Negotiating Partnership Preferred Equity

by Jennifer Ray and Kendra Simpson

Jennifer Ray

Kendra Simpson

Jennifer Ray is a principal and Kendra Simpson is a manager in the Washington National Tax office of Deloitte Tax LLP. They thank Jenny Alexander, Ben Applestein, Matt Sullivan, and Amy Sutton for their helpful comments on earlier drafts.

In this article, Ray and Simpson explore the federal income tax consequences of preferred equity investments in partnerships and the points that should be negotiated before investing, focusing on the consequences of an accruing preferred coupon that is not paid currently.

I. Introduction

With the rise of interest rates, more investors are making preferred equity investments in partnerships. Although terms can vary widely, many preferred equity instruments entitle the investor to both a coupon providing an annual rate of return on invested capital and a preferential return of its capital (in both cases, in priority to the common interests). Sometimes, the investor is also entitled to a preferential return of a multiple of its invested capital in addition to the coupon. Nonliquidating distributions often follow the same waterfall but may not be made currently. Because investors are taxed on partnership income whether they receive the cash or not, partnership agreements may provide for tax distributions to investors and often (but not always) those tax distributions are treated as advances on future distributions.

This article focuses on the federal income tax consequences of a preferred equity investment in a partnership and certain points that should be negotiated by the parties before the investment is made. It focuses on the consequences of an accruing preferred coupon that is not paid currently and discusses the importance of negotiating the tax treatment of the coupon, the tax distribution provisions, and the section 704(c) method.

II. Background

Generally, a coupon on an investor's preferred equity can be treated in two ways: as a guaranteed payment or as an income allocation.[1] The treatment depends on the facts, such as whether the coupon is payable in all events (including out of the other partners' capital), whether the coupon is currently paid, and whether the partnership has income at least equal to the coupon amount. This article does not fully examine the merits of these positions but assumes that either treatment is

[1] An income allocation may also be referred to as a partner's distributive share of income.

possible depending on the terms of the instrument chosen by the partners and seeks to analyze the consequences of each choice.[2]

A. Guaranteed Payments

A guaranteed payment is defined as a payment that is made to a partner without regard to partnership income. Because the fixed coupon on a preferred equity investment usually does not depend on partnership income or profitability, it could in theory end up being paid from the other partners' capital. A guaranteed payment is not an allocation of income. Rather, it is income to the partner and is deductible by the partnership based on the partnership's method of accounting.[3]

B. Income Allocations

Unlike a guaranteed payment, income allocations are made from partnership items of income, gain, loss, and deduction. These allocations are governed by section 704(b). Generally, allocations are determined by the partnership agreement. However, partnership allocations must also have substantial economic effect or be in accordance with the partners' interests in the partnership (PIP).[4]

Broadly, the PIP rules are designed to cause the partnership to allocate partnership items in a way that is consistent with the economic agreement among the partners. In determining PIP, the following factors are among those considered:

- the partners' relative contributions to the partnership;
- the interests of the partners in economic profits and losses (if different than in taxable income or loss);
- the interests of the partners in cash flow or other nonliquidating distributions; and
- the rights of the partners to distribution of capital upon liquidation.[5]

Because PIP is based on facts and circumstances, there may be significant flexibility in making income allocations. Many agreements use targeted allocations that seek to cause capital accounts to equal hypothetical liquidating distributions.[6] This calculation is often done based on the section 704(b) value of the partnership assets at the end of the year, though other approaches are possible.[7] In making these allocations, some partnership agreements provide for allocations of net profit or net loss only, while others allow for allocation of gross items if necessary to cause the partners' capital accounts to equal the amount to which they would be entitled upon liquidation. Increasingly, agreements simply provide that allocations will be made in a manner consistent with the economic provisions of the agreement.[8] In the latter case, the parties may still make allocations to target hypothetical liquidating distributions.

The calculation of section 704(b) income or loss starts with taxable income or loss but is subject to certain adjustments. As relevant here, section 704(b) and taxable income or loss will differ if a partner contributes appreciated or

[2] *See* reg. section 1.707-1(c), Example 2; reg. section 1.707-4(a)(2) ("The term preferred return means a preferential distribution of partnership cash flow to a partner with respect to capital contributed to the partnership by the partner that will be matched, to the extent available, by an allocation of income or gain."); REG-115452-14 (preamble to proposed fee waiver regulations). *See also* Sheldon I. Banoff, "Can Payments to a Partner Based on Net Cash Flow, Sales Revenues, Net Sale Proceeds, or Gains on Sale Be Section 707(c) Guaranteed Payments?" *J. Tax'n* (2023); New York State Bar Association Tax Section, "Report on Guaranteed Payments and Preferred Returns," Rep. No. 1357, at 24 (Nov. 14, 2016); Eric B. Sloan and Matthew Sullivan, "Chapter 124: Deceptive Simplicity: Continuing and Current Issues with Guaranteed Payments," *The Partnership Tax Practice Series* (Oct. 2019). In theory, the coupon could also be treated as a section 707(a) payment, but the payment is being made to the partner in the partner's capacity as a partner, so section 707(c) would be more appropriate to apply to a payment that is not an income allocation.

[3] For more background, see articles cited *supra* note 2.

[4] The substantial economic effect test generally requires liquidating distributions to be made in accordance with capital account balances. *See* reg. section 1.704-1(b)(2). These safe harbor agreements have become increasingly rare, and the examples in this article will assume that the partnership agreement does not provide for liquidating distributions to be made in accordance with capital account balances and that the PIP standard applies.

[5] Reg. section 1.704-1(b)(3)(ii). Other factors may also be relevant.

[6] *See* Todd D. Golub, "Target Allocations: The Swiss Army Knife of Drafting (Good for Most Situations — But Don't Bet Your Life on It)," 87 *Tax Mag.* 157, at 161-165 (2009); NYSBA Tax Section, "Report on Partnership Target Allocations," Rep. No. 1219 (Sept. 23, 2010). Of note, the NYSBA report cited has discussed whether targeted allocations can also satisfy the requirements of substantial economic effect by having "economic effect equivalence." That discussion is beyond the scope of this article.

[7] The hypothetical liquidation could instead be done based on fair market value. In that case, the partnership would need a procedure for determining FMV on an annual basis.

[8] Many partnership agreements with more specific allocation language also provide the general partner with discretion to modify allocations so that they are consistent with the economic arrangement of the partners.

depreciated property or a partnership revalues its assets for section 704(b) purposes. In those cases, the section 704(b) value of the property will differ from its tax basis, so section 704(b) depreciation or amortization will differ from tax depreciation or amortization. Section 704(c) generally requires that the built-in gain or loss in contributed property at the time of contribution be allocated to the contributing partner. If a partnership revalues its property for section 704(b) purposes, any built-in gain or loss at the time of revaluation should be allocated to the partners in the partnership at the time of the revaluation in accordance with section 704(c) principles.[9]

The partnership must use a reasonable method to comply with section 704(c), and three methods are described in the regulations. Under the traditional method, tax allocations of cost recovery deductions to noncontributing partners should generally match section 704(b) allocations. However, tax deductions are limited to the basis in the section 704(c) property, a rule known as the ceiling rule, which can have the effect of the noncontributing partner receiving less in tax depreciation or amortization than section 704(b) depreciation or amortization.[10] Under the traditional method with curative allocations, a partnership can generally allocate other items of income, gain, loss, or deduction to a noncontributing partner to reduce or eliminate disparities created by the ceiling rule.[11] Under the remedial allocation method, a partnership can create remedial items to eliminate disparities between book and tax items for the noncontributing partner. An offsetting remedial item is allocated to the contributing partner.[12] When negotiating section 704(c) methods in connection with partnership investments, ideally the parties will model the effects to the partners because sometimes the results are counterintuitive.[13] This is especially true with a preferred investment.

C. Tax Distributions

Tax distributions are intended to provide partners with enough cash to pay the federal and state income taxes on income allocated to them. Tax distributions are governed entirely by the partnership agreement. Therefore, it is important to consider several different issues. For example, which partnership items are taken into account when calculating tax distributions? Are tax distributions only made for income allocations, or are guaranteed payments included in the calculation? Are section 704(c) items[14] or section 743(b) adjustments included? What tax rates are used to calculate tax distributions (that is, a fixed rate, the rate of a hypothetical person, or different rates for items of different character)? Will tax distributions be made pro rata? Are tax distributions mandatory or at the discretion of the managing member or the board? Will the partnership have available cash to distribute? Are tax distributions permitted by the partnership's loan agreements, and will they be treated as advances?

Tax distributions are often treated as advances on future operating and liquidating distributions in an effort not to distort the economic waterfall.[15] If tax distributions are treated as advances, the investor's return is a pretax return. For example, the preferred investor could be entitled to a 10 percent return on its capital, regardless of the tax the investor has to pay on that return. In some cases, a preferred investor negotiates for a tax distribution that is not treated as an advance. In that situation, the investor is essentially

[9] Reg. section 1.704-3(a)(6)(i).

[10] Reg. section 1.704-3(b).

[11] Reg. section 1.704-3(c). Generally, the items used to cure a ceiling rule limitation are required to be of the same character as the ceiling limited items. Using the traditional method with curative allocations may not result in a complete amelioration of the ceiling limitation, and it is not necessary that it does. The traditional method with curative allocations could have timing benefits for the cash contributor compared with the remedial allocation method.

[12] Reg. section 1.704-3(d).

[13] While modeling will allow an investor to make an informed choice when negotiating, it can be difficult in practice if the preferred investor does not have enough information (*e.g.*, asset basis and value, historical section 704(c) layers, projected future cash flows, etc.).

[14] If section 704(c) items are excluded from the calculation of tax distributions, the parties should also clarify what that means. Does it mean to exclude only remedial income and deductions or curative allocations? Or does it mean to ignore any allocations of depreciation, amortization, gain, or loss on property with section 704(c) layers?

[15] It is still possible for tax distributions to distort the economics. For example, if tax distributions were made for the common interest before the preferred capital has been returned, the partnership may not have enough cash at the time of liquidation to pay the preferred coupon and return the preferred capital. It is rare for a partner (*e.g.*, the common partner) to have to return tax distributions in that scenario, even though the tax distributions were intended to be advances.

negotiating for a post-tax return (a return on capital of a certain percent after taking into account taxes due or deemed due on the return).[16]

III. Examples

The remainder of this article provides examples of how these issues arise when a preferred investment is being made in a partnership. These examples generally assume that the partnership agreement provides for targeted allocations based on section 704(b) value of partnership assets, but as noted earlier, other approaches are possible. The examples show how treatment of a preferred investment can cause a partnership with a net loss to allocate gross income to one partner and a larger gross loss to another (Example 1), how a preferred investor could end up receiving more taxable income than its accruing coupon when a partnership has appreciated assets (Example 2), how a preferred investor could realize taxable income even in a dry partnership (Example 3), and why the section 704(c) method matters to a preferred investor even when it buys a partnership interest from another partner (Example 4).

Example 1: *Cash investment in a start-up operating partnership*. On January 1, J and K each contribute $100 to a new partnership that will start a business. J receives a participating preferred interest, and K receives a common interest. Under the partnership agreement, distributions will be made first to J until J has received an annual preferred return of 10 percent on J's capital, next to J to return J's capital, next to K to return K's capital, and finally 20 percent to J and 80 percent to K. The parties agree that J's return will not be paid currently but rather will accrue and be paid at exit. The partnership expects to have losses in its first few years of operation. In its first year, the partnership expects to have gross income of $100 and deductible expenses of $120, for a total section 704(b) and taxable loss of $20. How might the parties agree to treat J's accruing coupon and allocate the loss to the partners?

Based on the economic deal, if the partnership liquidated at the end of the year and had $180 (original $200 minus $20 loss), it would distribute $10 to J for the coupon, $100 to J to return J's capital, and then the remaining $70 to K. In total, J would receive $10 more than J invested, and K would receive $30 less.

The first decision that must be made is whether to treat the accruing coupon as a guaranteed payment even though it will not be paid currently. In this example, if it is treated as guaranteed payment, generally J would have ordinary income of $10, and the partnership would have an additional $10 deduction. The partnership's loss would increase to $30.

The second decision is how the partnership will allocate taxable income and loss and whether it will allocate net or gross items. As noted, the partnership agreement might target allocations so that the partners' capital accounts at the end of the year equal, as nearly as possible, the amount the partners would receive if the partnership sold its assets and liquidated. If the parties agree to a targeted allocation provision, the first $100 of losses would be allocated to K because, under the distribution waterfall, K bears the first losses, up to K's contributed capital of $100.

If the coupon is treated as a guaranteed payment, J would have income of $10, and the partnership's net loss of $30 would be allocated to K.

If the coupon is not treated as a guaranteed payment, the partnership has a net loss of $20. If the parties agree to allocate net profit and loss only, the net loss of $20 would be allocated to K, and J would not be allocated anything. If the parties agree to allocate gross items to the partners (so that the accrued coupon is matched with current allocations of gross income), J would be allocated $10 of gross income, and K would be allocated the remaining items (for a total of $30 loss to K). In this example, if J is allocated gross income of $10, the results may be substantially similar to guaranteed payment treatment. In other

[16] This may be akin to a gross-up on the preferred return.

situations, there may be character differences between the two.[17]

The three possible allocations are summarized in Table 1.

Table 1. Start-Up Operating Partnership Allocation Possibilities

	J	K
Guaranteed payment	$10	($30)
Net income allocation	$0	($20)
Gross income allocation	$10	($30)

This is a zero-sum game. All three alternatives result in the same total $20 loss allocated among the partners, and all three are consistent with the partnership economics. Treating the accrued coupon as a guaranteed payment or allocating a corresponding amount of gross income to J reflects the economic accrual to J that will burden K's capital if the partnership does not have sufficient profit. On the other hand, J's return is hypothetical until actually paid. J will not receive a distribution of $10 in the first year and usually does not have the right to force the partnership to liquidate to pay the $10. Further, the parties often do not expect the $10 coupon to be paid from K's capital. They expect the partnership ultimately to have a profit (or to be sold at a profit) that will pay J's return. Treating J as receiving a guaranteed payment or receiving an allocation of gross income to reflect J's theoretical economic accrual may be inconsistent with general principles of federal income tax that delay taxation until recognition.

Given these alternatives, the parties should make clear in the partnership agreement how they intend to treat the coupon.[18] If the partnership has losses, is J willing to include current income to give K a current additional deduction? Often, J will not want current taxable income if the coupon is not being paid currently. On the other hand, sometimes J prefers to be allocated income or treated as receiving a guaranteed payment if it means that J will receive tax distributions. For example, J may be an investment fund that wants to make cash distributions to its own partners as quickly as possible. In that case, J may be indifferent to the taxable income allocation as such and happy that it generates a tax distribution. In these negotiations, the partners should also take into account the needs of the business. It may be best for the business to avoid making any distributions of cash (including tax distributions). If the partnership simply allocated a net loss of $20 to K, the partnership would not need to make tax distributions to either partner.

Example 2: *Cash investment in a mature operating partnership*. On January 1, J contributes $100 to a partnership with an existing business in exchange for a participating preferred interest. The other partners have common interests worth $100. Under the partnership agreement, distributions will be made first to J until J has received an annual preferred return of 10 percent on J's capital, next to J to return J's capital, next to the other partners to return their capital of $100, and finally 20 percent to J and 80 percent to the other partners. The parties agree that J's return will not be paid currently but rather will accrue and be paid at exit. The partnership revalues its assets for purposes of section 704(b) in connection with J's investment. Those assets are worth $100, have a tax basis of $0, and would be depreciable on a straight-line basis over five years. In the first year of J's investment, the partnership has gross taxable income of $100 and expenses of $72, for total taxable income of $28. The partnership's section 704(b) income starts with the $28 of taxable income and is reduced by section 704(b) depreciation of $20, for total section 704(b) income of $8. How might the parties agree to allocate the partnership's income and to treat J's accruing coupon?

In these facts, the partners will recognize more taxable income than section 704(b) (economic) income by $20. The partnership's assets are

[17] For example, if the partnership has capital gain, a gross allocation of gain would differ from a guaranteed payment, which would be ordinary. Treatment under the passive activity rules of section 469 may also differ because a guaranteed payment for the use of capital is considered portfolio income for purposes of section 469 while distributive share of income from an operating business might be passive to a preferred investor. Section 199A would have similar issues.

[18] However, even if the partners agree on how they intend to treat the coupon, the IRS may take a different view. Treasury indicated that guaranteed payment treatment or gross income allocations would be proper in situations in which a preferred investor is receiving a guaranteed coupon. *See* preamble to prop. reg. section 1.707-2, REG-115452-14. If a partnership chooses to allocate net income in respect of a preferred investor's coupon, it may not be respected.

assumed to depreciate economically and, for section 704(b) purposes, by $20, but the assets do not have tax basis and, thus, no tax depreciation. As a result, the partnership will have $20 more taxable income than economic income. Which partners will recognize the excess taxable income will depend on whether J's coupon is treated as a guaranteed payment, whether the partnership allocates only net income or loss or also allocates gross items if necessary, and the chosen section 704(c) method.

Further, in this example, treatment of the coupon as a guaranteed payment or not will affect whether the partnership has overall section 704(b) profit or loss, also affecting which partners recognize the excess taxable income. Based on the economic deal, if the partnership has an overall section 704(b) loss, that loss would be allocated to the common. If, however, there is overall section 704(b) income, it would be allocated first regarding the coupon and then 20-80. Here, if the partnership liquidated at the end of the year and had $208 (assets and cash at the beginning of the year of $200 plus section 704(b) income of $8), it would be distributed $10 to J for the coupon, $100 to J to return J's capital, and the remaining $98 to the other partners. In total, J would receive $10 more than it invested, and the common interest holders would receive $2 less. Because the common interest holders bear the first losses (up to $100), but J would be allocated the first profits (up to $10), characterization of the coupon affects which partners are allocated the excess taxable income. In some scenarios, the partnership's section 704(c) method will also be relevant.

If J's accruing coupon is treated as a guaranteed payment, J would have ordinary income of $10, and the partnership would have an additional $10 deduction. The partnership would thus have total taxable income of $18 and a section 704(b) loss of ($2). If the partners agree to use a targeted allocation provision, the partnership's ($2) section 704(b) loss would be allocated to the common interest holders. Tax items follow allocation of section 704(b) items, so the common interest holders would also be allocated the corresponding tax items, which here would equal a total of $18 of taxable income.[19] As noted, the $20 difference between section 704(b) loss of ($2) and taxable income of $18 is caused by the lack of tax depreciation in the partnership assets. On these facts, treating J's return as a guaranteed payment essentially forces the common partners to bear the cost of the lack of tax basis.[20]

If the coupon is not treated as a guaranteed payment, the partnership has net taxable income of $28 and section 704(b) profit of $8.

If the partnership has a targeted allocation provision that allocates only net income, the net section 704(b) income of $8 would be allocated entirely to J to reflect J's accrued coupon. Again, tax items will follow the section 704(b) items so that J is allocated all $100 of gross taxable income, $72 of tax deductions, and $20 of section 704(b) depreciation. The tax consequences to J depend on the partnership's chosen section 704(c) method. If the partnership uses the traditional method, the section 704(b) depreciation of $20 does not have any corresponding tax items, and J would be allocated all $28 of taxable income.[21] If the partnership uses the remedial allocation method, J would be allocated a notional $20 of tax

[19] The partnership's ($2) section 704(b) book loss comprises $100 of income, $82 of deductions (including the guaranteed payment), and $20 of section 704(b) depreciation for partnership assets.

[20] Because there is a section 704(b) loss under these assumed facts, the common interest holders are allocated all of the section 704(b) depreciation for the assets, so the partnership's section 704(c) method on that built-in gain is not relevant this year. Regardless of section 704(c) method, the common partners bear all of the additional tax cost. The common interest holders (who are the deemed contributors of the gain) are recognizing their section 704(c) gain as the asset is being amortized. However, if there were a section 704(b) profit even after the guaranteed payment deduction, that profit would presumably be allocated 20-80 in accordance with common sharing percentages. In that case, the section 704(c) method would be relevant as discussed below.

[21] This is in part a result of the ceiling rule. J is allocated section 704(b) depreciation of $20 and all of the corresponding tax depreciation on the property up to $20, but here, there is no tax depreciation on the property. This is also a result of the bottom-line allocation rule. Under reg. section 1.704-1(b)(1)(vii), an allocation to a partner of a share of partnership net or bottom-line taxable income or loss is treated as an allocation to that partner of the same share of each item of income, gain, loss, and deduction that is taken into account in computing that net or bottom-line taxable income or loss.

Table 2. Mature Operating Partnership Allocation Possibilities

	J	Other Partners	J	Other Partners
	Traditional		Remedial	
Guaranteed payment	$10	$18	$10	$18
Gross income reallocation	$10	$18	$10	$18
Expense reallocation	$29.57	($1.57)	$10	$18
Net income allocation	$28	$0	$8	$20

depreciation, and the common partners would be allocated a notional $20 of taxable income.[22] In total, J would be allocated a net $8 of taxable income, and the common partners would be allocated $20.

Instead, the partnership may have an allocation provision that provides for allocation of gross items "if necessary." Allocation of gross items might be viewed as necessary in this example because the partnership's net section 704(b) income is only $8, but J's coupon in the first year is $10. Thus, allocating only $8 to J does not cause J's capital account to equal J's hypothetical liquidating entitlement. If the partnership agreement provides for allocation of gross items, one simple way to do that would be to allocate $10 of gross income to J and to allocate the remaining items of income and loss to the common interest holders. In this example, this achieves the same result as treating the coupon as a guaranteed payment.[23]

Another way to allocate gross items in this example would be to make a preliminary allocation of all of the items to J but then reallocate enough items of deduction to the common interest holders to cause J to be allocated a total of $10 of section 704(b) income.[24] If taxable deductions and section 704(b) deductions were pulled from J proportionately, J would be allocated $100 in taxable income, $70.43 in taxable deductions, and $19.57 in section 704(b) depreciation.[25] The final tax consequences to the partners also depend on the partnership's section 704(c) method. If the partnership uses the traditional method, J would be allocated $29.57 of taxable income.[26] If the partnership uses the remedial allocation method, J would end up with $10 of taxable income, and the other partners would be allocated $18.[27]

Because multiple allocations are possible, if the partners agree that J's preferred coupon will not be a guaranteed payment, and the partnership agreement provides for targeted allocations with allocation of "gross items if necessary," the parties may also want to agree on what that means (allocating gross items of income first to the preferred partner or allocating gross items of deduction to the common partners). Depending on the facts, it may matter.

[22] J is allocated all of the section 704(b) depreciation. Using the remedial allocation method under section 704(c) would allow the partnership to create a deduction for J equal to J's section 704(b) depreciation, and the partnership would create a corresponding offsetting income allocation for the other partners. The traditional method with curative allocations could also be used to allocate $20 of the taxable income (if the taxable income is of the same character as the depreciation) to the other partners.

[23] As noted above, although the amount of income is the same here, there may be character differences that result from treatment as a gross income allocation as compared with a guaranteed payment.

[24] Alternatively, if a partner needed a section 704(b) loss, the partnership might first allocate the net section 704(b) loss to that partner and then allocate gross income away until the desired section 704(b) loss per partner is achieved.

[25] The partnership items are $100 gross taxable income, $72 deductions, and $20 section 704(b) depreciation. A total of $2 of deductions need to be pulled away from J to cause J to be allocated net section 704(b) income of $10. If the $2 deductions come proportionately from the taxable deductions and the section 704(b) depreciation, the common interest holders would be allocated about $1.57 of taxable deductions ($2/$92 * $72) and about $0.43 ($2/$92 * $20) of section 704(b) depreciation.

[26] This is a result of the ceiling rule. J is allocated section 704(b) depreciation of $19.57 and all of the corresponding tax depreciation on the property up to $19.57, but here, there is no tax depreciation on the property.

[27] J is allocated $19.57 of section 704(b) depreciation. Using the remedial allocation method under section 704(c) would allow the partnership to create a deduction for J equal to J's section 704(b) depreciation, and the partnership would create a corresponding offsetting allocation for the other partners. The traditional method with curative allocations could also be used to allocate $19.57 of the taxable income arising from other property (if the taxable item is of the same character as the depreciation) to the other partners. However, the remedial allocation method does not depend on the partnership having actual items to allocate to reverse the disparity.

The same issues arise if the partnership agreement merely provides that allocations will be made in a manner consistent with the economic provisions of the agreement. To prepare the tax returns, the language will need to be interpreted to determine whether to allocate net profit only or to allocate gross items (and, if gross items, how to do that).

The possible allocations of taxable income discussed above are summarized in Table 2.[28]

All of these alternatives result in the same $28 of total taxable income being allocated to the partners. The question is how it is allocated between the partners. Example 2 highlights that parties to a preferred equity investment should negotiate several aspects of the tax treatment. First, they must decide whether to treat the coupon as a guaranteed payment or an income allocation. Next, if they treat the coupon as an income allocation, they must decide how to allocate income (including whether the partnership will only allocate net profit or loss or whether it will allocate items of gross income or expense). Finally, they must choose a section 704(c) method for any new section 704(c) layers.

Ideally, each of these decision points could be modeled (assuming there is time and it is possible to obtain sufficient information). On these facts, the tax cost of the missing tax basis is borne either entirely by the preferred investor or by the other partners, depending on treatment of the coupon and the chosen section 704(c) method.[29] Treating the preferred coupon (if not a participating preferred) as a guaranteed payment may take some of the pressure off the section 704(c) negotiation while achieving the same result for the preferred investor as remedial allocations.[30]

Tax distributions are also an important factor in preferred investment negotiations. J may prefer to be allocated more taxable income to receive more tax distributions. J may also negotiate to have section 704(c) allocations excluded from consideration in determining tax distributions. For example, J may negotiate for net income allocations using the remedial allocation method but also negotiate for a tax distribution provision that excludes section 704(c) allocations from the calculation. In that case, J would be allocated $8 of taxable income but would receive tax distributions as if J was allocated $28 of taxable income. Assuming a 50 percent tax distribution rate, J could receive tax distributions of $14 even though J is only allocated $8. To the extent J benefits, there is a corresponding detriment to the other partners. The common interest holders would be allocated $20 of taxable income from the remedial allocations but would not receive any tax distributions because the remedial allocations would not be taken into account.[31]

Example 3: *Cash investment in a partnership with operations conducted through a subsidiary C corporation*. On January 1, J and K each contribute $100 to a new partnership that will contribute the cash to a subsidiary corporation to start a business. J receives a participating preferred interest, and K receives a common interest. Under the partnership agreement, distributions will be made first to J until J has received an annual preferred return of 10 percent on J's capital, next to J to return J's capital, next to K to return K's capital, and finally 20 percent to J and 80 percent to K. The parties agree that J's coupon will not be paid currently but rather will accrue and be paid at exit. The partnership's only potential source of income or gain is a dividend or sale of the stock. In the partnership's first year, it has no income. How might the partners agree to treat J's accruing coupon?

Based on the economic deal, if the partnership liquidated at the end of the year and had $200 (its original investment in the corporation of $200 and no income or loss), it would be distributed $10 to J for the coupon, $100 to J to return J's capital, and the remaining $90 to K. In total, J would receive $10 more than it invested, and K would receive $10 less.

---

[28] There may be other possibilities for allocations of taxable income, depending on the facts.

[29] If the partnership uses traditional with curative allocations, it may also be possible to partially cure the ceiling limit so that the partners share the cost of the missing basis.

[30] Although Example 2 illustrates how section 704(c) could result in the surprising scenario of the preferring investor receiving more taxable income than the accruing coupon, taxable income could also exceed the coupon when the preferred coupon is not treated as a guaranteed payment and the section 704(b) income includes nondeductible expenses (including business interest expense disallowed because of section 163(j)).

[31] If the tax distributions are not treated as advances, this scenario creates an iterative allocation issue with targeted allocations.

As in examples 1 and 2, the first question is whether to treat J's accruing coupon as a guaranteed payment. If it is treated as a guaranteed payment, J would have income of $10 and the partnership would have a deduction of $10. The loss would likely be allocated to K because K bears the first economic losses (up to $100). If the coupon is not treated as a guaranteed payment, the partnership would have no income or loss to allocate.

In most cases, J would not agree to have the coupon treated as a guaranteed payment unless J will receive tax distributions. In a dry partnership, however, there is often no cash to distribute. Depending on the facts, a distribution by the corporation to the partnership may be treated as a dividend or result in gain at the partnership level, potentially causing K to be allocated that dividend income or gain. Another problem with guaranteed payment treatment is that, because the partnership is not engaged in a trade or business, if K is an individual (or a partnership owned by individuals), the $10 guaranteed payment deduction would not be deductible by K.[32]

Most of the time, parties in this structure will not treat the accruing coupon as a guaranteed payment and instead will wait to make income allocations when the partnership has income or gain. As in Example 1 above, waiting to allocate an amount to J until the partnership has income or profit is consistent with the economics in that J's return is hypothetical until actually paid. J generally does not have the right to force the partnership to distribute the cash, and the parties generally expect the partnership to have income or profit in the future sufficient to pay the coupon.

Example 4: *Purchase of preferred interest in an operating partnership from another partner*. On January 1, J contributes $100 to a partnership and K contributes business assets worth $100 with zero tax basis, in each case in exchange for 50 percent of the common interests in the partnership. Shortly thereafter, but in an unrelated transaction, L buys 100 percent of K's interest from K for $100.[33] The partnership has a section 754 election in effect. L's interest is recapitalized into a preferred interest. Under the partnership agreement, distributions will be made first to L until L has received an annual preferred return of 10 percent on the $100 purchase price, next to L to return capital of $100, next to J to return J's capital of $100, and finally 50 percent to L and 50 percent to J. The assets contributed by K, which are worth $100 and have a tax basis of $0, would be depreciable on a straight-line basis over five years. In the first year, the partnership has gross taxable income of $100 and expenses of $72, for a total taxable income of $28. As in Example 2, its net section 704(b) income is $8 (because of the $20 of section 704(b) depreciation). How might the parties agree to allocate the partnership's income and to treat L's accrued coupon of $10 from the first year?

First, independent of allocations, if a partnership has a section 754 election in effect or a substantial built-in loss, the purchaser of a partnership interest will have an adjustment to its share of partnership basis under section 743(b). This accounts for the difference between the purchaser's outside basis in the partnership interest and its share of partnership "inside basis." Generally, it is meant to put the purchaser in a similar position as if it had purchased an interest in partnership assets, though, as discussed below, it does not account for the partnership's section 704(c) method.[34] In this case, regardless of the section 704(c) method, L has a section 743(b) adjustment of $100.[35] For purposes of this example, assume the adjustment is depreciable on a straight-line basis over five years at a rate of $20 a year.

[32]While section 212 would normally allow an individual to deduct expenses paid or incurred that are not in connection with a trade or business, section 67(g) disallows all miscellaneous itemized deductions for tax years 2018 to 2025.

[33]Assume K is respected as selling a partnership interest even though it sells 100 percent of its interest shortly after the partnership is formed.

[34]The buyer's section 743(b) adjustment generally matches the buyer's share of net built-in gain in the partnership assets. However, the calculation is static and does not take into account future allocations of depreciation and amortization under section 704(c). *See generally* Gregory J. Marich and William S. McKee, "Sections 704(c) and 743(b): The Shortcomings of Existing Regulations and the Problems of Publicly Traded Partnerships," 41 *Tax. L. Rev.* 627, 660-662 (1986); John G. Schmalz and Elizabeth Amoni, "Applying the Disparity Offset Method to Achieve Tax-Follows-Economics Results," 15(3) *J. Tax'n* 133, 156 (Sept. 2011).

[35]*See* reg. section 1.743-1. This is the excess of L's outside basis ($100) over its share of partnership previously taxed capital, which here is $0 (the amount L would receive in liquidation, $100, over the amount of gain that would be allocated to L if the partnership sold its assets, $100).

Table 3. Partnership Interest Purchase Allocation Possibilities

	L	J	L	J
	Traditional		Remedial	
Guaranteed payment	$10 + ($20) 743(b) adjustment = ($10)	$18	$10	($2)
Gross income reallocation	$10 + ($20) 743(b) adjustment = ($10)	$18	$10	($2)
Expense reallocation	$28 + 1.57 + ($20) 743(b) adjustment = $9.57	($1.57)	$10	($2)
Net income allocation	$28 + ($20) 743(b) adjustment = $8	$0	$8	$0

As in the previous examples, L's coupon could be treated as a guaranteed payment. In that case, L would have income of $10, and the partnership would have an additional deduction of $10, decreasing taxable income to $18 and resulting in a section 704(b) loss of ($2). If the partners agree to use a targeted allocation provision, the partnership's ($2) section 704(b) loss would be allocated to J as holder of the common interests. That allocation would preliminarily include the section 704(b) depreciation of $20 and the net taxable income of $18. Unlike in Example 2, even with the coupon being treated as a guaranteed payment, L's allocations will depend on the partnership's section 704(c) method. Here, although K contributed the appreciated property, when L purchased 100 percent of K's interest, L succeeded to K's status as a contributor for the appreciated property.[36] If the traditional method is used, J would be allocated the section 704(b) depreciation without any corresponding tax depreciation and would bear the cost of the lack of tax basis. In total, J would have $18 of income, and L would have a ($10) taxable loss ($10 of guaranteed payment income and $20 of section 743(b) depreciation). If the remedial allocation method is used, L would be allocated $20 of remedial income, and J would be allocated $20 of remedial deduction. In total, L would have $10 of taxable income ($10 of guaranteed payment income, ($20) of section 743(b) depreciation, and $20 of remedial income).[37] J would have a ($2) loss.

If, instead of guaranteed payment treatment, gross income is allocated to L (as opposed to expenses away from L), the same result is achieved. L could be allocated gross items of income equal to $10, leaving remaining taxable income of $18 and section 704(b) loss of ($2), which again would be allocated to J. The same section 704(c) considerations would apply.

If expenses are instead reallocated, similar to Example 2, if the preliminary allocation of all of the items were made to L and then $2 of deductions were pulled away from L to J, J would be allocated $1.57 of taxable deductions and $0.43 of section 704(b) deductions for its section 704(b) loss of ($2). The same section 704(c) considerations would apply.

Alternatively, if the partnership allocates only net income, the net section 704(b) income is $8. Under an agreement with targeted allocations, that amount would be allocated entirely to L to reflect L's accrued coupon. L would preliminarily be allocated all $100 of taxable income, $72 of tax deductions, and $20 of section 704(b) depreciation. In these facts, the partnership's section 704(c) method does not matter because J was not allocated any section 704(b) depreciation.

The possible allocations of taxable income discussed above are summarized in Table 3.[38]

Tax distributions would again be important. Here, J, the partner who did not contribute section 704(c) property and does not have a preferred interest, may negotiate to have section 704(c) allocations excluded from consideration in determining tax distributions while negotiating for a guaranteed payment or gross income allocations and the remedial allocation method. In that case, J would be allocated ($2) but would receive tax distributions as if J was allocated $18 of

[36] Section 704(c)(3); reg. section 1.704-3(a)(7).

[37] The disconnect between section 743(b) adjustments and particular section 704(c) methods is discussed in Marich and McKee, *supra* note 34.

[38] There may be other possibilities for allocations of taxable income, depending on the facts.

taxable income. Assuming a 50 percent tax distribution rate, J could receive tax distributions of $9 even though J is allocated a loss.[39] L may want to exclude section 743(b) adjustments from consideration. Regardless, the partners should consider the needs of the business for cash when negotiating the tax distribution provisions.

If D had purchased J's interest instead of K's, L would not have gotten a section 743(b) adjustment and would have wanted the partnership to adopt the remedial allocation method instead of the traditional method.[40] The resulting allocations would be the same as those shown in Example 2.

IV. Conclusion

For a preferred equity investment in a partnership, it is important to consider the tax treatment of the coupon and the partnership's section 704(c) method as the investment and distribution provisions are being negotiated. The parties will want to consider the consequences for themselves as well as for the business (regarding tax distributions). However, each term is interdependent on the others, so the negotiation is not as simple as conceding one point while winning another. One combination of tax positions may result in a smaller income allocation to the preferred investor, and another may result in a larger income allocation.

The preferred investor may desire a larger income allocation if it means an increased tax distribution. One or more partners may want to exclude section 743(b) items or section 704(c) allocations from the tax distribution calculations. The partners should also consider the consequences of treating the tax distributions as advances or not.

No negotiating position will be made in a vacuum, but they all will affect the amount of income allocated to an investor and the amount of cash an investor receives regarding that income in any given year. To negotiate effectively, an investor and its advisers should carefully consider the expected consequences of each combination of positions.[41] ■

[39]If K sold less than 100 percent of its interest, both K and L would be treated as contributors under section 704(c) and would be allocated remedial income if the remedial allocation method is used. Because L also has a right to a coupon, the results can be complicated and unexpected.

[40]To the extent that the preferred investment is made after a partnership has adopted a section 704(c) allocation method for a particular property and layer, the partnership would not be able to change that method.

[41]This article contains general information only, and Deloitte is not, by means of this article, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This article is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional adviser. Deloitte shall not be responsible for any loss sustained by any person who relies on this article. Deloitte refers to one or more of Deloitte Touche Tohmatsu Ltd. (DTTL), a U.K. private company limited by guarantee, its network of member firms, and their related entities. DTTL and each of its member firms are legally separate and independent entities. DTTL (also referred to as Deloitte Global) does not provide services to clients. In the United States, Deloitte refers to one or more of the U.S. member firms of DTTL, their related entities that operate using the Deloitte name in the United States, and their respective affiliates. Certain services may not be available to attest clients under the rules and regulations of public accounting. Please see www.deloitte.com/about to learn more about our global network of member firms.