

**UNTIL THE TAX LAWYER ARRIVES:
UNDERSTANDING TAX PROVISIONS IN LLC AGREEMENTS**

Gary E. Fluhrer
Foster Pepper & Shefelman PLLC
1111 Third Avenue, Suite 3400
Seattle, Washington 98101

Robert G. Gottlieb
Venable LLP
575 7th Street NW
Washington, DC 20004

**UNTIL THE TAX LAWYER ARRIVES:
UNDERSTANDING TAX PROVISIONS IN LLC AGREEMENTS**

Virtually every operating agreement for limited liability companies (or partnership agreement for limited or general partnerships) includes in the tax allocation sections the 704(b) “mumbo jumbo,” i.e., “qualified income offset,” “minimum gain chargeback,” and similar terms which we all accept as boiler plate. Very few of our clients, and probably their counsel, understand where those terms come from or what they mean. This workshop discusses the regulatory basis for this “mumbo jumbo” and offers some practical suggestions for minimizing unintended consequences.

I. BASICS OF SECTION 704(b) MUMBO JUMBO

*Cross references to
Model Limited Liability
Company Agreement*

A. Tax Allocations –

Under I.R.C. Section 704(b), a partner's distributive share of partnership¹ income, gain, loss, deductions and credit is generally determined pursuant to the partnership agreement.² Tax allocations contained in a partnership agreement will be respected if

Article 5

(i) The allocations have "substantial economic effect";³

(ii) the allocations are made in accordance with the partners' interest in the partnership (determined by taking into account all facts and circumstances) based on the economic relationships among the partners⁴; or

(iii) The allocations are deemed to be in accordance with the partners' interests in the partnership pursuant to the rules contained in Treas. Reg. §1.704-1(b)(4).

¹ "Partnership" includes any state law entity which has elected to be treated as a partnership for Federal income tax purpose under Treas. Reg. §301.7701-3.

² I.R.C. Section 704(a); Treas. Reg. §1.704-1(a).

³ Treas. Reg. §1.704-1(b)(2).

⁴ I.R.C. Section 704(b).

Underlying all of these rules is the premise that the allocation of tax items among partners must affect the economic benefit which a partner is entitled to receive from the partnership; accordingly,

-- if partners share losses other than proportionately, such disproportionate loss should reduce the capital account of such partner and the amount of distributions to which the partner allocated such loss is entitled (assuming such disproportionate loss is not reversed by other allocations of income and loss); and

-- if partners share income other than proportionately, such disproportionate income should increase the capital account of such partner and the amount of distributions to which the partner allocated such income is entitled (assuming such disproportionate income is not reversed by other allocations of income and loss).

There are two safe harbors for substantial economic effect contained in the 704(b) regulations – the "standard substantial economic effect test" (see Section B infra) and the "alternate test for economic effect" (see Section C infra).

B. Standard Substantial Economic Effect Test

§4.2
§4.4

1. Capital accounts to be maintained in accordance with the rules contained in Treas. Reg. §1.704-1(b)(2)(iv).⁵

⁵ Generally, a partner's capital account at any given date is equal to such partner's aggregate capital contributions to the partnership through such date (including the net fair market value of property contributed by such partner to the partnership), reduced by the aggregate sum of all distributions by the partnership to such partner through such date (including the net fair market value of partnership property distributed to such partner), and increased or decreased, as the case may be, by all allocations of partnership income, gain, loss, deduction (including such partner's share of expenditures described in I.R.C. Section 705(a)(2)(B)), credit and basis to such partner through such date. Treas. Reg. §1.704-1(b)(2)(iv).

§5.4(b)

2. Liquidation proceeds of the partnership must be made in accordance with positive capital account balances. Treas. Reg. §1.704-1(b)(2)(ii)(b)(2).

3. Any partner with a deficit balance in its capital account must upon the liquidation of its interest in the partnership have the unconditional obligation to restore (contribute) the amount of such deficit balance to the partnership upon the later to occur of the end of the taxable year in which liquidation occurs or 90 days after the date of liquidation. Treas. Reg. §1.704-1(b)(2)(ii)(b)(3).⁶

To demonstrate the effect of a deficit restoration obligation, assume the following with respect to the AB Partnership and its partners A and B:

(a)

<u>Initial Capital Contributions</u>	<u>Basis (end year 1)</u>	<u>Initial Capital Account</u>
A - \$500	\$500	A - \$500
B - 0	(\$25 depreciation)	B - 0

Assume in year one all items of income and deduction are equal plus there is \$25 worth of depreciation and a subsequent sale of the property at the adjusted cost basis of the property of \$475 at the end of year one (that is, no gain) – who bears the \$25 loss resulting from the depreciation?

A should receive 100% of the loss; if allocated to B (as to any part), B will need a deficit restoration obligation (equal to no less than its share of the depreciation) to permit its capital account to be less than zero.⁷

⁶ Treas. Reg. §1.704-1(b)(2)(ii)(c) specifies that if such obligation is imposed under state law, a partner will be treated as having such obligation. Treas. Reg. §1.704-1(b)(2)(iv)(c) specifies that a partner who as a guarantor is ultimately liable on partnership debt will be treated as having such obligation.

⁷ If deficit restoration obligation is limited, agreement must contain a "qualified income offset" – See Section C infra.

(b) Alternatively, assume the following:

Initial Capital Contributions	Basis (end year 1)	Initial Capital Account
A - \$250	\$500	\$250
B - \$250	(\$25 depreciation)	\$250

Assume in year one that A's capital is "preferred upon liquidation" to B's capital and in year one that all items of income and deduction are equal plus there is \$25 worth of depreciation and a subsequent sale of the property at the adjusted cost basis of \$475 at the end of year one (that is, no gain). In order to keep A's preferred capital intact, the \$25 deduction must be allocated to B and B's capital account reduced accordingly.

(c) Alternatively, assume that neither A nor B contribute capital and the partnership borrows \$500 to acquire the asset --

(i) if the debt is recourse, the allocation of the \$25 should be made to the partner or partners who have risk of loss through either a deficit restoration obligation (or state law equivalent) or ultimate risk of loss as a guarantor.

(ii) if the debt is nonrecourse, the \$25 will create minimum gain which is then allocable among the partners in accordance with the partnership agreement to the extent such agreement complies with the non-recourse deduction rule.⁸

C. Alternative Economic Effect Test

§1.1 – definitions of Adjusted Capital Account Balance and Adjusted Capital Account Deficit

Tax allocation provisions contained in a partnership agreement can have economic effect without an unconditional obligation to restore a negative capital account (see item B.3 above) if –

⁸ See Section D infra.

1. The allocations do not cause the deficit balance in a partner's capital account to exceed any limited dollar amount (that is, less than an unlimited obligation) the partner is obligated (or treated as obligated) to restore to the partnership upon liquidation; and

2. A partner whose capital account is unexpectedly reduced that causes such partner's capital account to be more negative than the "limited" deficit restoration obligation, must be allocated income or gain to eliminate any excess negative capital account as quickly as possible.

§5.3(f)

The allocation required by C.2 above is a "qualified income offset".⁹ Even if the limited deficit restoration obligation referred to in C.1 is zero, the inclusion of qualified income offset language in the partnership agreement permits the substantial economic test to be met.

D. Nonrecourse Debt

§5.3

For purposes of applying the "limited deficit restoration obligation" in Section C.1 above, a partner is treated as obligated to restore any minimum gain deductions (nonrecourse deductions) that have reduced such partner's capital account. Accordingly, a capital account may be negative to the extent of minimum gain allocated to a partner without requiring any deficit restoration. Such share of minimum gain is the equivalent of a deficit restoration.

*§5.7 – definitions of
Company Nonrecourse
Deduction
Company Nonrecourse
Liability
Member Minimum Gain
Member Nonrecourse*

Nonrecourse deductions equal the net increase in partnership minimum gain during a year reduced by distributions of proceeds of a nonrecourse liability that are allocable to an increase in partnership minimum gain.¹⁰ Minimum gain is calculated by determining for each nonrecourse liability of a partnership, the amount of gain which would be

⁹ Treas. Reg. §1.704-1(b)(2)(ii)(d)

¹⁰ Treas. Reg. §1.704-2(c).

*Deduction
Member Nonrecourse
Liability*

realized if the property which is the collateral for such loan were disposed of in full satisfaction of such debt.^{11 12} Each partner's allocable share of minimum gain is treated as a limited deficit restoration obligation under Treas. Reg. §1.704-1(b)(2)(ii)(d).

Allocations of nonrecourse deductions must be made in accordance with a partner's interest in the partnership in accordance with Treas. Reg. §1.704-2(e)F:

1. Throughout the full term of the partnership: (a) the partnership must maintain capital accounts in accordance with Treas. Reg. §1.704-1(b)(2)(iv); (b) liquidating distributions must be made in accordance with positive capital account balances; and (c) either there must be an unconditional deficit restoration agreement or there must be a qualified income offset provision;

2. Beginning in the first year in which there are nonrecourse deductions and thereafter, the agreement must provide that allocations of nonrecourse deductions are made in a manner reasonably consistent with allocations which have substantial economic effect with regard to some significant partnership item attributable to the property securing the nonrecourse debt;

§5.3(c)

3. Beginning in the first taxable year that it has nonrecourse deductions or there is a distribution of proceeds of a nonrecourse liability that are allocable to an increase in minimum gain, and thereafter, the agreement must comply with the minimum gain chargeback requirement of Treas. Reg. §1.704-2(f); and

¹¹ See Treas. Reg. §1.752-3(a)(2).

¹² Partnership AB borrows \$200 on a nonrecourse basis and purchases a building for \$300 on the first day of Year 1. Depreciation is \$100 a year and the loan balance does not decline. At the end of Year 1, the partnership minimum gain is \$0, because a disposition for satisfaction of the liability would produce no gain (\$200 relief of liability - \$200 basis). Thus, there would be no nonrecourse deductions. At the end of Year 2, there would be a minimum gain of \$100 (\$200 - \$100 basis), resulting in a net increase of \$100. In Year 2, there would be \$100 of Nonrecourse deductions. Likewise, in Year 3 there would be \$200 for minimum gain with a net increase of \$100.

§5.3(b)(d)

4. All other material allocations and capital account adjustments must have substantial economic effect.

§5.3(f)

Member Nonrecourse Deductions (deductions funded by the proceeds of a nonrecourse loan from a partner) must be allocated to the lender/partner.¹³

E. Phantom Income

Phantom Income refers to the circumstances where income is allocated to a partner in a year where the taxes payable with respect thereto exceed the amount of cash distributions received by such partner in such year.¹⁴ Phantom income is caused inter alia by:

- (i) creation of reserves;
- (ii) principal amortization in excess of depreciation deductions
- (iii) multiple asset ventures where the cash associated with profits allocated to a service partner are distributed as a return of capital.

§5.6 – Tax Distributions

In such situations, the service partner experiencing the phantom income should negotiate some form of distribution or tax loan to create a source for the payment of taxes. Such amount will necessarily decrease the funds available for distribution to the non-service partner.

Example

<u>Partnership AB</u>	<u>Capital Contribution</u>	<u>Profit Shares</u>
Partner A (service partner)	\$ 100	40%
Partner B	\$ 9,900	60%

¹³ Treas. Reg. §1.752-2

¹⁴ It is probably more accurate in an economic sense to calculate "phantom income" on a cumulative basis for all partnership years in order to offset earlier nonphantom income by phantom income which occurs thereafter.

Partnership AB acquires two assets with the \$10,000 (\$5,000 each) and after one year sells one asset for \$10,000. Assume no interim distributions or allocations; the \$5,000 gain is allocable \$2,000 to A and \$3,000 to B. Assume the \$10,000 will be distributed as a return of capital; all cash in excess of capital will be distributable pro rata in accordance with profit participation shares.

Partner A to receive \$100 and Partner B to receive \$9,900

Partner A has income of \$2,000, but only \$100 in cash

F. Built-In Gain (or Loss) Property

I.R.C. Section 704(c) authorizes the issuance of regulations to address allocations of income, gain, loss and deduction with respect to property contributed to a partnership in order to take account of the variation between the basis of the property to the partnership and the capital account credit given to the contributing partner at the time of contribution.¹⁵ The regulations recognize alternative methodologies (which are selected on an asset by asset basis¹⁶ for handling the variance between the tax basis of the property and the book value of the property as follows:

(1) The "traditional method" which eliminates disparity between contributing partner's book and tax capital accounts through (a) allocating tax gain (or loss) to contributor on sale of contributing property or (b) earlier by special allocations of depreciation to cash partners. Under the §704(b) regulations, tax depreciation must be allocated to cash partners in amounts equal, to the extent possible, to the book depreciation allocated to them.

¹⁵ Treas. Reg. §§1.704-1(b)(2)(iv)(b)(2) and (d).

¹⁶ Treas. Reg. §1.704(a)(2).

If there is insufficient tax depreciation to allocate to the cash partners, each cash partner will have a "ceiling rule" applying to its tax allocation.

(2) The "traditional method with curative allocation" – if "ceiling rule" prevents a cash partner from receiving full tax depreciation deductions, parties can specially allocate gross income to the property contributing partner to make up for shortfall.

(3) Remedial method – in applying the remedial method, the first step is to determining the amount of book items and allocate them to the partners. Normally, book items are determined under the rules of Treas. Reg. §1.704(b)(2)(iv). However, the remedial method, for book purposes, bifurcates the property and its basis into two portions – a contributed portion (the portion of the partnership's book basis in the property equal to the adjusted tax basis in the property at the time of contribution) and a noncontributed portion. Recovery with respect to the contributed portion is calculated using the tax recovery method; recovery with respect to the noncontributed portion is calculated using any method available to the partnership for newly purchased property of the same type.¹⁷ The second step is to make tax allocations using the traditional method. If the ceiling rule causes the book allocation to a noncontributing partner to be different than the tax allocation, the partnership creates a phantom allocation of income, gain, loss or deduction and allocates it to the noncontributing partner and simultaneously creates an offsetting item and allocates it to the contributing partner.¹⁸

II. Observations on 704(b) Mumbo-Jumbo

The complexity of the Section 704(b) regulations and interpretations, coupled with the perceived (or actual) discretion which it may place in the company's accountants or financial managers to adjust capital accounts, leaves many clients

¹⁷ Reg. §1.704-3(d)(2).

¹⁸ Reg. §1.704-3(d)(1).

uncomfortable. The reality is that the reasonably capable real estate executive (and perhaps his or her counsel) easily gets bogged down in the technical morass of the 704(b) regulations. With that background, we would offer the following observations for discussion:

A. We do not see deficit restoration obligations (“DRO”) included in operating agreements¹⁹; virtually all agreements specifically provide that no deficit restoration is required.²⁰ The reason, of course, is that an unlimited DRO may cause a member to have unlimited liability for the debts and obligations of the company at some future date plus the positive balances in the capital accounts of other members. DRO provisions, unless very carefully targeted to fit a particular circumstance involving sophisticated clients, may be hazardous to the practitioner’s health because, assuming the client understands the provision, the clients’ expectation of course is the DRO will never come into effect.²¹

B. There are a significant number of operating agreements, mostly for “traditional joint venture” arrangements, which utilize a fixed formula for cash distributions (the “waterfall”) from both operations and liquidation, rather than providing for liquidating distributions to be made in accordance with the positive capital account balances of the members. There are several reasons for this, including:

1. As noted above, the members are not comfortable with the 704(b) regulations, particularly their application to presently unforeseen or remote but possible circumstances (e.g., book ups, book downs, shifting percentage interests and dilutions) and the possible distortions in capital accounts that may occur.

2. The members are more concerned with providing certainty of the manner in which cash will be distributed under all circumstances than with certainty that each possible tax allocation under all circumstances will fall within one of the substantial economic effect “safe harbor” tests. This rationale is particularly prevalent with institutional or semi-institutional capital partners where the focus is on the cash.

¹⁹ For purposes of this discussion, operating agreements for limited liability companies with two or more members and partnership agreements for partnerships are referred to collectively as operating agreements and both are governed by Subchapter K of the Code. Likewise, partners and members are referred to collectively as members.

²⁰ See Section 4.6 of the operating agreement included in the main program materials (“Model Agreement”) which so provides and accompanying footnotes.

²¹ The absence of a DRO provision means the standard test for substantial economic effect will not be satisfied. See Treas. Reg. § 1.704-1(b)(2)(ii)(b) which requires for the standard safe harbor test (a) capital accounts be established and maintained in accordance with the Treas. Regs., (b) liquidating distributions be made in accordance with the positive balances in capital accounts, and (c) members with a negative capital account balance be obligated to restore the amount of the deficit balance. Thus, virtually all operating agreements will endeavor to rely on the alternative test or its economic equivalent for substantial effect or its equivalent.

We should be clear, however, what we mean by “traditional joint venture” arrangements where fixed formula cash distribution formulas are frequently utilized. In these agreements, the sponsor/developer contributes a small percentage of the initial capital contributions to acquire/develop a project, the capital partner contributes the balance of the initial capital contributions, and the sponsor/developer receives a “promotional” profits interest, usually expressed as a percentage interest, which is greater than its ratio of cash contributions. In a typical “traditional joint venture” the developer/sponsor might contribute 3%-5% of the initial cash contributions (most capital partners require some contribution) and have a percentage interest of 25%-35%. Capital contributions beyond the initial capital contributions (e.g., funding of operating losses and sometimes cost overruns in development projects) may be required in the ratio of percentage interests to keep the sponsor/developer focused on avoiding such additional capital contributions, but if made would be distributed prior to any other distributions and carry a “hefty” preferred return to encourage participation. The cash distribution formula among the members for this type of arrangement might provide in summary form as follows:

(a) Cash Distributions from Operations [excluding cash distributions from Capital Events]:

(i) First, among the members in proportion to and in the amount of their accrued but unpaid Additional Capital Preferred Return [the cumulative, compounded monthly return on Additional Capital Contributions beyond the Initial Capital Contributions, say 20%];

(ii) Second, among the members in proportion to and in the amount of their Unreturned Additional Capital Contribution Amounts [the amount of Additional Capital Contributions beyond the Initial Capital Contributions];

(iii) Third, among the members in proportion to and in the amount of their accrued but unpaid Initial Capital Contribution Preferred Return [the cumulative, compounded monthly return on Initial Capital Contributions, say 10%]; and

(iv) The balance, if any, among the members in proportion to and in the amount of their Percentage Interests [say 30% to sponsor/developer and 70% to the capital member].

(b) Cash Distributions from Capital Events [sale, refinance proceeds, casualty insurance proceeds or condemnation proceeds]:

(i) First, among the members in proportion to and in the amount of their accrued but unpaid Additional Capital Contribution Preferred Return;

(ii) Second, among the members in proportion to and in the amount of their Unreturned Additional Capital Contribution Amounts;

(iii) Third, among the members in proportion to and in the amount of their accrued but unpaid Initial Capital Contribution Preferred Return;

(iv) Fourth, among the members in proportion to and in the amount of their Unreturned Initial Capital Contribution Amounts; and

(v) Fifth, the balance, if any, among the members in proportion to their Percentage Interests.

The net income and net loss would then be allocated to follow the cash distributions (so-called “forced allocations” or “chase allocations”) so that income is allocated to force the book capital accounts to equal cash distributions on liquidation. These sorts of “forced allocations” are often expressed as a formula, but include maintenance of capital accounts, the regulatory allocations (e.g., qualified income offset and minimum gain chargeback) and a clause to permit adjustments if necessary to the allocations if unforeseen events occur.²²

²² A formula for allocations of net loss and net income to accomplish this result which follows the cash distribution formula set forth above in the text might in summary form look something like the following:

(a) Allocation of Net Income and Net Loss From Operations:

(i) Except as otherwise provided in the [regulatory allocation section] and in subsection (b) upon Capital Events, the company shall allocate net losses from operations, including non-recourse deductions, to the members in proportion to the members Percentage Interest.

(ii) Except as otherwise provided in the [regulatory allocations] and in subsection (b) upon Capital Events, the company shall allocate net income as follows:

(1) First, to the members in proportion to and to the extent of all prior net losses allocated to the members pursuant to subsection (i);

(2) Second, to the members in proportion to the aggregate cash distributions made to the members in the current year and all prior years pursuant to [distributions of Additional Capital Preferred Return and Initial Capital Preferred Return from Operations] until each member has been allocated net income in an amount equal to the excess of (x) the amount of cash distributed to such member for the current year and all prior years pursuant to [distributions of Additional Capital Preferred Return and Initial Capital Preferred Return from Operations] over (z) the amount of net income previously allocated to such member pursuant to this subsection; and

(3) Thereafter, all remaining net income shall be allocated in proportion to each members Percentage Interest.

(b) Allocation of Net Loss and Net Income From Capital Events, including liquidation. All net income and net loss upon liquidation of the company or from a Capital Event (collectively, “Gain on Sale” or “Loss on Sale”) shall be allocated as follows:

(i) Loss on Sale shall be allocated among the Members as follows:

(1) First, proportionately to those Members having positive Capital Account balances until all positive Capital Accounts have been reduced to zero; and

(2) Thereafter, among the Members in proportion to their Percentage Interests.

(ii) Gain on Sale to the extent available shall be allocated among the Members as follows:

(1) First to those Members having negative Capital Account balances in proportion to such negative balances until they are increased to zero;

This “traditional joint venture” arrangement with cash distributions controlling and allocations following will not as a technical matter satisfy the standard or alternative test for substantial economic effect due to the absence of a provision providing for liquidating distributions to be made in accordance with the positive balances of the members capital accounts.²³ Rather than allocations being made and reflected in capital accounts, and capital accounts driving distributions, this is essentially the reverse. How then do these types of distribution and allocation provisions comply with 704(b)? There are two possible bases for compliance:

(c) Simply stated (perhaps an oxymoron in this arena), Treas. Reg. § 1.704-1(b)(2)(ii)(i) provides that allocations that do not satisfy the standard or alternative tests for substantial economic effect will be deemed to have economic effect if such allocations would yield the same result upon a hypothetical liquidation of the company as would be obtained upon a liquidation under the standard or alternative test for substantial economic effect. Because the allocations of net income and loss for tax purposes are intended to follow the economics (i.e., cash distributions), this should generally be the case²⁴, and a general provision stating that intent and authorizing alterations as necessary to the allocation formula, but not the cash distribution formula, to accomplish compliance with the economic effect equivalence test can be included.²⁵

(2) Second, to each of the Members in proportion to and in the amount and manner necessary to cause each of the Members' Capital Accounts to be equal to the sum of such Member's Additional Capital Preferred Return, Unreturned Additional Capital Contribution Amount, Initial Capital Preferred Return, and Unreturned Initial Capital Contribution Amount (collectively, a “Member's Allocation Preference”).

(3) Third, if any Member's Capital Account exceeds such Member's Allocation Preference, then in such amounts and proportions as necessary to cause the excesses in all Members' Capital Accounts to be in proportion to the Members' Percentage Interests.

(4) Thereafter, any remaining Gain on Sale shall be allocated to the Members in proportion to their Percentage Interests.

Maintenance of capital accounts, the regulatory allocations, and a statement of intent that these allocations are intended to comply with the economic equivalence test of Treas. Reg. § 1.704-1(b)(2)(ii)(i) are generally included along with authorizing the managing member (sometimes with the consent of the other members) to make such adjustments as necessary to accomplish that result.

²³ As noted above, both the standard test and alternative test for substantial economic effect require that liquidating distributions be made in accordance with the positive balances in the members capital accounts. Treas. Reg. 1.704-1(b)(2)(ii)(d) and 1.704-1(b)(2)(ii)(c). See comments in Section 1 and the preface to Section 5 of the Model Agreement.

²⁴ Note, however, that compliance with this test will require some one to track through the capital accounts and hypothetical liquidations to confirm that this will be the case; thus, the 704(b) regulations cannot be ignored.

²⁵ See footnote 4 and the statement of intent set forth as Simplified Option 1 discussed in the introduction to Section 5 of the Model Agreement.

(d) If all else fails, it would seem that the allocations that are intended to “chase” the cash distributions are in accordance with the members interests in the company.²⁶ Although reliance on an analysis that allocations are in accordance with the members interests in the company, rather than the “safe harbor” tests for substantial economic effect, generally are not favored due to the subjective nature and inherent uncertainty of the “facts and circumstances” method for determining what the members interests in the company are, it would seem in “traditional joint ventures” that the operating agreement through the formula for cash distributions establishes explicitly the member’s economic interests. Because the income and loss allocations for tax purposes follow these cash distributions, it would seem that these allocations are in fact in accordance with the member’s economic interests in the company. After all, the whole point of Section 704(b) is to have the tax allocations and economic aspects of the company aligned.²⁷ The corollary of this argument perhaps is that the “traditional joint venture” type of agreement really has no “special” allocations.

C. Allocations Outside the Traditional Joint Venture Model. The IRS has vigorously attacked “tax shelters” over the past fifteen years or so (e.g., the passive loss rules in IRC § 469, the 704(b) regulations and the substantiality requirements for allocations in Treas. Reg. § 1.704-1(b)(2)(iii) attacking “flip-flop” and “transitory” allocations, and the at-risk rules in IRC § 465 except for qualified non-recourse financing). These rules have clearly altered the sort of tax motivated allocations in partnership agreements that we all saw in the early 1980s. As a result, we do not see many tax motivated allocation provisions in operating agreements.²⁸

D. Keeping out of Trouble--What practical means do “dirt lawyers” follow to keep out of trouble in this area:

1. Distribute cash by a fixed formula (see II(B) above) so that the cash distributions are correct in any event;
2. Involve their tax partners to review the allocation provisions after the operating agreement business issues have stabilized (cost issue for client);
3. Suggest or insist that the client run a few hypotheticals to test the distributions and allocation provisions and exchange them with the other members; and

²⁶ See Treas. Reg. § 1.704-1(b)(3).

²⁷ For a discussion of this issue, see Berg, Allocations With Respect To Contributed Property Under 704(c), PLI/Tax (June 2003) and the discussion in the introduction to Section 5 of the Model Agreement.

²⁸ That is not say to say that some tax planning is not possible, particularly when non-recourse debt is involved which permits the maintenance, and increase in, negative capital accounts.

4. Have the client's accountants review the operating agreement (cost issue), particularly if the allocations are unusual or liquidating distributions are made in accordance with positive capital accounts. Because the accountants will prepare the tax returns and review the operating agreement at some point anyway, this guards against the "why did you do this" question.

Questions for Discussion:

1. How often, if at all, do you see or use DRO provisions?
2. Do your typical agreements distribute cash in accordance with a formula and then have the allocations "chase" the cash distributions or do your typical agreements liquidate in accordance with positive capital accounts?
3. How comfortable are your clients with the provisions of 704(b)? What do you do to increase their comfort level? Involvement of their accountants? Working through hypotheticals?
4. How often do you your clients request "special" allocations of losses and elect to take the risk of diminished cash distributions (i.e. liquidating in accordance with positive capital accounts)?