Tax Allocation in Partnerships and LLCs
Minimize Tax Impact Through Strategic Allocation of Income, Gains, Losses and Liabilities

A Live 90-Minute Teleconference/Webinar with Interactive Q&A

Today's panel features:
Andrew W. Ratts, Partner, Winston & Strawn, Chicago

Tuesday, October 13, 2009

The conference begins at:
1 pm Eastern
12 pm Central
11 am Mountain
10 am Pacific

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Tax Allocations in Partnerships and LLCs
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Andrew W. Ratts
October 13, 2009
## Partnership v. Corporation

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<td>Minimizing Income Tax</td>
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Partnership Flexibility

- Only type of entity allowing for separate allocation of items of income, gain, loss, deduction and credit

- Only type of entity allowing for separate allocation of liabilities
Limits on Partnership Allocation Flexibility

- IRC § 704(b) – "Substantial Economic Effect"
- IRC § 704(c) – Book/Tax Differences
- Other Federal Income Tax Rules
  - IRC § 482
  - Economic Substance
  - Partnership "Anti-Abuse" Regulation § 1.701-2
Partnership Allocation Mechanics

- "Book" items of income, gain, loss, deduction and credit are calculated (with taxable income as starting point)
- Book items are allocated among tax partners
- Tax items of income, gain, loss, deduction and credit follow corollary book items
- IRC § 704(c) adjusts for any "book-tax difference"
- End Result – Partner's "distributive share" of partnership income
"Regular", "Regulatory" and "Curative" Partnership Book Allocations

- "Regular" allocations generally follow pre-tax economics
- "Regulatory" allocations are "boilerplate" provisions designed to cause regular allocations to comply with the Treasury Regulations under IRC § 704(b)
  - Minimum Gain Chargeback
  - Nonrecourse Deductions
  - QIO/Stop Loss/Gross Income Allocation
- Curative allocations to reverse the effect of required regulatory allocation to arrive back at regular allocations
Allocation Formats

- Regular Allocations
  - "Layer cake"
  - "Targeted"

- Regulatory Allocations
  - Full (McKee) Nelson
  - Shorthand/By Reference

- "Special" Allocations
  - Not defined other than as not the fallback allocations "in accordance with partners' interests"
  - "Partners' interests" not defined
Partnership "Tax Distributions"

- No entity level tax, but pass through of partnership income whether or not distributed
- Solution: Required distribution for partner taxes
  - What rate?
  - Prior year losses?
  - All partners participate?
  - IRC § 704(c) income included?
- The trap of common and preferred interests
Nonrecourse Deductions/Minimum Gain Chargeback

• Allocation of tax losses attributable to nonrecourse borrowing

• Very flexible – regular allocation of items sets range

• Minimum Gain = "Turnaround" income
Nonrecourse Liability Allocation

- Three tiers

- After minimum gain tier and IRC § 704(c) tier – flexibility

- Based upon "regular allocations" or "special allocation" of income or gain sets range or follows (nonrecourse) deductions
IRC § 704(b) – Substantial Economic Effect

- "Economic Effect" - §1.704-1(b)(2)(ii)
  - Maintenance/Liquidation with Capital Accounts
  - DRO/Alternate Test (QIO/Stop Loss)
  - Economic Effect Equivalence ("Targeted Allocations")
IRC § 704(b) — Substantial Economic Effect

- **DRO Termination**
  - Obligation must be enforceable
  - "Plan to avoid or circumvent obligation"
  - DRO may be "eliminated or reduced"
    - Does not result in remaining impossible negative
    - Example, a capital contribution
IRC § 704(b) – Substantial Economic Effect

• "Substantial" - § 1.704-1(b)(2)(iii): What it is not
  • Lack of Pre-Tax Economic Effect
    • Transitory
    • Shifting
  
• Lack of After-Tax Economic Consequence
  • After-tax present value consequences cannot be a "win-win" for all partners
IRC § 704(b) – Substantial Economic Effect

- "Substantial" - § 1.704-1(b)(2)(iii): What it is
  - Reasonable possibility
  - Affect dollar amounts "substantially"
"Substantial" – "Stuffing" Allocations

- Open End Investment Funds (Hedge funds)
  - Allow for periodic redemptions @ NAV
  - Hold many different securities

- IRC § 754 Election/IRC § 734 Multiple Adjustments not feasible

- Solution: Allocate tax items to cause tax basis to match NAV of redeeming partner
  - Whole or "Partial"
  - Order of priority -- capital gains, ordinary income?

- Do stuffing allocations "affect" dollar amounts?

- Do NAV calculations constitute "book-ups" of capital accounts? Must they?
"Substantial" - Special Allocation of ECI

- Non-US Investors want to invest in a portfolio of interests in closed-end private equity funds, generating
  - capital gains (0% tax rate)
  - dividends (30% withholding tax rate)
  - ECI (54.5% effective tax rate – uses wholly-owned blocker to reduce filing requirement)

- Manage with Special Allocations?

- Application of IRC § 482

- Are "offsetting" allocations of items that generate greater tax liability insubstantial?
Substantial Economic Effect – Rules of Convenience

• Rules contrary to economic reality, but permitted as a matter of administrative grace
  • "Value = Basis"
  • IRC § 754 adjustment to capital gain property greater than its FMV - § 1.755-1(c)(2)(i)
  • "Clearly contemplated" under anti-abuse rule of § 1.701-2?
IRC § 704(c)

- Castle Harbour – ceiling rule transaction

- IRC § 704(c)(1)(C)/ § 743(a) "Mandatory" step down
Conclusion

- Each set of special allocation possesses its own unique tax consequences and constraints

- Optimization takes experienced focus, creativity and patience
Thank You.