PUBLICATION

Target Tax Allocations for Partnerships and Limited Liability Companies

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Introduction

For decades, tax practitioners viewed the area of partnership taxation, which generally applies to both partnerships and limited liability companies, as fertile ground for aggressive tax planning. At the heart of the strategies was a focus on a company's after-tax results rather than its pre-tax performance. This tax-motivated approach encouraged a generation of investors to enter into transactions simply to harvest tax losses with little or no regard to operating profits. The Treasury took issue with this development and intervened with its promulgation of final regulations under Section 704(b) of the Internal Revenue Code (the "Code"). The principle underlying the 704(b) Regulations is simple: tax consequences should mirror the economic realities of a business arrangement. Although easy to recite, even 24 years after their enactment, the 704(b) Regulations remain some of the most scarcely understood provisions under the Code. In response, practitioners now frequently utilize "target allocations" to avoid many of the associated regulatory burdens.

Section 704(b) Regulations

The complex text of the 704(b) Regulations spans over 100 pages, but at their core is a basic carrot and stick approach. Those who comply with a series of safe harbor provisions are given comfort that the IRS will respect the entity's tax allocations, while those who stray from the path are left to fret over an audit and a potential tax reallocation. The regulatory safe harbor employs a straightforward, three-step approach for respecting tax allocations.

First, the entity must record the value of property or services contributed by each partner in separate "capital accounts." Second, each partner's share of the entity's operating results must be reflected in their individual capital accounts. Specifically, as the entity earns income or recognizes gain, the partners' respective capital account balances increase, and when the company takes deductions or recognizes losses, the partners' capital accounts decrease. Third, the 704(b) Regulations require that when the company terminates operations and liquidates, property must be distributed according to the balances in each of the partner's respective capital accounts. As illustrated by the following example, this final step provides the crucial link between the tax consequences and the economic deal.

Example 1: AB, LLC was capitalized with cash contributions of $90 from A, and $10 from B. In AB's first year, it earned net income of $50, which, under the LLC operating agreement, was allocated 90% to A and 10% to B, so that A received $45 and B received $5. Consequently, at the end of the first year, A and B's capital balances were $135 ($90 + $45) and $15 ($10 + $5), respectively. At the end of year one, A and B decide to liquidate AB. In compliance with the 704(b) Regulations, the assets are distributed by reference to each partner's capital account balance. Thus, A receives $135 and B receives $15.

Because A was burdened with a tax obligation on the $45 of income it was allocated in year one, the Regulations demand a corresponding benefit be extended. This benefit is conferred by the increase of A's capital account, by requiring an additional $45 be distributed to A upon liquidation. This simple example is quickly complicated, however, when operating distributions are made in a non-pro rata manner.

Example 2: Assume in Example 1 that A and B agree to split distributions 90/10, but only after A receives a 10% annual preferred return based on contributed capital. Because A now benefits from a priority distribution of $9 in the first year ($90 * 10%), the 704(b) Regulations require that A also be burdened by a priority income allocation. To appropriately assign this burden, tax practitioners create allocation "layers" where income is first allocated to A to the extent of the preferred return ($9), then to A and B, 90/10.

Layer Cake Approach

This approach commonly referred to as the "layer cake approach," can quickly result in more than a dozen complex allocation layers which frequently span multiple pages. Even worse, the layer cake approach is riddled with potential pitfalls. Drafting mistakes can occur even among seasoned tax attorneys, and non-pro rata allocations (such as preferred returns) have the potential to impact the business deal.

Example 3: Assume in Example 2 the company broke even in year one such that no income or loss was allocated, A is left with a $90 capital account balance and B with $10. If A and B liquidate at the end of the first year, the 704(b) Regulations require liquidation in accordance with capital account balances giving A $90 and B $10. This result clearly ignores the $9 preferred return A was entitled to receive in year one, thereby impacting the actual economics of A and B's deal.

Such distortions can be further complicated by increasingly complex distribution schemes, such as a private equity "waterfalls" and the treatment of tax losses. In certain circumstances, to avoid such errors and complexities, practitioners have increasingly begun to advise clients to stray from the 704(b) safe harbor, opting instead for the clarity associated with "target allocations."

Target Allocations

Agreements that utilize target allocation provisions generally deviate from the traditional layer cake structure in two respects: (1) liquidating distributions are made in the same manner as current distributions (rather than according to capital account balances), and (2) tax items are allocated to reflect the manner in which cash is distributed upon liquidation (rather than pursuant to the various layers).

Example 4: Assume in Example 3 the governing agreement incorporates target allocation provisions as described above. Because liquidating distributions mirror current distributions, upon liquidation at the end of year one, the initial $9 is distributed to A to reflect the accrued but unpaid preferred return. To resolve the issue of the company's lack of taxable income, the target allocation provision may give the management the authority to "force" an allocation to reflect the priority distribution either with a guaranteed payment or an allocation of gross income. Should a guaranteed payment be utilized, $9 of income would be allocated to A with a corresponding deduction allocated to B. This deduction would appropriately reflect B's right to only $1 at liquidation ($10 - $9).

In addition to curing the distortion related to non-pro rata distributions, target allocations are generally touted as more comprehensible to business owners than layer cake allocations. Target allocations accomplish this simplicity by allowing the cash to drive the tax allocations. To accomplish the cash-driven objective, management, or more likely the company's accountant, will perform a "hypothetical liquidation" at the close of each accounting period. Under this approach, it will be assumed that all company assets are sold for their book value, and that all of the hypothetical proceeds are immediately distributed according to the scheme used to make current, operating distributions. Using the hypothetical liquidation results as the "target," the agreement then permits the accountant to "back into" the appropriate tax allocations for the period. As a result, the need for the complex allocation layers is eliminated, and many of the associated drafting and interpretive challenges are thereby removed.

Conclusion

Although target allocations are not yet formally blessed by the IRS, recent industry articles suggest that guidance is forthcoming. Furthermore, practitioners are confident that such provisions will be respected as they achieve the ultimate goal of the 704(b) Regulations: linking the tax results with the partners' business arrangement. Consequently, not only should the result under the target approach nearly always mirror that of the regulatory safe harbor, but it should do so without putting at risk the partners' negotiated deal. When coupled with the elimination of many of the potential drafting pitfalls, target allocations may prove to be a more user-friendly and reliable set of allocation provisions for owners of limited liability companies and partnerships even with some risk of IRS challenge.