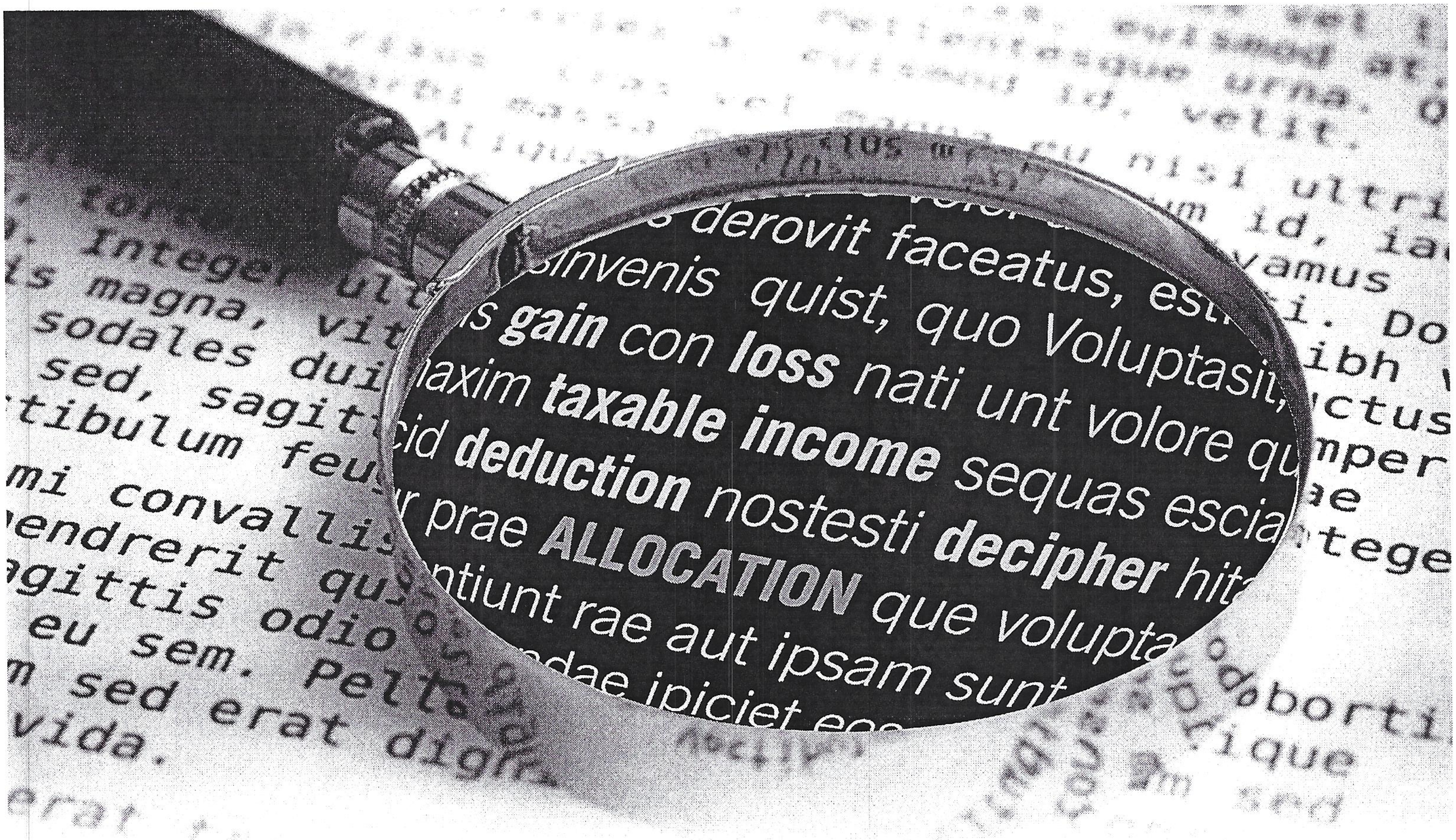

Deciphering Tax Allocation Provisions in a Partnership Agreement

By Philip R. Hirschfeld

A typical real estate limited partnership agreement or limited liability company (LLC) operating agreement includes provisions dealing with allocations of taxable income, gain, loss, and deductions that can be difficult to decipher. This article provides a brief explanation of the reasons for these tax allocation rules and the content of the basic tax allocation provisions, enabling a real estate lawyer to better understand and explain to his or her clients what many investors consider a tax morass. A targeted tax allocation provision also is discussed, which may better reflect the partners' intentions for sharing cash flow from the partnership and reduce the length of these tax provisions. In this discussion, any reference to partnerships also includes LLCs, which are usually treated as partnerships for tax purposes.

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Reasons for the Tax Allocation Rules

Partnerships are not taxpayers. Under Internal Revenue Code (IRC) § 702(a), a partnership's taxable income, gain, loss, and deductions are allocated to its partners who then include those items on their own tax returns and pay any required tax that is due.

Back in the 1980s, some real estate partnerships took aggressive tax positions and disproportionately allocated substantial tax losses to certain partners, allocations that had no economic reality. For example, a partnership could be formed between two partners—a tax-exempt investor and a taxable investor—to own a commercial office building. All contributions by the partners to the partnership and all partnership distributions to the partners were to be shared 50% by the tax-exempt partner and 50% by the taxable partner. Taxable income, gain, loss, and deductions were to be allocated 50%–50% between the partners, which is known as a "straight-up" allocation that does not vary over the life of the partnership.

Significant tax losses arose in the early years of operation, however, because of depreciation and interest deductions. Because the tax-exempt partner could not use tax losses, 100% of the tax losses generated in the early years were allocated to the taxable partner. This special tax loss allocation did not alter how partnership distributions were to be made (that is, they were still made 50%–50% between the two partners) so this special allocation had no basis in economic reality.

Adoption of Tax Allocation Regulations

In the late 1980s, the IRS shut down these tax shelters with IRC § 704(b), which requires tax allocations to have substantial economic effect (SEE). The IRS issued Treas. Reg. § 1.704-1, which is a detailed set of guidelines for what is required to have SEE. If SEE is lacking, then the IRS can reallocate these tax items in a way that matches the partners' interests in the partnership (PIP). These rules require losses in this type of deal to be allocated 50%–50% unless the partner getting the loss allocation takes some risk that this allocation will alter the 50%–50% sharing of distributions.

Under these IRC § 704(b) regulations, B bore no economic risk as a result of the special allocation of 100% of the tax losses, so the tax loss allocation lacks SEE. As a result, the IRS would look to the 50%–50% contribution and distribution sharing ratio, treat those percentages as reflecting the PIP, and reallocate the loss so B only gets 50% of the loss while A is allocated the remaining 50% of the loss. Compliance with these regulations shapes today's tax allocation provisions.

Partnership tax losses that satisfy the SEE rules are still subject to added tax hurdles before they can be used to offset other taxable income. The passive activity loss rules of IRC § 469 and the at-risk rules of IRC § 465 can limit their use. Nonetheless, tax losses are still valuable to certain investors.

Basic Requirements to Comply with Regulations

The IRC § 704(b) regulations create three requirements for allocations to have SEE:

1. a partnership maintains capital accounts;
2. the capital accounts determine how cash and other partnership property is to be distributed to the partners when the partnership liquidates; and
3. the partnership agreement contains either (a) a deficit restoration obligation or (b) a qualified income offset (QIO) provision. Treas. Reg. §§ 1.704-1(b)(2)(ii)(b), (d).

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For the first requirement, a capital account of a partner is increased by the amount of cash and the fair market value (FMV) of property contributed by the partner to the partnership and by such partner's share of partnership taxable income and gain allocated to the partner. A capital account of a partner is decreased by the amount of cash and the FMV of property distributed by the partnership to the partner and by such partner's share of partnership taxable loss and deductions allocated to the partner. These are the primary ingredients of a capital account, but other adjustments also are made (for example, because property contributed to the partnership is reflected in the capital account at its FMV rather than its tax basis, then book depreciation rather than tax depreciation is used to make future adjustments to capital account). Treas. Reg. § 1.704-1(b)(2)(iv).

For the second requirement, partnership agreements generally include a provision that distributions made in liquidation of the partnership are to be made in accordance with the partners' capital accounts. These agreements provide that the partnership will liquidate after it has sold off all or substantially all of its assets.

For the third requirement, a deficit restoration obligation provides that on liquidation of the partnership, a partner with a deficit in his or her capital account (that is, the capital account is a negative number) must contribute cash to the partnership equal to such deficit, and that cash would then be distributed to other partners having positive capital accounts. In practice, nearly all partners reject having a deficit restoration obligation because such a provision may require the partner to go out of pocket and contribute cash to the partnership.

The QIO provision was included as an alternative requirement that does not expose the partner to economic risk. A QIO provision requires a partner who "unexpectedly" receives an adjustment, allocation, or distribution that causes or increases a deficit balance in such member's capital account (in excess of any limited amount of such deficit that such member must restore) to be allocated income and gain in an amount and manner sufficient to eliminate such deficit balance as quickly as possible. Treas. Reg. § 1.704-1(b)(2)(ii)(d).

In practice, the QIO is routinely included in partnership agreements, but rarely ever used. Adoption of a QIO also requires the agreement to prevent a loss from being allocated to a partner if that partner's capital account would then go negative while another partner's capital account is positive.

Allowable Special Allocations of Tax Losses Under the Regulations

Based on the SEE regulations, if a special allocation of a tax loss is desired, that loss must reduce that partner's capital account and that capital account must affect that partner and govern how liquidating distributions are made. As demonstrated below, the effect of these rules is that a partner getting a special allocation of loss must be subject to some real economic loss that may result.

Assume A and B form a partnership. Each partner contributes $500 to the partnership in which they are equal 50%–50% partners. The partnership uses the $1,000 cash to buy depreciable property. In the first year, the partnership incurs a $100 taxable loss from $100 depreciation claimed on its assets. That depreciation lowers the tax basis of the property from $1,000 to $900. If that $100 loss is specially allocated to B, then the capital account of B gets reduced to $400 (that is, $500 cash contribution minus $100 loss) while A's capital account stays at $500.

If the partnership sells its assets for $900 cash at the start of the second year, no taxable gain will be recognized on the sale because the sale price of $900 matches the $900 adjusted tax basis of the property. If the partnership liquidates, then the $900 of cash liquidating distributions must follow capital accounts so A gets $500 cash while B gets only $400 cash. B got the $100 tax loss in the first year, but B then gets $100 less cash on liquidation of the partnership so the allocations have SEE and are respected by the IRS.

If the liquidating distribution did *not* follow capital accounts and the partners split the cash distributed in liquidation in equal shares (50%–50%) so A and B each get $450 cash, then the special allocation of the $100 loss to B in the first year did *not* have SEE. In that case, the IRS would reallocate that $100 loss in the first year equally between the partners to match their 50% interest in the partnership. As a result, $50 of the loss would then be reallocated to A and only the remaining $50 allocated to B. After that reallocation, the capital accounts of both partners would be $450 (that is, $500 initial cash contribution minus $50 loss), which matches the cash they get on liquidation of the partnership.

Compliance with the SEE regulations thus exposes a partner to the risk of getting less cash in return for getting greater tax losses. Although that risk cannot be eliminated, it can be reduced if there is an expectation that the property will be sold at a taxable gain (that is, a price higher than its tax basis). In that case, the partnership agreement can contain both (1) a special allocation of loss to a partner and (2) a special allocation of gain up to the amount of the earlier tax loss on a sale of partnership property to the partner who got the earlier special allocation of tax loss.

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In this example involving a special loss allocation in the first year, if the property was sold for $1,000 at the start of the second year, then the partnership recognizes $100 taxable gain (that is, $1,000 sale price minus $900 tax basis). The partnership agreement could specially allocate the $100 gain to B to offset the effect of the first year $100 loss allocation to B. B's capital account would then grow to $500 (that is, $400 at the start of year two increased by the $100 gain). If the partnership then liquidated, the $1,000 cash could be shared $500 to A and $500 to B to match their capital accounts.

If the property is sold for more than $1,000 (such as $1,200), then there is $300 taxable gain to allocate on the sale ($1,200 sale price minus $900 basis). The first $100 of gain would be allocated to B to offset the prior $100 loss allocation, and the excess $200 gain would be allocated in the basic 50%–50% sharing ratio so that $100 is allocated to A and $100 is allocated to B. In that case, the capital account of A and B would each be $600 after taking into account these gain allocations, and the cash distributed in liquidation could be split $600 to A and $600 to B to match their capital accounts.

Concerns with Technical Compliance with the Regulations

These SEE tax allocation provisions caused two main concerns with investors. First, tax was shaping how cash would be distributed because the regulations require that capital accounts determine how cash is distributed when the partnership liquidates. For many investors, investment in the partnership was not driven by taxes or a desire to realize tax losses but rather by economics. If these tax allocations did not work properly, the investor did not get the expected economic return on the investment.

Second, even in deals that did not have any special allocations of tax losses, these tax allocation provisions were very complex. This complexity occurs because many real estate deals do not have a straight up allocation of distributions to the partners (such as 50%–50%) that never vary over the life of the partnership. Rather, sharing partnership distributions can get complex based on the business deal among the partners or the presence of a carried interest granted to a manager or promoter who put the deal together and found investors for the project. With this added complexity in how cash is shared comes a matching complexity in how taxable income, gain, loss, and deductions are shared among the partners. That complexity can leave the investor worrying about what exactly they will get when they get a liquidating distribution based on their capital account.

For example, the business deal may be that partnership distributions (that is, cash flow from operation of the real estate project *or* from its sale) are shared:

- first, 99% to the limited partners and 1% to the general partner until the limited partners get a return of invested capital;
- second, 90% to the limited partners and 10% to the general partner until the limited partners get a return equal to twice their invested capital; and
- third, all excess is allocated 80% to the limited partners and 20% to the general partner.

The resulting tax allocation provisions can contain several matching levels of how tax allocations are made that may use a 99%–1% ratio, a 90%–10% ratio, an 80%–20% ratio or some other ratio. Because these tax allocations are reflected in capital accounts, every investor (or their counsel) must carefully review these tax allocation provisions to make sure they reflect the partners' economic deal and do not distort it.

Alternative-Targeted Tax Allocations

As a result of these concerns, there was increasing desire to eliminate the requirement to have liquidating distributions be made in accordance with capital accounts, shorten the tax allocation provisions, or do both. The resulting outcome was the adoption of a "targeted" tax allocation provision. Rather than having detailed steps on how taxable income and loss can be allocated, the basic tax allocation provision is reduced to one paragraph, which generally reads as follows:

> Partnership Profit or Loss for any fiscal year (or portion thereof) shall be allocated in a manner so as to cause the Partners' ending Capital Accounts (after adjusting for such allocations) to equal the amount they would receive if the Partnership were to sell all of its assets for their book value, pay all Partnership liabilities and liquidate pursuant to the liquidation provisions set forth in this Partnership Agreement.

In summary, this targeted tax allocation provision requires that at the end of each year, tax allocations for that year are made so that after taking these allocations into account in computing capital account balances, those adjusted capital account balances (that is, the target) will equal what the partners are to get under the basic distribution provisions of the partnership agreement assuming (1) all partnership properties are sold at their book value, (2) all partnership liabilities are paid, and (3) any remaining cash is distributed to the partners in accordance with how distributions are to be made when the partnership liquidates. Use of book value does not require the partnership to compute and obtain an appraisal to determine the FMV of its properties; rather, the partnership uses the book value of its assets maintained on its financial records, which simplifies the computation.

A favorable effect of the targeted tax allocation provision is that the partnership agreement does *not* provide that liquidating distributions are made to match capital accounts. Rather, the agreement has a clear direction on how cash is to be distributed in liquidation of the partnership that does *not* rely on tax concepts; this approach can make clients feel more comfortable that their partnership agreement matches their economic expectation. Although this approach does not comply with the regulatory requirement for liquidating distributions to follow capital accounts, these targeted allocations likely should be respected because the tax allocations are to match up with the intended cash distributions; therefore, there is real economic significance to this provision that should have SEE.

One concern about targeted tax allocations is the accountants that do the partnership's tax return are not given a clear step-by-step direction on how to allocate tax items. Each year, the accountants must go through the task of making sure they do the tax allocations correctly so the capital accounts wind up at the targeted level. If the accountants make an error, the IRS can adjust the tax allocations to get them right.

By contrast, if capital accounts governed how liquidating distributions are made, the IRS may accept those tax allocations without question, but the capital accounts may be at a level that does not match the economic deal of the partners and distort liquidating distributions. For many investors, the risk of an IRS audit and a possible tax adjustment is of less concern than the risk of getting cash coming out of the partnership in the wrong manner if capital accounts determine how cash is to be distributed.

Targeted capital accounts are not perfect for every deal. For example, it is still possible to specially allocate taxable losses among the partners (as discussed earlier), but then the partnership agreement must generally provide that liquidating distributions are made in accordance with capital accounts to ensure that the loss allocation has SEE. Also, if a partner leaves the partnership before year end, there is a need to close the books of the partnership and apply targeted allocations at that time. Last, targeted tax allocations may need to be supplemented to address what happens when property is contributed to a partnership and the FMV of the property on the date of contribution does not equal its tax basis. In that case, IRC § 704(c) and the Regulations thereunder add another set of special allocation rules that must be addressed.

Conclusion

Tax allocation provisions can get very complex. Although targeted tax allocations may not be the perfect fit for all situations, they can be a good practical choice to both reflect the tax requirements and the business deal of the partners. The bottom line is that a tax advisor may need to be consulted, but when a meeting with that adviser takes place, the real estate lawyer can now have a better understanding of what the tax advisor is saying and make sure tax does not distort the client's business deal.■