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## Boilerplate Tax Distribution Provisions Can Get You Into Hot Water

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Tax distribution provisions are not deeply technical. Perhaps that is the reason they do not often receive the attention they deserve. How common is it for drafters to discuss the details of the tax distribution provisions of a partnership agreement with their clients and seek input from them? Probably not that common. Yet, how often do drafters receive client calls just before the due date of a tax distribution asking for clarification on one or more aspects of these provisions? Probably fairly often.

When it comes to tax distribution provisions, there is no one size fits all. Depending on the particulars of the deal, these provisions can vary greatly and it would be a disservice to the client to simply use a “form” provision. Over the years, I have accumulated a long list of issues to address in the tax distribution provisions of partnership agreements, and although none of these issues will appear particularly revolutionary, I have found it useful to refer to my cheat sheet each time I draft a partnership agreement.

### PURPOSE OF TAX DISTRIBUTIONS

Should partners provide for tax distributions in their partnership agreement? It depends. Simply stated, tax distributions provide a means for partners to pay the tax liabilities resulting from allocations of partnership income. As such, in a partnership involving pro rata allocations of income and losses where the partnership is required to make monthly or quarterly distributions of its net available cash flow, there generally is no need to include a tax distribution provision. One exception to this general rule is where the partnership has third-party debt. Lenders often include

terms in loan agreements to prevent the partnership from making any distributions other than tax distributions while the debt is outstanding. In that case, including a tax distribution provision in the partnership agreement ensures that the partners receive enough distributions to pay their tax liabilities. Partners should be careful, however, that there is consistency between the terms of the tax distribution provisions included in the loan agreement and the partnership agreement.

For arrangements involving multiple tiers of distribution, especially in those cases where there is a priority return for contributed capital, tax distributions are necessary to protect against phantom income. Take a simple case of a two-partner partnership involving an investor partner and a service provider partner where the contributed capital is invested in a nondepreciable asset that generates cash flow and taxable income. If the partners’ arrangement is to distribute cash flow first to return the investor partner’s capital and thereafter one half to each of the partners, then every dollar of income earned by the partnership must be allocated equally to each of the partners. This means that the service provider partner will have phantom income as the partnership earns the taxable income being used to fund the return of the investor partner’s capital. In such a case, including a tax distribution provision in the partnership agreement helps the service provider partner to receive enough distributions from the partnership to cover the tax liability resulting from partnership income allocations.

The potential for phantom income, and thus the need for tax distributions, is not limited to situations in which there is a priority return of capital. For example, a similar situation can arise whenever there are multiple distribution tiers, representing different sharing arrangements in different layers of partnership income, and the taxable income of the partnership exceeds its net available cash flow. In these circumstances, although a tax distribution provision would be of no help if there is no cash available to distribute, such a provision would help ensure that any limited cash flow is distributed in a manner that takes into account the tax liability of the partners.

## MANDATORY VERSUS DISCRETIONARY AND SOURCE OF FUNDS

Some partnership agreements give discretion to the managing partner<sup>1</sup> to determine whether to make a tax distribution. One reason for this is that the managing partner may wish to repay preferred partners in lieu of making tax distributions if the cost of borrowing to pay tax liabilities is less than the preferred rate of return charged on the preferred partners' capital, or if the partners have outside losses that they can use to offset partnership income. Another reason is to give flexibility to the managing partner to reinvest the net available cash flow of the partnership in the business, especially during its crucial early years.

Although some partnership agreements give discretion to the managing partner to determine whether to make a tax distribution, it is more common for partnership agreements that include tax distribution provisions to state that the partnership "shall" make such distributions. But even when the tax distribution is mandatory, the source of the funds from which such distributions will be made can leave a lot of discretion in the hands of the managing partner. Thus, it is important to determine how the tax distributions will be funded.

For example, many partnership agreements provide that tax distributions will be made out of the net available cash flow of the partnership. A tax distribution provision of this type may read as follows:

To the extent of **Net Available Cash Flow**, the total distributions to a Partner for each Fiscal Year (and the 90-day period following such Fiscal Year) shall not be less than an amount equal to the product of (i) the Partnership's net taxable income allocated to such Partner for such Fiscal Year for federal income tax purposes, multiplied by (ii) the highest marginal federal tax rate for an individual set forth in §1 of the Internal Revenue Code for ordinary income or capital gain, as the case may be, regardless of the actual federal tax rates applicable to the Partners.

Net available cash flow typically is a defined term that takes into account cash on hand less amounts necessary to pay reasonably expected debts of the partnership and less any reserves. The managing partner generally has the power to determine how much to set aside for upcoming expenses and reserves, giving the managing partner discretion as to how much is available for tax distributions. Partners wishing to limit the

<sup>1</sup> References to managing partner are for convenience only and can be replaced with terms such as manager, board of managers, general partner, and so on.

managing partner's discretion in this regard, may ask to have net available cash for this purpose be determined without reserves, contingencies, or proposed acquisitions and capital improvements.

In other partnerships, tax distribution provisions do not identify the source of funds for distribution. A tax distribution provision of this type may read as follows:

To the extent that a Partner is allocated taxable income from the Partnership in any Fiscal Year as a result of being a Partner, the Partnership shall make a Distribution to such Partner within thirty (30) days of the end of the Fiscal Year during which such Partner is allocated such income in amounts to be determined as set forth in this Section X.

Failure to identify the source of funds can lead to disputes among partners and can be difficult for the managing partner, especially in a cash-strapped business, who has to balance the needs of the partnership with the needs of the partners to meet their tax obligations.

Not only is it important to identify the source of the funds from which tax distributions will be made, but partnerships should consider including provisions that warn partners about the possibility that the partnership will not be able to make a tax distribution, such as:

Although the Partnership intends to make a Tax Distribution, the Partnership may be prohibited from doing so (i) by a third-party, if the terms of a third party loan restricts such distributions, or (ii) under the LLC Act, if after taking into account the amount of the Tax Distribution, the liabilities of the Partnership exceed the fair value of the assets of the Partnership. Therefore, any Tax Distribution is subject to the restrictions that may be imposed upon the Partnership by third party lenders or the Act.

## FREQUENCY AND TIMING

An important consideration in drafting tax distribution provisions is the frequency and timing of the tax distributions. Ideally, tax distributions should be made to coincide with the due date of quarterly estimates for the partners. However, determining each partner's share of income for each quarter may be administratively burdensome, especially for smaller partnerships. Thus, many partnerships provide that tax distributions will be made on or before April 15 of the following year.

For those partnerships that do make quarterly distributions, the manner in which the partners' income for each quarter is determined can have a great impact on how the partners share in tax distributions. Some

partnership agreements provide that the tax distribution will be made based on the amount of income allocated to the partner through the end of such quarter. A provision of this type may read as follows:

To the extent that a Partner is allocated taxable income from the Partnership in any Fiscal Year as a result of such Partner being a Partner, excluding any allocations pursuant to §704(c) of the Internal Revenue Code, the Partnership shall, to the extent it has funds available, make a Distribution to such Partner within thirty (30) days of the end of each quarter during which such Partner is allocated such income in amounts to be determined as set forth in this Section X. The amount distributable to each Partner shall be equal to (i) the total tax that would be due at the Assumed Tax Rate on the taxable net income that has been allocated to such Partner through the end of such quarter over (ii) the aggregate amount of Distributions, including any tax distributions, that such Partner has received from the Partnership during the Fiscal Year through the end of such quarter.

While such a provision may work well in some partnerships, it may create issues in other partnerships. For example, if the partnership has \$1 million of income in quarter one, the partnership would make tax distributions as if its tax year ended at the end of such quarter. In a pro rata partnership, this methodology would not be problematic. But in partnerships with multiple layers of income allocations, such methodology could leave some partners without the means to timely make quarterly estimated tax payments. For example, assume A is entitled to a \$1 million income and distribution preference and thereafter A, B, and C share income and distributions equally. Assume the partnership earns \$1 million in each quarter. For the full year, A's distributive share of the partnership's income is therefore \$2 million, and B and C's distributive share of the partnership's income is \$1 million each. If the tax distributions will be made based on the amount of income allocated to each partner through the end of a quarter, then all of the quarter one income would be allocated to A only, and only A would be entitled to a tax distribution in quarter one. Each, A, B, and C, would then be allocated one-third of the income in each of the following quarters and would receive one-third of the tax distributions in such quarters. Estimated tax is generally payable in four equal quarterly installments, and each installment

must be 25% of the "required annual payment."<sup>2</sup> And, unless B and C can qualify for the annualized income method under §6654(d), the partnership's methodology for determining quarterly estimated tax distributions can leave them without sufficient cash flow to fund their quarterly estimated tax installments.

As an alternative, at the end of each quarter, the partnership can attempt to estimate the distributive share of income for each partner for the entire year and then make a distribution based on one-fourth of that amount. Using this methodology, the partnership can reasonably determine its income for the year at the end of each quarter based on information available to the partnership at the time and make adjustments to its subsequent quarterly distributions based on updated information available at that time. A provision of this sort may read as follows:

To the extent of Net Available Cash Flow (determined without regard to contingencies and proposed acquisitions) and subject to any restrictions on the Partnership imposed by any third party lenders, the Partnership will make quarterly distributions ("*Tax Distributions*") to each of the Partners in an amount not less than one-fourth of such Partner's distributive share of the Partnership's estimated annual net taxable income, multiplied by the Effective Tax Rate. The Managing Partner shall make each quarterly distribution within five (5) days of the due date of the federal quarterly estimated tax payments for individuals and may adjust each such distribution based on the partner's distributive share of the Partnership's estimated net taxable income on or about the date of the distribution. In the event that (i) distributions are made during one quarter in a Calendar Year in excess of the amount of Tax Distributions required during such quarter, and (ii) in subsequent quarters during such Calendar Year there is insufficient Net Available Cash Flow to make the full amount of required Tax Distributions for such quarter, then the distributions described in clause (i) of this sentence shall be deemed Tax Distributions in respect of such Fiscal Year to the extent necessary for the Partnership to be deemed to have made the full amount of required Tax Distributions for such Calendar Year.

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<sup>2</sup> §6654(c). Except as otherwise specified (for example, in the context of sample partnership agreement provisions), references to "§" are to the Internal Revenue Code of 1986, as subsequently amended.

## TREATMENT AS AN ADVANCE TOWARDS OTHER DISTRIBUTIONS

As discussed above, the purpose behind tax distributions is to provide a means for partners to pay the tax liabilities resulting from allocations of partnership income. The question becomes whether such tax distributions should be treated as an advance towards other amounts payable to the partners, or whether tax distributions should be in addition to any other amounts payable to the partners. There is no correct answer to this question as it is simply a business issue to be decided between the partners.

If tax distributions are treated as an advance, then when all is said and done, no partner will generally have received more or less as a result of the tax distributions. Presumably, the theory behind this approach is that the tax liability associated with a partner's share of partnership income is a liability of the partner, not that of the partnership. If tax distributions are not treated as an advance, then the tax liability of each partner is essentially satisfied by the partnership and can be viewed as a partnership expense. In that case, each partner receives such partner's share of partnership income free of any additional tax liability.

Of course, the two approaches have no meaningful economic differences in partnerships that make pro rata distributions of all cash flow and pro rata allocations of all income. But in a partnership with multiple tiers of allocations and distributions, failure to treat a tax distribution as an advance benefits any partner that has a disproportionately higher share of the top tiers of income. Viewed another way, the higher the "tax distribution" expense of the partnership, the less there is available for distribution under the lower tiers of distribution. For example, in the ABC Partnership example above, A is entitled to the first \$1 million of income each year. Assuming a tax rate of 50% and \$4 million of total annual partnership income, A would

be entitled to \$1 million in tax distributions each year, and B and C would each be entitled to \$500,000 of tax distributions each year. If tax distributions are treated as an advance, then A would receive \$2 million and B and C would receive \$1 million from the partnership. Conversely, if tax distributions are not treated as an advance, then after paying \$2 million in tax distributions to the partners, ABC Partnership would have another \$2 million left for distribution, of which the first \$1 million would go to pay A's preference and the remaining \$1 million would be split one-third each between A, B and C. Under the second scenario, A would receive a total of \$2.33 million from the partnership (as compared to \$2 million in the first scenario), whereas B and C would each only receive \$.833 million (as compared to \$1 million in the first scenario).

What is more, if a tax distribution is not treated as an advance, then the partnership must allocate income to the partner to account for the fact that the partner is entitled to an additional distribution in order to comply with §704(b). Thus, in the example above, the fact that A is entitled to an additional \$500,000 tax distributions on A's \$1 million preferred return requires the partnership to allocate an extra \$500,000 of income to A, which itself would presumably be accompanied by \$250,000 in tax distribution, which then would require an additional income allocation, and so on. Doing the calculation, at a 50% tax distribution rate, the \$1 million in preferred return would entitle A to an additional \$1 million in tax distributions resulting from income allocations in the amount of \$2 million (taking into account the allocations relating to the tax distributions). After distributing the first \$2 million to A to satisfy A's preferred return and the associated tax distributions, the partnership would distribute the remaining \$2 million to each A, B and C. The total distributions to A, B and C would be as follows:

	A	B	C
Income allocated with respect to preferred return and associated tax distributions	\$2,000,000	\$0	\$0
Other income allocated	\$666,666	\$666,666	\$666,666
Total income allocated	\$2,666,666	\$666,666	\$666,666
Total distributions	\$2,666,666	\$666,666	\$666,666
Total tax liability	\$1,333,333	\$333,333	\$333,333
Total after-tax proceeds	\$1,333,333	\$333,333	\$333,333

Based on the discussion above, A's after-tax proceeds have increased by \$333,333 when comparing the two scenarios of whether or not tax distributions are treated as an advance against other amounts otherwise payable to the partners. If the partners wish to avoid bearing the tax liability for the preferred partners' preferred returns, then they should include lan-

guage such as follows in their tax distribution provision:

Distributions made pursuant to this Section X shall be treated as advances of amounts distributable to the Partners pursuant to [reference section of agreement providing for

non-tax distributions] and shall reduce such amounts on a dollar-for-dollar basis.

Assuming the partners agree to treat tax distributions as an advance, an issue that should be considered is whether the tax distributions should be an advance against the next dollars to be distributed by the partnership, or whether they are only an advance against the bottom distribution tier. This is a timing issue and can affect the total amounts distributed to a partner in any given year.

Again, take the ABC Partnership discussed above and assume that the partners agree to treat tax distributions as an advance towards the next dollar distributable by the partnership. A is allocated \$2 million in income that year and receives \$1 million in tax distributions. B and C are each allocated \$1 million in income and receive \$500,000 in tax distributions. If, after tax distributions, the partnership only had \$1 million of net available cash flow to distribute for the year, the partnership would distribute it as follows:

	<b>A</b>	<b>B</b>	<b>C</b>
Tax distribution	\$1,000,000	\$500,000	\$500,000
Tax distribution treated as advance towards tier 1 distribution	\$1,000,000	n/a	n/a
Tax distribution treated as advance towards tier 2 distribution	\$0	\$500,000	\$500,000
Tier 1 distribution left after tax distribution	\$0	n/a	n/a
Tier 2 distribution to catch up to other partners that have already received tier 2 distributions as advances of tax distributions	\$500,000	n/a	n/a
Remaining net available cash flow for distribution	\$166,666	\$166,666	\$166,666
Total distributions	\$1,666,666	\$666,666	\$666,666

By contrast, if ABC Partnership was to treat tax distributions only as an advance against the last tier of

distributions, A's total distributions for the year would increase as follows:

	<b>A</b>	<b>B</b>	<b>C</b>
Tax distribution	\$1,000,000	\$500,000	\$500,000
Tax distribution treated as advance towards tier 1 distribution	\$0	n/a	n/a
Tax distribution treated as advance towards tier 2 distribution	\$1,000,000	\$500,000	\$500,000
Tier 1 distribution left after tax distribution	\$1,000,000	n/a	n/a
Total distributions	\$2,000,000	\$500,000	\$500,000

Of course, under these facts, if the partnership were to distribute its entire income in the same year, it would make no difference whether tax distributions

are treated as an advance towards the next dollar to be distributed or towards only the bottom tier distributions:

	<b>A</b>	<b>B</b>	<b>C</b>
Tax distribution	\$1,000,000	\$500,000	\$500,000
Tax distribution treated as advance towards tier 1 distribution	n/a	n/a	n/a
Tax distribution treated as advance towards tier 2 distribution	\$1,000,000	\$500,000	\$500,000
Tier 1 distribution left after tax distribution	\$1,000,000	n/a	n/a
Tier 2 distribution to catch up to other partners that have already received tier 2 distributions as advances of tax distributions	n/a	\$500,000	\$500,000
Total distributions	\$2,000,000	\$1,000,000	\$1,000,000

## CLAWBACKS

If tax distributions are simply an advance towards other distributions payable to the partners, what happens if, at the time the partnership winds down and is liquidated, a partner has received more from the partnership as a result of the tax distributions than the partner would have received without the tax distributions? This can happen if, for instance, the partnership is profitable in early years but incurs losses in later years. In that case, the partnership will have made tax distributions on income that is reversed through subsequent allocations of losses. The partnership should determine whether the partners receiving an allocation of losses to chargeback prior income must be required to pay back their tax distributions, either at the time the losses are allocated or upon the liquidation of the partnership.

Assume A and B form AB partnership and each contributes \$1 million. The partners agree that A is entitled to a return of his capital contribution before B. In year one, the partnership earns \$200,000, allocates it equally to each A and B, and makes a tax distribution in the amount of \$50,000 to each partner. In year two, the partnership incurs \$200,000 in losses and liquidates. To the extent any loss is allocated to the partners in year two, that loss presumably can be used to offset other income of the partners or be carried back to the prior year. So, should the partners be required to repay their tax distributions? The answer is not simple. It is possible that A's and B's only other income in year two is capital gain income, reducing the value of the partnership losses allocated to the partners in that year. Alternatively, it is possible that the year two losses are capital losses, and therefore cannot be carried back, and the partners have no capital gains from sources outside the partnership. Under these circumstances, requiring the partners to repay their tax distributions would require them to come out of pocket. On the other hand, without a repayment of the tax distributions, B will not receive back his full capital contribution even though the partnership has not incurred a net loss over its life. This is a business decision that the partners should make at the outset, taking into account the particular circumstances of the partnership. Ideally, the partnership should prepare pro-formas and take into account the particular circumstances of the partners before reaching a decision. If the partners agree to include a clawback provision, following is sample language that may be used:

If upon termination of a Partner's Interest in the Partnership such Partner shall have received more by virtue of this Section X than the partner would have otherwise received under [reference section of agreement providing for non-tax distributions], such Partner shall contribute such excess to the Part-

nership within ten (10) days of termination of such Partner's Interest.

## INTERPLAY BETWEEN TAX DISTRIBUTIONS AND PREFERRED RETURN HURDLES

Whether or not tax distributions are treated as an advance, another issue to be considered is whether such distributions count towards any preferred return hurdles, such as any IRR hurdles. Again, this is a business point that should be decided between partners. Partners that regularly invest in C corporations may have different expectations in this regard, especially given that the tax rate on ordinary income which is passed through the partnership is currently higher than the tax rate on corporate dividends. For these types of investors, an alternative approach may be to tax-effect the hurdle rate for the difference between ordinary and dividend income tax rates.<sup>3</sup>

## TAX RATE

One of the most basic decisions that the partners must make relating to tax distributions is the rate of tax that will be applied. Many partnership agreements provide a stated rate at which tax distributions will be made. But given the changes to tax rates over time, a stated tax rate can become quickly outdated. Other partnership agreements assume that partners are subject to income tax at the highest combined federal, state and local ordinary income tax rate for any partner. Although more accurate, such a provision requires the managing partner to determine the tax rate of each partner in order to determine which partner's rate is the highest. This process can be administratively burdensome if the partners reside in different states. What is more, if the partnership has other pass-through entities as partners, then the question becomes whether the managing partner should look through to the ultimate taxpaying owners of the pass-through entities to determine what state tax rate to apply. Alternatively, it may be easier for the partners to designate that the tax rate of a particular state, such as the state in which the partnership is located, will be used.

It would also be helpful for the partnership agreement to specifically address whether the highest federal ordinary income tax rate includes the tax imposed on net investment income under §1411. Whether or not the tax on net investment income under §1411 applies to any particular partner, or an owner of a pass-through partner, depends on facts and circumstances.

<sup>3</sup> This assumes that the partner is not tax-exempt.

And disputes can arise between the partners, or between the partnership and third-party lenders, whether the highest federal ordinary income tax rate should include the tax on net investment income under §1411. Thus, for partnerships that wish to include the 3.8% tax rate in their tax distribution, the partnership agreement should specifically provide for the same. Finally, it may be prudent for the partnership to give discretion to the managing partner to adjust the tax rate to take into account special types of income recognized by the partnership, such as long-term capital gains, unrecaptured §1250 gain, income from the sale of qualified small business stock under §1202, or dividend income:

In determining the amount that will enable each Partner to pay the Tax Due, the Managing Partner may reduce the tax rate used to calculate the Tax Due when appropriate to take into consideration the different rates applicable to special types of income, such as long-term capital gains or qualified dividends income.

It should be noted that it is fairly typical for the same tax rate to apply to each partner. The idea behind using the highest tax rates is to avoid the administrative burden of determining the effective rate for each partner. At the same time, special types of partners, such as tax-exempt partners, generally believe that if some partners are receiving tax distributions, it is only fair for all partners to receive such tax distributions. As a result, in many cases, tax distributions could actually exceed the tax liability of the partners. For a start-up needing cash flow to reinvest in the business, making tax distributions in excess of amounts necessary to satisfy the partners' tax liability can obviously take a heavy toll on the business. However, due to fairness (among partners) and administrative ease concerns, many small businesses still use the highest effective tax rate as the benchmark for making tax distributions.

## CUMULATIVE VERSUS ANNUAL

Another decision point in drafting tax distribution provisions is whether to use a cumulative approach or an annual approach to determining tax distributions. It is fairly typical for tax distributions to be based on the total income allocated to a partner for a particular year multiplied by the assumed tax rate. This approach does not take into account any prior year distributions or any prior year losses that may have been allocated to the partners. By contrast, an alternative approach determines the total income, net of losses, allocated to each partner over the life of the partnership and multiplies that amount by the assumed tax rate to come up with the maximum required distributions:

The amount distributable to each Partner shall be equal to the excess, if any, of (a) the total tax that would be due at the Assumed Tax Rate on the cumulative net taxable net income (net of all cumulative tax losses previously allocated to such Partner in all prior years) that has been allocated to such Partner over (b) the aggregate amount of Distributions, including any tax distributions, that such Partner has received from the Partnership.

If total distributions over the life of the partnership have exceeded the maximum required distributions, no tax distribution is necessary. This approach can come as a surprise to some partners. During a booming economy, a partnership may distribute all or substantially all of its income and the partners may invest such distributions in other assets. If the economic boom is followed by an economic downturn, no tax distribution would be required, given that the partnership made distributions in excess of the minimum required tax distributions. This can create a cash shortage for the partners, especially if the partnership is prevented from making distributions other than tax distributions because of an outstanding third-party loan. For this reason, many partnerships avoid cumulative tax distribution provisions.

Still, some partners find it unfair to make a tax distribution to a partner that has previously been allocated losses and is being charged back income with respect to such losses. For this reason, some partnerships utilize a quasi-cumulative approach whereby the managing partner is granted discretion to take into account prior allocations of losses in determining whether to make tax distributions to any partner:

### **Requirement to Make Tax Distributions.**

Before making any distributions pursuant to [reference section of agreement providing for regular distributions] the Partnership must make periodic cash distributions ("Tax Advances") from Net Available Cash Flow to each Partner no less than ten (10) days prior to the quarterly federal estimated income tax payment due dates for individual or corporate taxpayers (as the case may be), in amounts sufficient (taking into account any other Net Cash Flow distributed under [reference section of agreement providing for regular distributions] of this Agreement to such Partner during such relevant quarterly federal estimated income tax period) to enable the ultimate taxpaying owners of the Partner to pay timely federal, state and local taxes attributable to allocations to them under Section X of this Agreement for the tax-

able year of tax items from the Partnership (the “Tax Due”). **In determining the amount that will enable each Partner to pay the Tax Due, the Partnership must take into account the effect of cumulative losses, deductions and carry-overs allocated to each Partner by the Partnership.**

## PROFITS VERSUS TAXABLE INCOME

In determining the amount of tax distributions, a partnership must decide the base for calculating a partner’s share of tax distributions. Some partnerships use the partnership’s “Profits” as the base for making such distributions. Profits are typically defined as the partnership’s taxable income adjusted to take into account other economic items, such as tax-exempt income or nondeductible expenses. For this reason, if the goal of tax distributions is to enable partners to pay their taxes, it is more accurate to base tax distribution calculations off of the partnership’s taxable income rather than its Profits.

Also, using the partnership’s Profits as the basis for making tax distribution fails to take into account the special allocations required under §704(c). Partners contributing property with a fair market value that is in excess of its basis would be well advised to ensure that the tax distribution provisions of the partnership agreement accounts for the special allocations required under §704(c) or they may find themselves without sufficient cash flow to pay their partnership-related tax liabilities. The same issue can arise as a consequence of reserve §704(c) allocations and may impact all legacy partners when admitting a new partner into the partnership.

Adjustments made as a result of a §754 election should also be considered. If a partner purchases the interest of another partner and the partnership has a §754 election in effect, should the partnership make tax distributions to the transferee partner that take into account the §743 adjustments? A partnership that uses “Profits” as the base for making tax distributions would not take such adjustments into account.

By contrast, a partnership that uses taxable income as the base for making tax distributions would automatically take into account the special allocations required under §704(c) and any adjustments made as a result of a §754 election. If the partners wish to exclude these items, language such as the following should be included in the tax distribution provision:

Solely for purposes of this Section X, any election made by the Partnership under Internal Revenue Code §754, and any similar adjustment to basis by reason of a deemed

purchase of assets, shall be disregarded in computing the amount of taxable income allocable under this Agreement to the Partners, and the special allocations required by §704(c) shall not apply.

## DEDUCTIBILITY OF STATE INCOME TAXES

As discussed above, tax distributions typically also include the state income tax liability of the partners. Because state income taxes are deductible against a partner’s federal income, some partnerships provide that in determining the amount of tax distribution, the partnership will take into account the deductibility of state income taxes. Since state income taxes are only deductible to the extent paid in any given year, if a partnership makes all or a portion of its tax distributions after the end of the tax year, the partners must decide whether the partnership should take into account the deductibility of state income taxes based on the assumption that partners paid all state income taxes in the previous year or whether to base the determination off of the timing of its tax distributions. Further, because state income taxes are a preference item in determining alternative minimum taxes,<sup>4</sup> the partners should decide whether to account for the alternative minimum tax adjustments for those partners that are subject to the same.

## PROPORTIONALITY AMONG PARTNERS

Proportionality of tax distributions among partners is another important decision to be made by the partners. Some partnerships make distributions based on the income or profits allocated to each partner versus the percentage interest of the partners. Assume A contributes appreciated depreciable property with a fair market value of \$1 million and B contributes \$1 million cash to a 50/50 partnership. Taking into account the special allocations under §704(c), A’s share of the partnership’s taxable income will exceed B’s share. As discussed above, if the partnership makes tax distributions based on taxable income allocated to each partner, then A’s tax distributions will exceed B’s. Although B may be willing for the partnership to make enough tax distributions to cover A’s tax liabilities, B may not be willing to allow for disproportionate distributions out of the partnership. Under these circumstances, the tax distribution provision can be drafted to state that all tax distributions will be made proportionately based on the percentage interests of the partners:

<sup>4</sup> See §53(d).



To the extent that a Partner is allocated taxable income from the Partnership in any Fiscal Year as a result of such Partner being a Partner, the Partnership shall, to the extent it has funds available, make a Distribution to such Partner within thirty (30) days of the end of each quarter during which such Partner is allocated such income in amounts to be determined as set forth in this Section X. The amount distributable to each Partner shall be equal to the excess, if any, of (a) the total tax that would be due at the Assumed Tax Rate on the cumulative net taxable net income (net of all cumulative tax losses previously allocated to such Partner in all prior years) that has been allocated to such Partner over (b) the aggregate amount of Distributions, including any tax distributions, that such Partner has received from the Partnership; **provided however, that all amounts distributable pursuant to this Section X shall be distributed to the Partners in proportion to the number of Units held by each Partner relative to the total number of Units outstanding.**

## NEW PARTNERS

When buying an interest in a partnership, the partners should take a close look at the tax distribution provisions of the partnership agreement. For instance, if C buys into the AB Partnership in January 2016, should the partnership be able to make tax distributions to A and B in April 2016, for income allocated to them in 2015? Often, new partners are surprised to find that the legacy partners are entitled to tax distributions for income allocated to them before the effective date of the amended and restated partnership agreement. To address this issue, a simple fix would be to state that tax distributions will be made only with respect to any partnership income allocated to the partners after the effective date of the amended and restated partnership agreement.

## INTERPLAY BETWEEN TAX DISTRIBUTIONS AND OTHER DISTRIBUTIONS

Obviously, for a tax distribution provision to have the intended effect, it should take precedence over other distributions otherwise payable to the partners. Thus, phrases such as “Before making any distributions under [reference section of agreement providing for non-tax distributions], the Partnership shall make Tax Distributions under this Section X” should be

used at the beginning of the tax distribution provision to ensure that tax distributions take precedence over other ordinary course distributions. Although this type of provision ensures that tax distributions take priority over other distributions, it can prevent the partnership from making any distributions during the year, especially if the Partnership is required to make tax distributions on an annual basis only and does not typically make such distributions until close to April 15 of the following year. Another approach might be to state “Notwithstanding [reference section of agreement providing for non-tax distributions], the Partnership shall make Tax Distributions under this Section X.” Such a provision would not prevent the partnership from making other distributions during the year, but can leave the partnership without available funds to make timely tax distributions after the end of the year. Thus, it would be helpful for the partnership agreement to include a statement that in making any ordinary course distributions, the managing partner must take into account the obligation of the partnership to make tax distributions and, when appropriate, to set aside reasonable reserves.

Although tax distributions should take priority over other distributions, the partnership would presumably not wish to obligate itself to make tax distributions if other distributions during the tax year have already exceeded the amounts that would otherwise be paid as tax distributions, and may therefore wish to include language such as follows in the tax distribution provision:

The amount to be distributed to a Partner as a Tax Distribution in respect of any Fiscal Year shall be computed as if any distributions made pursuant to [reference section of agreement providing for non-tax distributions] during such Fiscal Year were a Tax Distribution in respect of such Fiscal Year.

## PARTNERSHIP-RELATED INCOME NOT COVERED BY TAX DISTRIBUTIONS

Tax distribution provisions typically cover only the tax liability relating to a partner’s distributive share of income. As such, no tax distributions will be made for items such as gains triggered as a result of the operation of the “mixing bowl” rules under §704(c)(1)(B) or §737 or “hot asset” rules under §751(b). Similarly, no tax distributions will be made with respect to guaranteed payments under §707(c), disguised sales under §707(a), or gains with respect to distributions in excess of basis under §731(a).