Substantial Economic Effect / Partner’s Interest in the Partnership

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Allocation Provision 1 – Not So Great

At the end of each Fiscal Year, the Company shall allocate all of its taxable income or loss for such Fiscal Year in a manner such that, after such allocations have been made, the balance of each Member’s Capital Account shall, to the extent possible, be equal to an amount that would be distributed to such Member if the Company were to sell all of its assets and distribute the proceeds of such sale in accordance with [THE DISTRIBUTION PROVISION] of this Agreement.

Allocation Provision 2 – Not So Great But Better Than Allocation Provision 1

At the end of each Fiscal Year, the Company shall allocate all of its Net Profit and Net Loss for such Fiscal Year in a manner such that, after such allocations have been made, the balance of each Member’s Capital Account shall, to the extent possible, be equal to an amount that would be distributed to such Member if the Company were to sell all of its assets and distribute the proceeds of such sale in accordance with [THE DISTRIBUTION PROVISION] of this Agreement.

Definition:
“Net Profit and Net Loss” is defined as “book” income or loss as determined under Treas. Reg. 1.704-1(b)(2)(iv).

Allocation Provision 3 - Better

At the end of each Fiscal Year, the Company shall allocate all of its Net Profit and Net Loss for such Fiscal Year in a manner such that, after such allocations have been made, the balance of each Member’s Capital Account shall, to the extent possible, be equal to an amount that would be distributed to such Member if (a) the Company were to sell the assets of the Company for their Gross Asset Values, (b) all Company liabilities were satisfied (limited with respect to each nonrecourse liability to the Gross Asset Values of the assets securing such liability), (c) the Company were to distribute the proceeds of sale pursuant to [THE DISTRIBUTION PROVISION]
Allocation Provision 3 – Better (cont’d.)

And (d) the Company were to dissolve pursuant to [THE LIQUIDATION PROVISION], minus such Member’s share of Company Minimum Gain or Member Minimum Gain, computed immediately prior to the hypothetical sale of assets.

Definitions:
“Gross Asset Value,” “Company Minimum Gain” and “Member Minimum Gain” follow the Treasury Regulations definitions.

Allocation Provision 4 – Better Than the Rest, But Not For Everyone

Except as otherwise provided in [THE REGULATORY ALLOCATIONS PROVISION], and after adjusting for all Capital Contributions and Distributions made during such Fiscal Year, Net Income and Net Loss (and, if necessary, individual items of gross income or loss) shall be allocated annually (and at such other times as the Management Committee determines), the Company shall allocate all of its Net Profit and Net Loss for such Fiscal Year in a manner such that, after such allocations have been made, the balance of each Member’s Capital Account shall, to the extent possible, be equal to an amount that would be distributed to such Member if (a) the Company were to sell the assets of the Company for their Gross Asset Values, (b)

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Target Allocations: The Swiss Army Knife of Drafting (Good for Most Situations—but Don’t Bet Your Life on It)

By Todd D. Golub

Todd D. Golub discusses how a carefully drafted target allocation provision can ensure partners will ultimately receive the correct distributions.

Partnerships and LLCs have become the entity of choice for many investments due in large part to the tax-efficiency of Subchapter K. Investors are also becoming much more savvy when it comes to equity structures. Complex capital structures in partnerships and LLCs beget complex distribution provisions.

In response to these complex distribution provisions, more and more tax practitioners are abandoning the use of “layer cake” or “waterfall” allocations in their agreements and are relying on “target” or “forced” allocation provisions instead. Many practitioners believe this is a practical, user-friendly method for dealing with allocations in complex deals. Other practitioners question the use of target allocations since they typically don’t comply with the Code Sec. 704(b) safe harbor rules and believe that such allocation provisions fail to address some of the tax and economic pitfalls that may arise in the life of the partnership.

A typical “layer cake” or “waterfall” provision will establish an ordering (or layers) for allocating the partnership’s profits and losses. Generally, profits are allocated first to eliminate negative “adjusted” capital accounts, then to offset prior year’s losses that eliminated the partners’ contributed capital and undistributed profits that were reflected in their capital accounts at the time such losses were allocated, and finally to reflect the manner in which the profits would be distributed if the partnership had cash available to distribute. Losses are generally allocated in the reverse order of profits. This style of drafting is designed to have the capital accounts reflect the economic deal of the partners. Partnership agreements that use layer cake allocations will generally provide that liquidating distributions will be made in accordance with positive capital account balances. While not always the case, partnerships that use layer cake allocations liquidate in accordance with positive capital account balances to comply with the “substantial economic effect” (SEE) safe harbor contained in Reg. §1.704-1(b)(2)(ii). As a result, the partners’ rights to liquidation proceeds are explicitly tied to their capital accounts.

A typical target allocation provision will cause the partnership to undertake two steps. In the first step, the partnership will calculate the amount of money it would realize if it were to sell all of its assets for their book value in a hypothetical sale and distribute the sales proceeds to the partners in liquidation of their partnership interests in accordance with the distribution priorities established in the partnership agreement. In the second step, the partnership allocates its profit or loss to the partners in a manner that will cause the partners’ capital accounts to reflect (as closely as possible) the amounts that would be distributed to them in the hypothetical liquidation transaction. Partnership agreements that use target allocations usually do not liquidate...
in accordance with positive capital account balances. Therefore, the partners’ economic rights are tied to the distribution provisions contained in the partnership agreement.

Noncompliance with the SEE safe harbor causes much of the controversy surrounding target allocations for many tax practitioners. In spite of the fact that target allocations won’t satisfy the SEE safe harbor, they are very much in vogue, and it is becoming very common for many tax practitioners to use target allocations in their partnership agreements. The main reason that so many people use them is that, rather than relying on capital accounts to control the liquidation distributions, target allocations assure the drafter that in the event that the complex rules contained in the Treasury Regulations under Code Sec. 704(b) cause the capital account balances to be out of synch with the planned distribution scheme, the partners will still receive the amount of cash they expect to receive. This would not be the case if liquidation proceeds were distributed pursuant to capital accounts that, due to some error or unexpected event, did not match the partners’ expected distributions. If the allocation provisions are properly drafted and the capital accounts are properly maintained, the ending capital account balances and the amounts distributed upon liquidation of the partnership should match. But mistakes can be made, and some of these mistakes can be quite costly.

People take differing views on the issue of whether it is good drafting to not liquidate in accordance with capital accounts or bad drafting. My personal view, and the one that will be set forth in the remainder of this article, is that in most cases target allocations are a good idea for partnerships that involve complex distribution structures. Moreover, despite the fact that target allocations don’t satisfy SEE, these allocations should be respected under either the “economic effect equivalence” test set forth in Reg. §1.704-1(b)(2)(ii)(i), or else are consistent with the partners’ interest in the partnership (PIP); and as such should be a viable drafting alternative to strict compliance with the SEE safe harbor.

**SEE Safe Harbor**

Under Code Sec. 704, the IRS will respect partners’ allocations of income, gain, expense or loss, provided the allocations have SEE. The determination of whether an allocation to a partner has SEE involves a two-part analysis. First, the allocation must have “economic effect.” Second, the economic effect of the allocation must be “substantial.”

Generally, for an allocation to have economic effect, it must be consistent with the underlying economic arrangement of the partners. This means that in the event an allocation corresponds to an economic benefit or detriment, the partner who is allocated that economic benefit or bears the economic detriment must actually receive that economic benefit or detriment. To determine if an allocation has economic effect, the Treasury Regulations under Code Sec. 704 set forth a primary and an alternative test that are intended to serve as a safe harbor for satisfying the economic effect test. The primary test provides that an allocation to a partner will have economic effect if the partnership agreement incorporates all of the following requirements:

1. The partners’ capital accounts are maintained in accordance with the rules of Reg. §1.704-1(b)(2)(iv).
2. Upon liquidation of the partnership (or any partner’s interest in the partnership), liquidation distributions are required in all cases to be made in accordance with the positive capital account balances of the partners, as determined after taking into account all capital account adjustments for the partnership tax year during which such liquidation occurs (other than those made pursuant to this requirement and requirement 3 below), by the end of such tax year (or, if later, within 90 days after the date of such liquidation).
3. The partner who receives the allocation at issue is unconditionally obligated to restore its deficit capital account balance on liquidation.

Very few partners or members of an LLC will agree unconditionally to restore a negative capital account balance on liquidation of the partnership or LLC. In recognition of this economic reality, the Treasury Regulations under Code Sec. 704(b) provide for an alternative test. The alternative test generally requires that the partnership agreement provide for the same two requirements enumerated above for the primary test. In lieu of the primary test’s requirement that the partner at issue must have an unconditional obligation to restore a deficit capital account balance, the alternate test provides that the partnership agreement provide for a “qualified income offset” provision (QIO). A QIO must require that a partner who unexpectedly receives an adjustment, alloca-
tion of losses or deductions, or distribution that causes that partner to have a deficit capital account balance will be allocated items of income (gross or net) and gain in an amount sufficient to eliminate their deficit capital account balance as quickly as possible. 12 Like many other areas involving SEE, the QIO requirement is a curious one as it is almost never invoked; when it is, it is likely contrary to the partners’ economic arrangement. 13

The economic effect of an allocation is generally considered to be substantial if there is a reasonable possibility that the allocation will substantially affect the dollar amounts the partnership provides to the partners, independent of tax consequences. 14 In other words, the goal of the substantiality requirement is to ensure that tax consequences follow the economic consequences of the partnership arrangement. 15

The issue of whether an allocation is substantial is beyond the scope of this article. However, substantiality is not typically an issue with most situations in which target allocations should be used. In general, target allocations are best suited for partnerships that have complex distribution provisions. Target allocations try to allocate the profits and losses in a manner that will track the distributions. So, the profits and losses should be allocated to the partners that benefit from such profits or suffer the detriment from the losses, and substantiality should typically be satisfied.

**Economic Effect Equivalence**

Partnership agreements that use target allocations generally don’t liquidate in accordance with capital account balances. Therefore, these allocations can’t have economic effect. However, allocations that do not otherwise have economic effect may still be deemed to have economic effect under the so-called economic effect equivalence test. 16 Many proponents of target allocations believe that such allocations should be respected under the economic effect equivalence test.

Under the economic effect equivalence test, allocations will be deemed to have economic effect provided that at the end of each tax 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 that would occur if the three requirements necessary to satisfy the economic effect test “had been satisfied,” regardless of the economic performance of the partnership. 17

Recall that the three requirements of economic effect are (1) that the partnership maintain capital accounts in accordance with the rules of Reg. §1.704-1(b)(2)(iv); 18 (2) that the partnership make liquidating distributions in accordance with the partners’ capital account balances; 19 and (3) that the partnership agreement contain a deficit restoration obligation (DRO). 20

Many partnerships that use target allocations will still maintain capital accounts in accordance with Reg. §1.704-1(b)(2)(iv). Therefore the first prong of the economic effect equivalence test is generally not a problem.

Partnerships using target allocations typically don’t liquidate in accordance with capital accounts. Thus, the second prong of the economic equivalence test will generally not be satisfied.

In addition, many limited partnership agreements and most LLC agreements don’t contain a DRO. So, it must be determined under what circumstances the absence of a DRO and the failure to liquidate in accordance with capital accounts will still produce the same result as would occur if the partnership agreement did satisfy these requirements.

The Regulations provide some guidance, but it is not particularly helpful. In the pertinent example, 21 G and H contribute $75,000 and $25,000, respectively, to form a general partnership. The partnership agreement provides that the partnership will allocate its income and loss 75 percent to G and 25 percent to H, and will make all distributions in the same 75–25 ratio. The partnership agreement does not maintain capital accounts. Following liquidation of the partnership, neither partner is required to restore any deficit balance in its capital account for distribution to partners with positive capital account balances. However, under state law, G and H are ultimately liable (under a state law right of contribution) for 75 percent and 25 percent, respectively, of any debts of partnership. The example notes that the partnership agreement does not satisfy the three requirements of the economic effect safe harbor. Nevertheless, the example concludes that the allocations will be deemed to have economic effect under the economic effect equivalence test. 22

The simplistic nature of the example makes it difficult to apply to partnerships other than general partnerships that have proportionate sharing ratios; although it is not difficult to understand how the example reached its conclusions. In the example all
capital contributions were made pro rata (75–25), and all distributions were pro rata in the same proportionate amounts. Thus, it is easy to see that regardless of whether capital accounts were maintained the economics would be the same. Therefore, maintaining capital accounts on these facts would seem to be unnecessary.

In the example, the G H partnership does not liquidate in accordance with capital account balances. Nevertheless, since all capital contributions, allocations, and distributions were all made pro rata, it is easy to conclude that the failure to liquidate in accordance with capital account balances should not cause the allocations to fail to be deemed to have economic effect. The only way that the ending capital account balances under these facts would not produce the same economic effects as actually occurred in the example would be if the capital accounts were not properly maintained.

So, the example does not provide much guidance with respect to determining under what circumstances the failure to liquidate in accordance with capital account balances will mean that the allocations won’t be deemed to have economic effect under the economic effect equivalence test. Target allocations are designed to cause the capital account balances to match the distribution priorities. If the target allocation causes the capital accounts to reflect the economics, it would be difficult to understand why they would not produce the same economic results that would occur if the partnership maintained capital accounts. Therefore, it seems likely that most target allocation provisions should satisfy this aspect of the economic effect equivalence test.

It is the third test of economic effect equivalence (that the partnership provide for a DRO) that is the most interesting aspect of this example. In the example, there is no explicit DRO. However, the facts of the example indicate that there is a state law obligation to satisfy the debts of the partnership. Accordingly, there is a DRO under Reg. §1.704-1(b)(2)(c)(2).

The example notwithstanding, we live in a world where many tax partnerships are formed as limited liability companies. State limited liability company statutes protect their members from unlimited liability. Usually, there would be no state law obligation to contribute additional capital to restore a deficit capital account balance. Tax practitioners are left to ponder whether a court would overlook the absence of a DRO in applying the economic effect equivalence test in the context of target allocations. Target allocations are designed to get the capital accounts to match the distribution priorities. If the allocations are intended to match the economic agreement between the parties and actually lead to the intended economic results, a reviewing court may be sympathetic and respect allocations under the economic effect equivalence test in the absence of a DRO. But, this conclusion is nothing more than speculation. Others may take a more literal approach to this test and conclude that a DRO is required. Given the widespread use of LLCs, guidance from the IRS on this issue is needed.

**Partners’ Interest in the Partnership**

If a partnership’s allocations don’t satisfy SEE, profit and loss will be allocated to the partners in accordance with PIP (taking into account all facts and circumstances). Target allocations don’t satisfy SEE. Many tax practitioners believe that target allocations do, however, satisfy PIP. According to the Treasury Regulations, PIP is designed to allocate the partnership’s items of income, gain, loss, deduction or credit to the partners in the same manner in which partners have agreed to share the economic benefit or burden of such items. Under the PIP test, the determination of the partners’ interests in the tax items of the partnership is generally made on an item-by-item basis. Thus, according to the Treasury Regulations under Code Sec. 704, a partner with a 50-percent overall interest in the partnership may have a 90-percent interest in a particular item of income or deduction.

Determining PIP is made by taking into account all of the facts and circumstances relating to the economic agreement of the partners. The Treasury Regulations under Code Sec. 704 provide that the following four factors are relevant in determining PIP:

1. The partners’ relative capital contributions to the partnership
2. The partners’ interests in the economic profits and losses of the partnership (if they are different from their interests in taxable income and loss)
3. The partners’ interests in the partnership’s cash flow and other nonliquidating distributions
4. The partners’ rights to distributions upon liquidation of the partnership.
The legislative history to Code Sec. 704(b) provides similar, but not identical, guidance by providing that PIP is determined based upon three of the four factors enumerated above. The legislative history does not mention the partner’s capital contribution as a determinative factor. This position in the legislative history is also consistent with the recent change to Reg. §1.704-1(b)(3)(i). Prior to the change, this Treasury Regulation provided that all of the partners’ interests in the partnership were presumed to be equal on a per capita basis. This was a rebuttable presumption. However, the per capita presumption was removed because the Treasury and IRS felt that it failed to consider factors relevant to a determination of the manner in which the partners agreed to share the economic benefits or burdens corresponding to the allocation of partnership items, and thus rarely reached the correct results.

All four factors closely resemble the capital account maintenance rules: Capital accounts are (1) credited with capital contributions; (2) increased or decreased by allocations of partnership profits and losses; and (3) reduced by distributions (both current and liquidating). People that believe that target allocations satisfy PIP generally support their position by looking to a special rule in the Treasury Regulations under PIP that is commonly referred to as the “comparative liquidation test,” which applies when a partnership maintains capital accounts and provides for distributions on liquidation to be made in accordance with the positive balances in the partners’ capital accounts, but the partnership agreement has neither a DRO nor a QIO. Under the comparative liquidation test, the partnership will allocate its income or loss based upon the way the partnership will distribute the proceeds from a hypothetical sale of its assets for their book value. Specifically, Reg. §1.704-1(b)(3)(iii) provides:

If—

(a) Requirements (1) and (2) of paragraph (b)(2)(i)(b) of this section are satisfied, and
(b) All or a portion of an allocation of income, gain, loss, or deduction made to a partner for a partnership tax year does not have economic effect under paragraph (b)(2)(ii) of this section,

the partners’ interests in the partnership with respect to the portion of the allocation that lacks economic effect will be determined by comparing the manner in which distributions (and contributions) would be made if all partnership property were sold at book value and the partnership were liquidated immediately following the end of the tax year to which the allocation relates with the manner in which distributions (and contributions) would be made if all partnership property were sold at book value and the partnership were liquidated immediately following the end of the prior tax year, and adjusting the result for the items described in (4), (5), and (6) of paragraph (b)(2)(ii)(d) of this section. A determination made under this paragraph (b)(3)(iii) will have no force if the economic effect of valid allocations made in the same manner is insubstantial under paragraph (b)(2)(iii) of this section.

Strictly speaking, target allocations don’t fall under the comparative liquidation test as the partnership agreement will not liquidate in accordance with capital accounts. Nevertheless, the two-step formula of target allocations has its roots in this test. Both calculate the amount of money the partnership would receive if it were to sell all of its assets for their book value and were to then distribute the sales proceeds to the partners in liquidation of their partnership interests in accordance with the distribution priorities established in the partnership agreement. Both then seek to determine how the partnership must allocate its profit or loss to the partners in a manner that will result in the partners’ capital accounts to match (as closely as possible) the amounts that would be distributed to them in the hypothetical liquidation transaction. While not squarely on point, this hypothetical liquidation approach under PIP is the foundation that many tax practitioners rely on for the position that target allocations satisfy PIP. This position has merit as both attempt to force the allocations to match the economic agreement of the partners. However, in the absence of direct authority, this position is still susceptible to challenge. Therefore, guidance from the IRS on this point would be most welcome.

What Is the Target?

While it may seem intuitively obvious what the “target” ought to be when drafting target allocations, in practice some agreements miss the mark. It is simple to think that target allocation provisions cause the allocations to follow the cash. However,
in many complex arrangements, the actual drafting must account for a number of crucial variables (such as nonrecourse debt that encumbers the partnership's assets, minimum gain chargebacks, partner nonrecourse debt minimum gain chargebacks and nonrecourse deductions). The same variables that must be accounted for in a well-drafted target allocation provision are the same variables that must be accounted for in a well-drafted layer cake allocation provision. A poorly drafted layer cake allocation provision has the same shortcomings of a poorly drafted target allocation. Similarly, a well drafted target allocation is just as capable of handling all the allocation nuances as a well-drafted layer cake.

Partnerships with complex distribution provisions can benefit from target allocations because it assures that the economics are properly reflected in the allocations. A layer cake allocation should give the same results. However, the bigger concern is that there may actually be more room for error in a layer cake allocation. In drafting both styles of allocation provisions, the drafter must be cognizant of the various nuances of the allocation provisions set forth in the Treasury Regulations under Code Sec. 704(b) and 704(c). These nuances must be anticipated, planned for and explained to the partners of the partnership (and their other advisors) to avoid any unwelcome surprises—both tax and economic. However, with the layer cake allocation, the drafter also must make sure that he or she has properly reflected the economic allocation in both the distribution provision and the allocation provision. Herein lies the most dangerous potential foot fault for the drafter. If the economic deal is not properly captured in the allocation provision, it won't matter if the distribution provision is perfect. In the end, the capital accounts won't reflect the economics and if the liquidation distribution is governed by the capital accounts, there is a problem that can't be fixed.

The starting point for allocations in both the target and the layer cake allocation is to properly define the income and loss that will be allocated. Again, a seemingly simple concept, but in practice, one that is not always properly executed. The first hurdle to overcome is to avoid the use of taxable income and loss. The allocation provision typically allocates so-called “book” income or loss as measured under Code Sec. 704(b) and Reg. §1.704-1(b)(2)(iv). Taxable income and loss are generally allocated under Code Sec. 704(c) and the Treasury Regulations promulgated under that provision. While the two may be the same, this is not always the case.

The distinction is that the book income concept of Code Sec. 704(b) and Reg. §1.704-1(b)(2)(iv) is designed to track the equity ownership of the partners using financial accounting concepts, and Code Sec. 704(c) is designed to track the taxable income and loss. In other words, the economics are dealt with in Code Sec. 704(b), and tax is dealt with in Code Sec. 704(c). Consider the following simple example to demonstrate the difference: X and Y form the XY partnership. X contributes $100 of cash for a 50-percent interest, and Y contributes blackacre with a fair market value of $100 and an adjusted tax basis of zero for a 50-percent interest. Economically, both have contributed $100 of property and have $100 of equity in the deal. However, if XY were to sell blackacre, XY has taxable gain of $100 and no book gain. Since Y contributed blackacre, it is not only fair to allocate all of the taxable gain to her, Code Sec. 704(c) requires it.

Accordingly, if the XY partnership agreement only provided that allocations of taxable income be made, the XY partnership would not properly reflect the economic or tax deal that X and Y made. Presumably X and Y intended to share all of the profit and loss on a 50–50 basis. In this case, there is no economic profit as the partnership’s value never went up or down. On the other hand, there is $100 of taxable income to allocate. So, if the allocation provision provides (improperly) that the taxable income must be allocated 50–50, the allocation provision will cause a disparity of tax and economics.

On the other hand, if the XY partnership allocated book income and loss, no income or loss would be allocated to X, and the economics are properly captured.

Therefore, a well-drafted allocation provision allocates the partnership’s book income and loss and has a separate provision that allocates taxable income and loss under Code Sec. 704(c). This basic drafting point is a requisite of both target allocations and layer cake allocations.

A second issue with drafting proper target allocations is how to address nonrecourse debt that encumbers the partnership’s assets. The target allocation is based upon a hypothetical sale of the partnership’s assets. If a partnership has assets that are encumbered by nonrecourse debt, a sale of the property for no consideration other than
satisfaction of the debt would result in the partnership having an amount realized equal to the full amount of the debt under Crane,\textsuperscript{17} Tufts\textsuperscript{18} and Reg. §1.11001-2. If the target uses the full amount of the nonrecourse debt as the amount realized and the property has been depreciated, this will overstate the profit that must be recognized for tax purposes, and the target amount may be overstated. Most target allocation provisions deal with this issue by limiting the amount realized in the hypothetical sale to the book value of the asset under Reg. §1.704-1(b)(2)(iv) in the hypothetical sale. This adjustment, or another method of backing out the actual gain that would be required to be recognized in a true sale, should be made to get to the proper target amount.

A third issue with drafting target allocations is how to deal with nonrecourse deductions.\textsuperscript{39} Losses funded by nonrecourse debt and the corresponding minimum gain chargeback can play havoc with target allocations if they aren’t properly dealt with.

Nonrecourse deductions do not have economic effect because only the creditor bears the economic risk of loss that corresponds to such deductions.\textsuperscript{40} In addition, nonrecourse deductions are not generally part of the target allocation. Such deductions produce tax losses, but they are not typically a part of the economics of the distribution provisions. These losses will inevitably be charged back under the minimum gain chargeback rules that are discussed below. This income will not typically result in distributable cash. So, unless such losses and the corresponding minimum gain chargeback are carved out of the target, the target amount will likely be misstated. Therefore, it is best to have a separate provision that allocates the nonrecourse deductions.

There is some uncertainty with regard to whether allocations of nonrecourse deductions will be respected when the partnership has a target allocation provision. Reg. §1.704-2(e) sets forth the following safe harbor test, which if complied with, will result in such deductions being deemed to be in accordance with PIP:

Allocations of nonrecourse deductions are deemed to be in accordance with the partners’ interests in the partnership only if—

(1) Throughout the full term of the partnership requirements (1) and (2) of §1.704-1(b)(2)(ii)(b)

are satisfied (i.e., capital accounts are maintained in accordance with §1.704-1(b)(2)(iv) and liquidating distributions are required to be made in accordance with positive capital account balances), and requirement (3) of either §1.704-1(b)(2)(ii)(b) or §1.704-1(b)(2)(ii)(d) is satisfied (i.e., partners with deficit capital accounts have an unconditional deficit restoration obligation or agree to a qualified income offset);

(2) Beginning in the first tax year of the partnership in which there are nonrecourse deductions and thereafter throughout the full term of the partnership, the partnership agreement provides for allocations of nonrecourse deductions in a manner that is reasonably consistent with allocations that have substantial economic effect of some other significant partnership item attributable to the property securing the nonrecourse liabilities;

(3) Beginning in the first tax year of the partnership that it has nonrecourse deductions or makes a distribution of proceeds of a nonrecourse liability that are allocable to an increase in partnership minimum gain, and thereafter throughout the full term of the partnership, the partnership agreement contains a provision that complies with the minimum gain chargeback requirement of paragraph (f) of this section; and

(4) All other material allocations and capital account adjustments under the partnership agreement are recognized under §1.704-1(b) without regard to whether allocations of adjusted tax basis and amount realized under section 613A(c)(7)(D) are recognized under §1.704-1(b)(4)(v)).

One of the requirements of this safe harbor is that the partnership must satisfy the economic effect safe harbor set forth in Reg. §1.704-1(b)(2). In other words, the partnership agreement must maintain capital accounts in accordance with Reg. §1.704-1(b)(2)(iv), the partnership must make liquidating distributions in accordance with positive capital account balances, and the partnership agreement must contain either a DRO or a QIO. Since partnership agreements using target allocations are not going to liquidate in accordance with capital account balances, the safe harbor will not be satisfied.
If target allocations satisfy the economic effect equivalence test, strict compliance with this aspect of the safe harbor really shouldn’t be necessary as the allocations would be deemed to have economic effect.\(^{41}\)

If, however, target allocations are tested under PIP, the safe harbor is not going to be satisfied, and it is possible that the allocation of nonrecourse deductions may not be respected. If the partners want assurance that the allocation of nonrecourse deductions will be respected, the partnership should rely on the safe harbor and not use target allocations.

A corollary issue to the allocation of nonrecourse deductions is how the target allocation deals with minimum gain chargebacks. To account for the fact that the partner does not bear the risk of loss associated with nonrecourse deductions, the Treasury Regulations incorporate a chargeback of such deductions when the debt is paid down.\(^{42}\) This chargeback is known generally as a minimum gain chargeback. Minimum gain is created whenever the tax basis of the asset encumbered by the nonrecourse liability is reduced due to depreciation or amortization deductions without a corresponding reduction in the principal amount of the nonrecourse liability.\(^{43}\) Minimum gain is created when the tax basis of the asset encumbered by the nonrecourse liability is reduced (due to depreciation or amortization deductions) without a corresponding reduction in the principal amount of the nonrecourse liability.\(^{44}\)

Similarly, minimum gain is decreased when the principal amount of the debt is reduced.\(^{45}\) When minimum gain is reduced, the Treasury Regulations require that the partnership must “chargeback” an amount of income or gain equal to that reduction, and that such income must be allocated to the partners who received the benefit of the nonrecourse deductions.\(^{46}\)

The minimum gain chargeback rules take into account the fact that tax depreciation deductions funded with nonrecourse debt are deductions for which the partner does not bear any economic risk of loss; accordingly, these partners must be specially allocated the corresponding gain that is recognized when the property is either sold or the principal amount of debt is reduced.

It is also important to note that partnership property that is encumbered with nonrecourse debt can be factored into a partner’s capital account balance. For example, assume C and D form the CD partnership with each contributing $100 for a 50-percent interest. Assume further that the CD partnership incurs $800 of nonrecourse debt and purchases a depreciable asset for $1,000. At this point C’s and D’s capital accounts are both equal to $100. Assume further that CD’s asset will generate $100 of depreciation each year and no operating income. At the end of year 2, C’s and D’s capital accounts will be zero (reflecting the cumulative $200 of depreciation incurred in the first two years). In year 3, C and D will each be allocated an additional $50 of depreciation driving their capital accounts down to –$50. The negative capital account balance is supported by the minimum gain chargeback requirements because if the property were sold for the $800 of debt relief, each of C and D would have to recognize $50 of gain.\(^{47}\) For each subsequent year that the CD’s only item of income or loss is $100 of depreciation, C’s and D’s capital accounts will continue to go more negative. Once the asset is sold, the minimum gain will be recognized, and C’s and D’s negative capital accounts will be eliminated.

The impact of minimum gain chargebacks and nonrecourse deductions is generally unrelated to the distribution priorities. Accordingly, a target allocation provision must take the amount of minimum gain that will be allocated to the partners into account in formulating the correct target amount. One common and sensible way to do so is to subtract the amount of minimum gain from the target amount because the minimum gain represents income that will be recognized in the future, and if it is in the target amount, the target will likely be overstated and will not reflect the economic deal. For example, assume partnership CD’s depreciable asset in the example above has been fully depreciated. The assets fair market value has also decreased to $800 and is still subject to the nonrecourse liability of $800. CD also has cash of $100. C and D are the only partners and they each have a 50 percent interest in the partnership. If CD sells the asset, it will recognize $800 of minimum gain that will be allocated 50–50 to C and D. This gain will not produce any distributable cash as it will all be used to pay off the loan. C and D will only expect to receive $50 apiece. If CD uses a target allocation and calculates the target as the gain that would be realized from a hypothetical sale of the assets and the target is not reduced by
minimum gain, C’s and D’s target capital accounts would be $450 (50 percent of the $100 + $400 of minimum gain). But both C and D have negative capital accounts of $350 because of the $800 of depreciation that was funded with the nonrecourse debt ($50 of cash – $400 of depreciation). So, failure to net out the latent minimum gain would overstate C’s and D’s target capital accounts.

A fourth and related issue for target allocation is the need to address the allocation of “partner nonrecourse deductions.” Similar to nonrecourse deductions and minimum gain chargebacks, a good target allocation provision should specially allocate the partner nonrecourse deductions and the associated “partner nonrecourse debt minimum gain” in accordance with the rules set forth in Reg. §1.704-2(i). The target should also subtract out any partner nonrecourse debt minimum gain in the same manner as minimum gain is netted out.

Do Target Allocations Require Allocations of Gross Items?

In many cases, target allocations will provide that allocations of gross items of income and loss can be made if such allocations are necessary to cause the capital account balances to match the target. Allocating gross items is not universally accepted by tax practitioners. Many feel allocations of gross items are necessary when there are insufficient net items to get the target amount to match the amounts that the partners will receive in a liquidating distribution. However, other practitioners feel that it is sufficient to limit allocations to net items even if the allocation of such items won’t allow the capital accounts to match the target amounts in the year at issue. These practitioners believe that future adjustments to the capital accounts should produce the correct economic results and that it is therefore not necessary to allocate gross items.

The need to use gross items and the tax implications thereof are most apparent whenever one partner has a distribution preference over another that is supposed to be satisfied out of partnership profits rather than the partners’ capital, but there is insufficient net income to allocate to the preference partner and the nonpreference partner has a positive capital account. In such a case, an allocation of gross income to the preference partner may cause its capital account to more closely match the target amount, especially if the other partner gets an offsetting allocation of gross loss to reduce its capital account to the correct target amount.

Consider the following example: A and B each contribute $100 to the AB LLC for 50 percent of the AB LLC common units. A also contributes $1,000 for a preferred unit in the AB LLC. As preferred unit entitles her to a 10-percent return on her $1,000 invested capital and her $1,000 invested capital before B receives any distributions; thereafter, A and B will split the profits 50–50. The AB LLC agreement provides that net book income will first be allocated to A to the extent of her 10-percent preferred return, and thereafter 50 percent to A and 50 percent to B. AB LLC uses a target allocation provision that will cause the members’ capital accounts to match the amount they will receive in a liquidation based upon a hypothetical sale of the LLC’s assets at the end of the year. AB LLC does not liquidate in accordance with capital account balances.

AB LLC has $100 of gross income and $100 of gross loss in year 1. Accordingly, AB has no net income or net loss in year 1. At the end of year 1, a hypothetical sale of AB’s assets for their book value would produce a total of $1,200 calculated by:

- Adding the sum of:
  - A’s contributed capital of $1,100 plus
  - B’s contributed capital of $100 plus
  - Gross income of $100; and
- Subtracting gross loss of $100.

If AB were to liquidate at the end of year 1, A would expect to receive $1,100 with respect to her preferred unit ($1,000 of capital that she contributed in exchange for her preferred unit, plus $100 from the 10-percent preferred return). A and B would then receive 50 percent of the remaining $100. Therefore, A would receive $1,150 and B would receive $50.

A needs to be allocated $100 of income to get her capital account to match her target distribution amount with respect to her preferred unit. If AB only allocates net items, A won’t be allocated any income or loss, and her capital account will equal $1,100 (the amount of her contributed capital). B’s capital account will equal $100. A’s capital account will be $50 less than the amount she should receive upon liquidation of AB, and B’s capital account will be overstatement by $50.

If AB allocates gross items, A will be allocated all $100 of gross income and A and B will each be allocated $25 of gross loss. In this case, A’s capital account will equal $1,150 ($1,100 of contributed capital + 100 of gross income – $50 of gross loss), and
B’s capital account will equal $50. Allocating gross items produces the correct economic results.

As the above example shows, allocations of gross items can produce the correct economic results. But, does that mean that target allocations have to allocate gross items to be respected under PIP or the economic effect equivalence test?

The economic effect equivalence test in Reg. §1.704-1(b)(2)(ii)(i) provides:

Allocations made to a partner that do not otherwise have economic effect under this paragraph (b)(2)(ii) shall nevertheless be deemed to have economic effect, provided that as of the end of each partnership tax 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 would occur if requirements (1), (2), and (3) of paragraph (b)(2)(ii)(b) of this section had been satisfied, regardless of the economic performance of the partnership.

Allocations under the economic effect equivalence test are going to be deemed to have economic effect only if such allocations will produce the same economic results that would occur in a liquidation of the partnership. If allocations of net items won’t cause the partners’ capital accounts to match the economic results that would occur in a liquidating distribution and allocations of gross items will, then it seems that allocations of gross items should be made to comply with this test.

A similar argument can be made for requiring allocations of gross items under PIP. As described above, PIP incorporates the comparative liquidation test in certain cases. Under Reg. §1.704-1(b)(3)(iii) this test provides:

If–

(a) Requirements (1) and (2) of paragraph (b)(2)(ii)(b) of this section are satisfied, and

(b) All or a portion of an allocation of income, gain, loss, or deduction made to a partner for a partnership tax year does not have economic effect under paragraph (b)(2)(ii) of this section,

the partners’ interests in the partnership with respect to the portion of the allocation that lacks economic effect will be determined by comparing the manner in which distributions (and contributions) would be made if all partnership property were sold at book value and the partnership were liquidated immediately following the end of the tax year to which the allocation relates with the manner in which distributions (and contributions) would be made if all partnership property were sold at book value and the partnership were liquidated immediately following the end of the prior tax year, and adjusting the result for the items described in (4), (5), and (6) of paragraph (b)(2)(iii) of this section. A determination made under this paragraph (b)(3)(iii) will have no force if the economic effect of valid allocations made in the same manner is insubstantial under paragraph (b)(2)(iii) of this section.

While target allocations typically don’t fall under this test, target allocations start by calculating the amount of money the partnership would receive if it were to sell all of its assets for their book value and were to then distribute the sales proceeds to the partners in liquidation of their partnership interests. Target allocations then seek to determine how the partnership must allocate its profit or loss to the partners in a manner that will result in the partners’ capital accounts to match (as closely as possible) the amounts that would be distributed to them in the hypothetical liquidation transaction. As the above example shows, sometimes it may be necessary to allocate gross items to get the capital accounts to match the amount that would be received in a hypothetical liquidation. Therefore, allocations of gross items may be necessary to satisfy PIP.

On the other hand, the Treasury Regulations don’t mandate allocations of gross items. In the absence of an express requirement for an allocation of gross items, the partners may be willing to wait and see if the partnership will actually recognize sufficient net items of income and loss to achieve their economic deal. Otherwise, the allocation of gross items may force the partners to recognize income or loss in a year in which there was no net income realized. In other words, requiring the partners to recognize gross items may be contrary to their intended economic arrangement.

There are no authorities that directly address whether a partnership has to allocate gross items of income or loss, and practitioners differ on their view of this issue. Until this issue is affirmatively addressed, practitioners need to consider the possibility that
Sample Target Allocation Provision

Taking all of the above principles into account, a good (but not perfect) sample target allocation provision looks like this:

Except as otherwise provided in [THE REGULATORY ALLOCATIONS PROVISION], and after adjusting for all capital contributions and distributions made during such tax year, Net Income and Net Loss (and, if necessary, individual items of gross income or loss) shall be allocated annually (and at such other times in which it is necessary to allocate Net Income or Net Loss), the Partnership shall allocate all of its Net Profit and Net Loss for such tax year in a manner such that, after such allocations have been made, the balance of each Partner’s Capital Account shall, to the extent possible, be equal to an amount that would be distributed to such Partner if (a) the Partnership were to sell the assets of the Partnership for their Book Values, (b) all Partnership liabilities were satisfied (limited with respect to each nonrecourse liability to the Book Values of the assets securing such liability), (c) the Partnership were to distribute the proceeds of sale pursuant to [THE DISTRIBUTION PROVISION] and (d) the Partnership were to dissolve pursuant to [THE LIQUIDATION PROVISION], minus the sum of (1) such Partner’s share of Minimum Gain or Partner Minimum Gain, and (2) the amount, if any, that such Partner is obligated (or deemed obligated) to contribute, in its capacity as a Partner, to the Partnership; computed immediately prior to the hypothetical sale of assets.\(^{51}\)

Before using this sample provision (or any other for that matter), consider the following:

- This provision takes great care to make the allocations (after accounting for the so-called regulatory allocations) based upon the distribution provision. This will allow the economics to force the capital account balances to match the distributions. However, if the partnership has different distribution provisions for different events (e.g., operating cash flow may be distributed differently than capital event proceeds) this provision does not provide a workable mechanism to deal with this situation. So, if the partners expect a portion of their preferred return to be derived from capital gain or from ordinary income, the drafter will need to take the character and timing of the income or loss into account in drafting this provision.
- This provision carves out so-called Regulatory Allocations and specially allocates those items. These regulatory allocations should include the minimum gain chargeback, the partners nonrecourse debt minimum gain chargeback, a QIO, nonrecourse deductions and partner nonrecourse deductions.
- This provision allows for allocations of gross items if necessary. However, this provision does not indicate how such items will be allocated. This is a potential shortcoming of this provision as it allows discretion in selecting the character (i.e., capital or ordinary) of such items. The drafter should consider adding additional guidance on this point.
- The hypothetical sale of the assets is based upon the “Book Value” of the assets. The definition of Book Value should correspond to the way that book value is calculated in Reg. §1.704-1(b)(2)(iv).
- This provision does not address Code Sec. 704(c). A separate provision for such matters should be included in the partnership agreement.

Do Target Allocation Provisions Create Taxable Capital Shifts?

One of the most interesting issues with respect to target allocation provisions is whether this allocation method produces a taxable capital shift between the partners when one partner has a distribution preference over another that is supposed to be satisfied out of partnership profits, but there is insufficient income (net or gross) to allocate to the preference partner and the nonpreference partner has a positive capital account. This issue can be seen with the following example: A contributes $1,000 to the AB LLC for a preferred interest that accrues a 10-percent annual return, and does not own any common units.\(^{52}\) B invests $100 for all of the common units of the AB LLC, which entitles him to all of the distributable cash of AB LLC after A receives her preferred return and her invested capital back. The AB LLC uses a target allocation, and is a cash basis taxpayer. AB
LLC has no income or loss in year 1. AB LLC does not liquidate at the end of year 1; but if it did A would be entitled to $1,100 ($1,000 capital contribution for the preferred unit + $100 (10-percent return)). Under a hypothetical sale analysis, AB LLC has $1,100 to distribute. The $1,100 is comprised of A's contributed capital ($1,000) and B's contributed capital ($100). Since there is no income or loss to allocate to A to get her target capital account to equal the $1,100 she would receive if AB were to liquidate, the only asset AB LLC has to pay A's preferred return is B's contributed capital.

One way to analyze this example is to conclude that there is a taxable "capital shift"53 from B to A to pay for A's preferred return at the end of the year. Under this analysis, A must accrue a $100 guaranteed payment under Code Sec. 707(c) in year 1 and B would have an offsetting deduction even though the AB LLC had no income during the year and did not liquidate.54 A guaranteed payment is a payment that is made by a partnership to a partner for services or capital and that is made without regard to the partnership's income.55 Proponents of this approach have three (and possibly more) theories they advance to argue for a taxable capital shift.

The first theory is that Code Sec. 707(c) requires that the guaranteed payment be accrued based upon Example 2 of Reg. §1.707-1(c). In that example, partner C in the CD partnership is entitled to receive 30 percent of CD's income as determined before taking into account any guaranteed payments, but not less than $10,000. In a year in which the CD partnership has $60,000 of income, C is entitled to $18,000 (30 percent of $60,000) and the example concludes that no part of that payment is a guaranteed payment because it represents C's proportionate share of partnership income. In contrast, if the partnership has only $20,000 of income, C is only entitled to $6,000 as its proportionate share of income. So, the example concludes that the remaining $4,000 is a guaranteed payment. What is significant in this example is that the partnership has sufficient income to satisfy its obligation to pay C its $10,000. It is also significant to note that C is entitled to a minimum distribution amount that is not expressed as a percentage of CD's income or cash flow. What is not clear in the example is what occurs if CD does not have sufficient income to satisfy the $10,000 payment to C. Nevertheless, many practitioners believe that this example stands for the proposition that if a partnership has insufficient income to allocate to a preferred partner and the preference would be paid out of the other partners' capital if the partnership did in fact liquidate, then the preferred partner should accrue a guaranteed payment.

It can be inferred from Example 2 above, that any time a partner is entitled to a share of partnership capital in excess of their distributive share that the excess share should be accounted for as a guaranteed payment to the recipient partner. This inference has intellectual appeal for those who like to see capital accounts “balance” at the end of each year. A capital shift makes the capital accounts at the end of the year match the applicable target capital account. Certainly even those practitioners who don't feel a capital shift has occurred in this example would believe that one has occurred if the AB LLC liquidated at the end of year 1. A similar argument for accruing a capital shift can be made under the economic effect equivalence test of Reg. §1.704-1(b)(2)(ii)(d), which provides:

Allocations made to a partner that do not otherwise have economic effect under this paragraph (b)(2)(ii) shall nevertheless be deemed to have economic effect, provided that as of the end of each partnership tax 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 would occur if requirements (1), (2), and (3) of paragraph (b)(2)(ii)(b) of this section had been satisfied, regardless of the economic performance of the partnership.

In order for the allocations to be deemed to have economic effect under this test, at the end of the partnership tax year at issue, the capital accounts need to match the economic results that would occur in an actual liquidation “regardless of the economic performance of the partnership.” Therefore, under this argument, a taxable capital shift is needed to cause the capital accounts to match the economic results that would occur at the end of the year at issue, even if the actual liquidation occurs in a future year.

A third argument for accruing a taxable capital shift can also be made under PIP. This argument is similar to the argument above in that it seeks to make the capital accounts balance at the end of the year in such a way as to reflect the target amount that the partners would receive if the partnership liquidated at the end of the year. This result is supported by
the comparative liquidation test under PIP. It is also supported by Reg. §1.704-1(b)(3)(ii)(d), (which looks to the partners rights to distributions of capital upon liquidation as a factor in determining PIP), and Reg. §1.704-1(b)(3)(iii)(c) (which looks to the partners' rights to distributions of cash flow and nonliquidating distributions in determining PIP).

All of the above arguments indicate that a taxable capital shift may occur if the partnership has insufficient items of income (including gross income) to get the partners’ capital accounts to match the target amounts they would receive in an actual liquidation. However, none of the authorities directly address the issue.

There are other practitioners that do not believe that a taxable capital shift has to be accrued by the preferred partner unless it is actually paid, and the amount paid exceeds the partnership’s income in the year it is paid. This argument is based on the view that the guaranteed payment rules of Code Sec. 707(c) are primarily designed to deal with the tax characterization of an actual payment that is not based upon partnership’s income, and is only secondarily a timing provision. Example 2 of Reg. §1.707-1(c) (discussed above) holds that when the CD partnership has sufficient income to support C's payment of $10,000, the payment is a distributable share of CD's income under Code Sec. 704, and is not a guaranteed payment. But, when CD has insufficient income, C's payment is characterized as a guaranteed payment. In both cases, Example 2 seems to imply that the CD partnership pays C the $10,000. What is not clear from Example 2 is whether C has to accrue the $10,000 guaranteed payment if no payment is made. Accordingly, it is unclear whether the preference partner must accrue a guaranteed payment until a payment is actually made from the other partner's capital as that is the moment in which the capital has actually shifted since the payment is not made without regard to the partnership's income. Forcing the accrual of a capital shift before the partner has actually received a payment will lead to income recognition when there has been no event that causes gain to be recognized, and there is every possibility that there will be no gain in the end; it is also contrary to the annual accounting period concept underlying the Code.

There are no authorities that directly address the capital shift issue, and many people differ on their views of this issue. Until this issue is affirmatively addressed, practitioners need to consider the possibility that partners may have to accrue a taxable capital shift when using target allocations.

There is a related issue involving whether a partner will be forced to accrue a taxable capital shift out of its own capital. For example, assume the same facts above except that A also contributes $100 for 50 percent of AB LLC’s common units. Assume further that AB LLC has no income or loss in year 1, and liquidates at the end of the year. AB LLC has $1,200 to distribute in the liquidation ($1,100 from A's capital contribution + $100 from B’s capital contribution). A is entitled to $1,100 with respect to her preferred unit ($1,000 capital contribution for the preferred unit + $100 (10-percent return)). Since AB LLC had no income, the only source of the $100 preferred return would be from the capital of the common unit holders (A and B). The remaining $100 will be distributed $50 to B and $50 to A.

Under the terms of the AB LLC agreement, A and B share losses 50–50 with respect to their common units. Therefore, both A and B bear the cost of A's preferred return. Since AB LLC liquidates at the end of year 1, it seems clear that a $50 taxable capital shift from B to A occurs, so that A has a $50 guaranteed payment and B has a $50 loss.

Does A also have a taxable capital shift from her common unit to her preferred unit? Conceptually, A and B have the same economic deal with respect to their common units, yet A shouldn’t be required to accrue a taxable capital shift out of her own capital. After all, A has simply taken money from one pocket, and put it into her other pocket. A is not economically better off. Forcing her to accrue an additional $50 as a taxable capital shift out of her own capital account would be the equivalent of treating her as if she has two capital accounts (one for her preferred unit and one for her common units). However, Reg. §1.704-1(b)(2)(iv)(B) provides, “a partner who has more than one interest in a partnership shall have a single capital account that reflects all such interests, regardless of the class of interests owned by such partner (e.g., general or limited) and regardless of the time or manner in which such interests were acquired.” Accordingly, A should not have to accrue a taxable capital shift with respect to her share of the preferred return because to do so would be counter to the Treasury Regulation’s rule that A has only one capital account.

There is also support for this position in case law. In A.M. Lloyd, a case decided before the 1939
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Code was promulgated, the Board of Tax Appeals held that when a partner’s salary exceeded that partner’s share of net partnership income, the partner’s salary was only taxable to the extent that such salary was paid out of the other partners’ capital contributions; the additional amount represented a return of that partner’s capital. Specifically, the court found that “there was but one source from which the payments made to these petitioners as salaries in excess of the partnership earnings could be made, and that was the capital of all of the partners. We entertain no doubt that to the extent the amount paid to each petitioner was paid out of the capital of the five other partners, it constitutes taxable income to him; but we hold that to the extent it was paid out of his own capital, it represents a return of capital and is not subject to the tax.” Accordingly, A does not have to accrue a taxable capital shift with respect to her share of the preferred return.

Do Target Allocations Work for Every Agreement?

Using target allocations for every agreement is a very bad idea. Target allocations are designed to prevent a mismatch of capital account balances and the distribution rights. Therefore, target allocations work best with partnership agreements that have complex distribution preferences and/or priorities.

Practitioners should not be lulled into a sense of false security by using target allocations. The theoretical simplicity of target allocations does not translate into simplicity in practice. Thus, as one commentator says about target allocations, “[t]he indiscriminate use without careful consideration of the multitude of issues that must be addressed is almost certain to lead to disaster.” The drafter needs to address a partnership using target allocations with the same care and consideration he or she would use for an agreement using a layer cake allocation.

There are situations in which target allocation provisions are inappropriate. Most notably, if the partnership and its partners need to comply with the so-called fractions rule of Code Sec. 514(c)(9)(E), the agreement will have to liquidate in accordance with capital account balances. Accordingly, target allocations won’t satisfy the fractions rule.

Partnerships that also want to make tax-driven allocations such as special allocations of losses should avoid using target allocation provisions. Target allocations don’t handle special allocations of losses particularly well.

If the partnership agreement is straight-up (e.g., each partner will contribute their allocable share of capital and receive a corresponding share of profits and losses), target allocations are not necessary. Instead, drafters may want to consider eliminating capital accounts altogether as PIP will inevitably get to the same allocation scheme, and the capital account maintenance rules may only add additional complexity.

Conclusion

In the right set of circumstances, target allocations will provide the drafter a certain degree of comfort that the partners will ultimately receive the correct distributions. But as the title of this article suggests, target allocations are not suitable for every agreement.

There are many unresolved issues that will need to be carefully considered when using target allocations. Hopefully this article has highlighted many of them.

Even if target allocation provisions are used, they are no substitute for careful tax planning. Tax practitioners are still strongly advised to model out the expected economic consequences of the deal to assure that the parties’ economic arrangement is preserved in both the distribution provisions and the allocation provisions. The same care should be taken when drafting target allocations as one would use with layer cake allocations.

ENDNOTES

1 The author would like to thank Terence F. Cuff and Richard M. Lipton for their helpful comments and suggestions in preparing this article.

2 For purposes of this article, it will be assumed that when referring to an LLC, the LLC is taxable as a partnership for tax purposes.

3 Unless otherwise noted herein, all references to the “Code” are to the Internal Revenue Code of 1986, as amended.

4 “Book value” of an asset for this purpose is defined to reflect the rules under Reg. §1.704-1(b)(2)(iv)(B). Therefore, the initial book value of contributed property is the asset’s fair market value as provided in Reg. §1.704-1(b)(2)(iv)(B) and is adjusted
from time to time under Reg. §1.704-1(b)(2)(iv)(d)–(g).

Target allocations get their name because they allocate the profits and losses to the partners’ capital accounts to match the “target” amount that the partner would receive in the hypothetical liquidation.

Reg. §§1.704-1(b)(2)(ii) and (iii).

5 Target allocations get their name because of Idiots? Specifically, Reg. §1.704-1(b)(2)(iii)(a) provides in pertinent part that:

The economic effect of an allocation (or allocations) is not substantial if, at the time the allocation becomes part of the partnership agreement, (1) the after-tax economic consequences of at least one partner may, in present value terms, be substantially diminished compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement. In determining the after-tax economic benefit or detriment to a partner, tax consequences that result from the interaction of the allocation with such partner’s tax attributes that are unrelated to the partnership will be taken into account. See also Terence Floyd Cuff, Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements, NYU Inst. Fed. Tax’n ¶8.86 (2007).

Reg. §1.704-1(b)(2)(ii)(b). This test has also been referred to by practitioners as the “dumb but lucky” test because it can be used to support allocations in an agreement that failed to properly comply with the economic effect rules. See, e.g., McKee, Nelson & Whitmire, Federal Taxation of Partnerships and Partners (Warren Gorham & Lamont), at ¶ 11.02, note 31.

Reg. §1.704-1(b)(2)(ii)(b).


Reg. §1.704-1(b)(2)(iii)(a).

It is the first of two articles in complex partnership agreement considered fatal to petitioner’s claim that partnership allocation had economic effect, vac’d and rem’d on another issue, CA-9, 2000-1 ustc ¶50,501, 221 F3d 1348.

11 As one commentator rightly notes, “The qualified income offset rarely serves a greater function than the human appendix.” Terence Floyd Cuff, Working With Target Allocations—Idiot-Proof or Drafting for Idiots? 2 R. E. Tax’n (2d quarter, 2008) (“Alice I”). Alice I is the first of two articles by Terry Cuff in which Mr. Cuff addresses a variety of issues with respect to target allocations. The second is Working with Target Allocations—Drafting in Wonderland, 3 R. E. Tax’n (3d quarter, 2008) (“Alice II”).


13 The determination of whether an allocation is “substantial” is quite complex. Specifically, Reg. §1.704-1(b)(2)(ii)(a) provides in pertinent part that “[e]xcept as otherwise provided in this paragraph (b) (2)(ii), the economic effect of an allocation (or allocations) is substantial if there is a reasonable possibility that the allocation (or allocations) will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences. Notwithstanding the preceding sentence, the economic effect of an allocation (or allocations) is not substantial if, at the time the allocation becomes part of the partnership agreement, (1) the after-tax economic consequences of at least one partner may, in present value terms, be enhanced compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement, and (2) there is a strong likelihood that the after-tax economic consequences of no partner will, in present value terms, be substantially diminished compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement. In determining the after-tax economic benefit or detriment to a partner, tax consequences that result from the interaction of the allocation with such partner’s tax attributes that are unrelated to the partnership will be taken into account. See, e.g., Lipton, Nonrecourse Deductions of Lower-Tier Partnerships: No Room at the Interhotel? 88 J. Tax’n 42 (Jan. 1998).

The test set forth above is often referred to as the “after-tax” test or the “overall tax-effect rule.” See McKee, Nelson & Whitmire, Federal Taxation of Partnerships and Partners (Warren Gorham & Lamont), at ¶ 11.02(2)(b)(iv).


11 Id. This change to the Treasury Regulations was also accompanied by another change dealing with substantiality. In that change, the Treasury Regulations were amended to provide that in certain cases, the baseline for determining if an allocation is substantial is to measure it against the allocation under PIP. See T.D. 9398, IRB 2008-24, 1143 (May 20, 2008). Specifically, Reg. §1.704-1(b)(2)(iii)(a) provides in pertinent part that:

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gain to X upon the sale of blackacre because the value of XY has not increased. It had assets of $200 before the sale and $200 after. Both X and Y contributed $100 of property for their interest, and they agreed to share in all profit and loss 50–50. There is no economic profit or loss, so neither is enriched or burdened. But, there is taxable income of $100. Because X does not share in any economic gain, X should not be saddled with any taxable gain. Y should have to bear all of the taxable gain, and Code Sec. 704(c) provides so.

Ultimately such a misallocation could reverse itself out. If X received an allocation of $50 of taxable income, X would increase his basis in his partnership interest by the same amount under Code Sec. 705(a)(1) and his basis would go from $100 to $150. Upon a subsequent liquidation, X would only receive $100 of cash. If this is a liquidating distribution, X would be allowed to recognize a $50 loss. But, the loss will be a capital loss under Code Sec. 774, and it may be in a subsequent year. Of course if the XY partnership liquidated in accordance with capital account balances, and the allocation provision allocated taxable income, and not book income, X would receive a $50 windfall at the expense of Y.

Note 38. Other sample target allocation provisions can be found in (1) Klig and Sloan, Partnerships—Taxable Income; Allocation of Distributable Shares; Capital Accounts, BNA TAX MAG., PORTFOLIO 712-2d at Worksheet 10; and (2) Whitmire, Nelson, McKee, Kuller, Hallmark & Garcia, Structuring and Drafting Partnership Agreements: Including LLC Agreements (Warren Gorham, & Lamont), at ¶ 5.05[2]. It is assumed that A’s interest is not debt for tax purposes.

For a discussion of capital shifts, see Schneider and O’Connor, LLC Capital Shifts: Avoiding Problems When Applying Corporate Principles, 92 J. TAX’N (Jan. 2000); and Cuff, Alice II, supra note 13.

See, e.g., Cuff, Alice II, supra note 13; and O’Connor and Schneider, Capital-Account-Based Liquidations: Gone With the Wind, or Here to Stay? 102 J. TAX’N 21 (Jan. 2005).

See Code Sec. 707(c).

See, e.g., Steinberg, Fun and Games with Guaranteed Payments, 57 TAX LAW. 533 (Winter 2004).

See Steinberg, Fun and Games with Guaranteed Payments, 57 TAX LAW. 533, at 566 ("section 707(c) is primarily a characterization provision for dealing with amounts that cannot otherwise be accounted for under section 704(b); only secondarily is it a timing provision"). See also Sheldon I. Banoff, Guaranteed Payments for the Use of Capital: Schizophrenia in Subchapter K, TAXES, Dec. 1992, at 820.

Id. ( citing Code Sec. 441(b)(1)). See also Burnett v. Sanford Brooks, S.C., 2 USTC ¶ 636, 282 US 359 (1931).


Whitmire, Nelson, McKee, Kuller, Hallmark & Garcia, Structuring and Drafting Partnership Agreements: Including LLC Agreements (Warren Gorham, & Lamont), at ¶ 5.05[2]. See Code Sec. 514(c)(9)(I) (II).

Such a situation does not eliminate the need to think through all of the complexities and nuances of Subchapter K. For example, the partners will still need to evaluate the implications of Code Sec. 704(c).