Gross Asset Values in accordance with the standards set forth in Treasury Regulations Section 1.704-1(b)(2)(iv)(q); provided, however, that adjustments pursuant to clause (i) and clause (ii) of this sentence shall be made only if the Board reasonably determines that such adjustments are necessary or appropriate to reflect the relative economic interests of the Members in the Company;

(c) the Gross Asset Value of any Company asset distributed to any Member shall be the gross fair market value of such asset on the date of distribution, as determined by the Board and the distributee Member; and

(d) the Gross Asset Values of Company assets shall be adjusted to reflect any adjustments to the adjusted basis of such assets pursuant to Code Section 734(b) or Code Section 743(b), but only to the extent that such adjustments are taken into account in determining Capital Accounts pursuant to Treasury Regulations Section 1.704-1(b)(2)(iv)(m).

If the Gross Asset Value of an asset has been determined or adjusted pursuant to paragraph (a) or paragraph (b) above, such Gross Asset Value shall thereafter be adjusted by the Depreciation taken into account with respect to such asset for purposes of computing Profits and Losses.
**Example 2**

“Gross Asset Value” and “Depreciation”

“**Depreciation**” means, for each Fiscal Year or other period, an amount equal to the depreciation, amortization or other cost recovery deduction allowable for federal income tax purposes with respect to an asset for such Fiscal Year as determined by the Members; *provided, however*, that if the Gross Asset Value of an asset differs from its adjusted basis for federal income tax purposes at the beginning of such Fiscal Year or other period, Depreciation for such Fiscal Year or other period shall equal to the amount of book basis recovered for such Fiscal Year or other period under the rules prescribed by Treasury Regulation Section 1.704-3(d)(2) and *provided further*, that if the federal income tax depreciation, amortization or other cost recovery deduction for such Fiscal Year or other period is zero, Depreciation shall be determined with reference to such beginning Gross Asset Value using any reasonable method selected by the Members.
Capital Accounts – General Maintenance Rules for Tax Purposes

- Increases to a partner’s capital account
  - Money contributed to the partnership
  - FMV of property contributed to the partnership (net of liabilities encumbering the contributed property)
  - Partner’s distributive share of the partnership’s book income and gain (or items thereof), including tax-exempt income
Capital Accounts – General Maintenance Rules for Tax Purposes

- Decreases to a partner’s capital account
  - Money distributed to the partner
  - FMV of property distributed to the partner (net of liabilities encumbering the distributed property)
  - Partner’s distributive share of nondeductible, noncapitalizable expenditures described in §705(a)(2)(B)
  - Partner’s distributive share of the partnership’s book loss and deductions (or items thereof) other than items already accounted for as distributive shares of partnership expenditures under §705(a)(2)(B)
Liquidations
Liquidations – Introduction

- Liquidating distributions based on partners’ positive balances in their capital accounts
- Other alternatives (nonexclusive)
  - Liquidating distributions based on partners’ ownership percentages
  - Liquidating distributions made in the same proportions as other distributions
- Partnership agreement should provide that partnership property is revalued and unrealized gain or loss is recorded for book purposes prior to the liquidation.
Example 1
Liquidation in Accordance with Capital Accounts

(a) Liquidating Trustee; Liquidating Distributions. Upon dissolution of the Company, the Board (in such capacity, the “Liquidating Trustee”) shall carry out the winding up of the Company and shall immediately commence to wind up the Company’s affairs; provided, however, that a reasonable time shall be allowed for the orderly liquidation of the assets of the Company and the satisfaction of liabilities to creditors so as to enable the Members to minimize the normal losses attendant upon a liquidation. The proceeds of liquidation shall be applied first to payment of all expenses and debts of the Company and setting up of such reserves as the Board reasonably deems necessary to wind up the Company’s affairs and to provide for any contingent liabilities or obligations of the Company; provided that the unpaid principal of and interest on any loans made to the Company by Members (and their Affiliates) shall be distributed pro rata to the Members (and their Affiliates) who made such loans, in proportion to the total amount of principal and interest payable on such loans, such distributions being treated first as a payment of accrued interest on such loans and next as in payment of principal on such loans. Any remaining proceeds shall be distributed to the Members in accordance with their respective Capital Account balances.

(b) Profits and Losses. The Profits and Losses arising from liquidation of the Company shall be allocated among the Members so that, to the maximum extent possible, each Member’s Capital Account balance equals the amount of cash that would be distributed to such Member if liquidating distributions were made in accordance with Section 8.2.
Example 2

Liquidation in Accordance with Ownership Percentages

11.2 Liquidation.

(b) Upon the dissolution of the Partnership, the liquidating trustee shall sell the Partnership assets at the best price available, or, with the consent of all Partners, the liquidating trustee may distribute those assets in kind; provided, however, that the liquidating trustee shall ascertain the fair market value by appraisal or other reasonable means of the Partnership assets to be distributed in kind, and each Partner’s Capital Account shall be charged or credited, as the case may be, as if such asset had been sold for cash at such fair market value and the net gain or net loss recognized thereby had been allocated to and among the Partners in accordance with Article VI above. All of the Partnership assets shall be applied and distributed, with reference to the fair market value thereof, by the liquidating trustee on or before the later to occur of (x) the end of the taxable year in which the dissolution of the Partnership occurs, (y) the date that is 90 days following the date upon which substantially all of the Partnership assets are sold or otherwise disposed of by the Partnership, or (z) the date that is 90 days following the date any other event of dissolution occurs, and in the following order:

(i) First, to the creditors (other than the Partners with respect to Partner Loans) of the Partnership;

(ii) Next, to setting up the reserves that the liquidating trustee may deem reasonably necessary for contingent or unforeseen liabilities or obligations of the Partnership;

(iii) Next, to the Partners in an amount equal to the sum of the credit balances of their respective Partner Loan Accounts, in the ratio that the credit balance of each Partner Loan Account bears to the sum of the credit balances of all Partner Loan Accounts;

(iv) Next, to the Partners in an amount equal to the sum of the credit balances of their respective Contribution Accounts, in the ratio that the credit balance of each Contribution Account bears to the sum of the credit balances of all Contribution Accounts;

(v) Finally, the balance, if any, to and among the Partners in accordance with their respective Ownership Percentages.
Liquidations – Basic Tax Consequences

Distributee-Partner’s Recognition of Gain or Loss

- §731(a)(1) – Partner recognizes gain only if she receives cash in excess of the basis of her partnership interest.

- §731(a)(2) – Partner may recognize loss if:
  - Receives *nothing* other than cash and/or unrealized receivables and inventory.
  - Amount of cash and *basis* of unrealized receivables and inventory is less than basis in partnership interest.
Liquidations – Basic Tax Consequences

Distributee-Partner’s Recognition of Gain or Loss

- Exceptions
  - Distribution of marketable securities
  - Payments to a retiring partner or a deceased partner’s successor in interest subject to §736
  - Distributions subject to §751
  - Distributions subject to §737 (re: recognition of pre-contribution gain in the case of certain distributions)
Liquidations – Basic Tax Consequences

Partner’s Basis in Property Received

- §732(B) – Partner takes basis in property received equal to basis in partnership interest less any cash received
- Liability relief treated as cash received
- Assumption of liabilities treated as cash contribution
Liquidations – Basic Tax Consequences

Partner’s Holding Period in Property Received

- §735(b) – Partnership’s holding period tacks onto partner’s holding period for distributed property.
- §735(a) – Partnership inventory retains its ordinary income character for five years.
Circular 230 Disclosure

These materials are intended for internal discussion purposes only. To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. tax advice contained in this communication is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or any other state or local law, or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.
Allocation and Distributions

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In determining its income tax, each partner must take into account separately its "distributive share" (whether or not any cash or property is distributed) of certain listed items (e.g. short-term capital gains and losses, long-term capital gains and losses, § 1231 gains and losses, etc.). § 702.

A partner's distributive share is determined by § 704 and the regulations thereunder.
 Allocation of Income—sec. 704(b)

- A partner's distributive share is determined by § 704 and the regulations thereunder.

- Sections 704(a) and (b) provide that a partner's distributive share of income, gain, loss, deduction or credit (or item thereof) is determined by the partnership agreement unless the partnership agreement does not provide an allocation rule for the item or the allocation under the partnership agreement does not have substantial economic effect, in which case the allocation is determined "in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances)."
## Allocation of Income—sec. 704(b)

- Treas. Reg. § 1.704-1(b) provides the rules to determine whether an allocation will be respected for tax purposes as either
  - (i) **having substantial economic effect** or
  - (ii) **being in accordance with the partners' interest in the partnership.**
Treas. Reg. § 1.704-1(b) provides the rules to determine whether an allocation will be respected for tax purposes as either

(i) having substantial economic effect or

(ii) being in accordance with the partners' interest in the partnership.
### Allocation of Income—sec. 704(b)

- The operation of the § 704(b) regulations is, in its technical details, extremely complex. One can, however, say in general that an allocation of income, gain, loss, or deduction (or item thereof) to a partner will have economic effect under the regulations if, and only if -- (see next page)
Allocation of Income—sec. 704(b)

- (i) the allocation is reflected in that partner's capital account, which capital account is maintained in accordance with the regulations;

- (ii) liquidation proceeds are, throughout the term of the partnership, distributed in accordance with the partners' positive capital account balances; and

- (iii) any partner with a deficit in that partner's capital account following the liquidation of that partner's interest is required to restore the amount of the deficit to the partnership by the later of the end of the taxable year of the liquidation or 90 days after the liquidation.

- Tax has to follow the economics.
Allocation of Income—sec. 704(b)

Where a partner has no obligation to restore a deficit in that partner's capital account, an allocation will still be considered to have economic effect if the partnership agreement contains a so-called "qualified income offset" and the allocation itself does not cause or increase a deficit balance in such partner's capital account. Treas. Reg. § 1.704-1(b)(2)(ii).
## Allocation of Income—sec. 704(b)

- In order for the economic effect of an allocation to be considered substantial, the regulations require that the allocation must have a reasonable possibility of substantially affecting the dollar amounts to be received by the partners, independent of tax consequences.

- In applying the substantiality test, tax consequences that result from the interaction of the allocation with such partner's tax attributes that are unrelated to the partnership must be taken into account. Treas. Reg. § 1.704-1(b)(2)(iii)(a). An allocation can fail to be "substantial" if it is --
Allocation of Income—sec. 704(b)

- In order for the economic effect of an allocation to be considered substantial, the regulations require that the allocation must have a reasonable possibility of substantially affecting the dollar amounts to be received by the partners, independent of tax consequences.

- In applying the substantiality test, tax consequences that result from the interaction of the allocation with such partner's tax attributes that are unrelated to the partnership must be taken into account. Treas. Reg. § 1.704-1(b)(2)(iii)(a). An allocation can fail to be "substantial" if it is --
Allocation of Income—sec. 704(b)

(i) shifting (after-tax effect within a taxable period considered) Treas. Reg. § 1.704-1(b)(2)(iii)(b);

(ii) transitory (after-tax effect between taxable periods considered) Treas. Reg. § 1.704-1(b)(2)(iii)(c); or

(iii) insubstantial under the general test of Treas. Reg. § 1.704-1(b)(2)(iii)(a).
Allocation of Income—sec. 704(b)

- The proper maintenance of capital accounts is essential in establishing substantial economic effect.

- Capital accounts are properly maintained if, and only if, each partner's capital account is increased by --
### Allocation of Income—sec. 704(b)

- **(i)** the amount of money contributed;

- **(ii)** the fair market value of property contributed by him to the partnership (net of liabilities secured by such contributed property that the partnership is considered to assume or take subject to under § 752);

- **(iii)** allocations to him of partnership income and gain (or items thereof), including income and gain exempt from tax and income and gain described in Treas. Reg. § 1.704-1(b)(4)(iv)(g), but excluding income and gain described in Treas. Reg. § 1.704-1(b)(4)(i);
Allocation of Income—sec. 704(b)

and is decreased by --

(i) the amount of money distributed to him by the partnership;

(ii) the fair market value of property distributed to him by the partnership (net of liabilities secured by the distributed property that the partner is considered to assume or take subject to under § 752);

(iii) allocations to him of expenditures of the partnership described in § 705(a)(2)(B), and
(iv) allocations of partnership loss and deduction (or item thereof), including loss and deduction described in Treas. Reg. § 1.704-1(b)(2)(iv)(g), but excluding items described in (vi) above and loss or deduction described in Treas. Reg. § 1.704-1(b)(4)(i) or Treas. Reg. § 1.704-1(b)(4)(iii); and it otherwise adjusted in accordance with the additional rules set forth in Treas. Reg. § 1.704-1(b)(2)(iv).
Allocation of Income—sec. 704(c)

- Section 704(b) capital accounts are credited with the fair market value rather than the tax basis of contributed property. Thus, there can exist book/tax disparities which reflect either a built-in gain or built-in loss in the contributed property. Section 721(a) provides that upon contribution this built-in gain or loss is not realized.

- However, §704(c) provides that partnership taxable income, gain loss and deductions with respect to contributed property must be allocated so as to take into account any book/tax differences.
Allocation of Income—sec. 704(c)

- Treas. Reg. § 1.704-3 provides three methods for eliminating book/tax disparities: the traditional method, the traditional method with curative allocations and the remedial method.

- If a partner contributes built-in gain property, the general effect of each of these methods is to cause the contributing partner to take the amount of built-in gain deferred under § 721(a) into income over some period of time.

- Thus, if one partner (A) contributes, for example, depreciable property with tax basis of 80 and value of 100 and partner (B) contributes 100 of cash, even though A and B agree to allocate all economic income 50/50 under § 704(b), § 704(c) will effectively cause A to realize over time more than 50% of the partnership’s taxable income, viz., the extra 20 of built-in gain, all other things being equal.
## Distributions

- Cash distributions from a partnership to a partner generally are not equivalent to partnership income as determined for federal income tax purposes or as determined under generally accepted accounting principles. If the amount of a distribution to a partner by the partnership (which constructively includes any decrease in the partner's share of liabilities of the partnership) does not exceed the partner's adjusted basis in his partnership interest immediately before the distribution, the distribution does not constitute income to the partner for federal income tax purposes but reduces the partner's adjusted basis in his partnership interest.
Distributions

- However, if a distribution of cash (or in some cases, "marketable securities") to a partner in any taxable year of the partnership exceeds the partner's adjusted basis in his partnership interest immediately before the distribution, the excess is taxable to the partner as though it were gain recognized on the sale or exchange of the partner's interest.
Distributions

- Distributions of property other than cash (and in some cases, "marketable securities"), either current or in liquidation, generally do not cause recognition of gain at either the partnership or partner levels. Rather, the distributed property either has a carryover or substituted basis. However, gain or loss is recognized on distributions of property other than cash in the following circumstances:
Distributions

(i) If the appreciated property contributed by one partner is distributed (directly or indirectly) to the other partner within 7 years of contribution, the contributing partner must recognize precontribution gain or loss as if the property had been sold at its fair market value at the time of distribution. § 704(c)(1)(B). See Prop. Reg. § 1.704-4.
Distributions

(ii) If a partner contributes appreciated property and if, within 7 years of such contribution any property is distributed to such partner (other than the property it contributed) when the "book value" of the contributed property exceeds its tax basis as adjusted over the life of the partnership to date ("adjusted built-in gain"), then upon a distribution of any property (including property contributed by the other partner), the contributing partner will recognized gain equal to the lesser of (i) the fair market value of the distributed property over the recipient partner's basis in its partnership interest or (ii) the "adjusted built-in gain." § 737.
(iii) If a partner receives a distribution of "ordinary income assets" in a ratio different from its interest in partnership assets generally, § 751(b) will apply to treat the partner who receives such disproportionate distribution of "ordinary income assets" as having sold the difference to the partnership in return for a disproportionately large share of the non-"ordinary income assets."
Structuring Tax Provisions in Partnership and LLC Operating Agreements

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• TEFRA Partnership Provisions

  • Unified Audit

  • Not always applicable by default

  • Always Elective

- Tax Matters Partner
- Notice Partner
- Power to Bind Settlement
- Power to Extend Statute of Limitations
Transactions Between Partners and Partnerships – Key Provisions

- Classification of Payments
  - Payments to Partner
  - IRC 736 Payments to “Retiring Partner”
Transactions Between Partners and Partnerships – Key Provisions

• Classification of Payments to Partner
  • IRC 707(a) Payment – not in capacity as partner
    • “Disguised Sale”
    • “Disguised Services”
  • IRC 707(c) Guaranteed Payment
  • Distributive Share of Partnership Income
Transactions Between Partners and Partnerships – Key Provisions

• Classification of Payments to Retiring Partner
  • Payment for Share of Partnership Property
  • IRC 707(c) Guaranteed Payment
  • Distributive Share of Partnership Income
  • IRC 751(b)
Tax Audit Provisions – Tax Consequences

• Drafting Issues
  • TMP Discretion
  • Identification of Notice Partners
  • Participation in Audit Process
Transactions Between Partners and Partnerships – Key Provisions

- Drafting Issues
  - Agreed Reporting
  - Guaranteed Payments
  - Allocation of IRC 736 Payments
Conclusion

- Complex sets of Differing Rules
- Unanticipated Consequences
- Carefully Planning (and patience) required
Thank You.