

Targeted Allocations Hit the Spot

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Cavanagh analyzes the economic effect prong of the substantial economic effect test applicable to partnership allocations and discusses traditional allocations as well as targeted and tracking allocations. He describes the function of some of the standard tax boilerplate provisions and suggests that those provisions be included as an appendix to partnership agreements rather than incorporated into the text of agreements. (A sample appendix is included.)

The author compares the traditional "liquidate in accordance with capital accounts" allocation provisions with targeted and tracking allocation provisions that, although not explicitly sanctioned by the regulations, are nonetheless favored by many tax practitioners. He argues that the targeted/tracking allocation "tax follows cash" model is far superior to

the traditional allocation "cash follows tax" model, and he recommends that the IRS provide guidance (regulations or rulings) indicating that targeted and tracking allocations will satisfy the economic effect or alternative economic effect tests.

Cavanagh also recommends that the IRS modify applicable rules to help tax practitioners avoid mistakes in drafting partnership tax allocation provisions, including confirming that the equivalent economic effect test applies to partnerships with qualified income offset provisions; permitting taxpayers to rely on the value-equals-basis rule in determining a partner's interest in the partnership; providing in the regulations that qualified income offset, minimum gain charge-back, and partner non-recourse debt minimum gain charge-back provisions are automatically incorporated into partnership agreements; and providing in the regulations that minimum gain charge-backs automatically carve out any gain that duplicates profits already allocated to the partner.

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This report is a clarion call for action. The section 704(b)¹ substantial economic effect regulations applicable to partnerships desperately need a rewrite. The IRS and tax practitioner groups should make it a high priority to devote significant resources to this project since so many of today's businesses are partnerships.² This report focuses on the economic effect prong of the regulations. The substantiality rules also present several issues that merit reconsideration, but we leave them for another day.³

I. Introduction

A. Cash-Follows-Tax Is Wrong for Clients

Here's the problem. For 20-plus years now, sophisticated tax practitioners have been dutifully following the McKee treatise tax allocation model, memorialized in the section 704(b) safe harbor economic effect regulations. These regulations bless tax allocations when the partnership maintains proper capital accounts reflecting the allocations and agrees to liquidate in accordance with capital accounts. The intellectual and economic underpinning for these rules makes sense. The allocation of tax items has economic significance only if it is matched dollar for dollar in the economics of the deal. The approach is ill-conceived, however.

The safe harbor economic effect regulations are built on the notion that cash follows tax (more appropriately, cash follows book, but we will postpone that discussion), which means that cash is distributed in liquidation the way that taxable profits have been allocated to capital accounts. This requires partners to agree upfront to accept cash from the partnership in liquidation of their interest based on their capital account balances.

Somehow tax practitioners have convinced business folks that they should trust the complicated tax

allocation provisions to produce the correct capital accounts and thus the cash they expected. These business folks would be very surprised (and probably horrified) to learn that the standard impenetrable tax boilerplate provisions, which tax advisers do not (and perhaps cannot) explain, actually bear on the economic results they will enjoy. Anyone explained "qualified income offset" to clients recently?

B. How Did We Get to Cash-Follows-Tax?

How did we get here? Recall that the section 704(b) substantial economic effect regulations were developed when partnerships were being used primarily for tax shelter transactions. The great tax shelter debate at the time for tax practitioners and the IRS alike focused on the tax allocation provisions of tax shelter partnerships. The IRS wanted to develop rules that linked tax and economics. Tax practitioners wanted as much tax certainty as possible.

In this context it is easy to understand why we ended up with a cash-follows-tax capital account liquidation analysis. The regulations were designed to maximize certainty for the tax results, not the economic results. In retrospect, this approach does not seem to serve client interests very well. Why should some arcane section 704(b) capital account rule that no one truly understands determine how much cash the partner is entitled to receive?

C. Where's the Beef?

Well, why haven't there been more problems? One might rightly ask whether this is a solution in search of a problem, since there has not been a huge outcry of disgruntled clients whose economic expectations have been dashed in capital accounts.

How have tax lawyers been so successful in convincing their clients that the traditional "liquidate in accordance with capital accounts" theory works, and why have there apparently been so few surprises? There are several fairly obvious answers. First, who can tell? It can be difficult for businesspeople to determine whether their economic results are the product of capital accounts gone astray or the bona fides of the business deal. Not many tax practitioners step up to blame lousy tax allocation provision drafting for poor economic results. Second, businesspeople are not worried about the liquidation scenario because partnerships typically go on forever, and when they liquidate early, it is probably because the economics fell short of expectations anyway. Third, tax return preparers often ignore the complicated tax allocation provisions and try to come up with the right economic result. Fourth, during the life of the partnership, the partnership's distribution of cash to pay taxes probably covers a lot of unpleasant surprises and other sins,

¹Section references are to the Internal Revenue Code unless the context indicates otherwise. The term "partnerships" as used in this report refers to all entities classified as partnerships for federal income tax purposes.

²It was a welcome development at the July 10, 2010, New York State Bar Association (NYSBA) Tax Section's summer meeting to receive some reassurance about the efficacy of targeted allocations from Curtis Wilson, IRS associate chief counsel (passthroughs and special industries). Amy S. Elliott, "IRS to Address Problems Caused by LLC Guidance," *Tax Notes*, July 19, 2010, p. 258, *Doc 2010-15509*, 2010 TNT 134-3. See also recently released NYSBA Report on Partnership Target Allocations, Sept. 23, 2010, *Doc 2010-20877*, 2010 TNT 185-18.

³For insightful discussion of substantiality, see the recently released NYSBA Report on Partnership Target Allocations, September 23, 2010, *Doc 2010-20877*, 2010 TNT 185-18. See also Richard M. Leder, "Tax-Driven Partnership Allocations With Economic Effect: The Overall After-Tax Present Value Test for Substantiality and Other Considerations," 54 *Tax Law.* 753 (2001).

which provides a cushion for tax practitioners. Fifth, there is some fairly uniform tax boilerplate that protects against most tax traps for the unwary, even for unsophisticated tax advisers, unless the tax boilerplate is unwittingly tinkered with for “simplification” purposes. And sixth, buyers and sellers rarely consider capital accounts when pricing partnership interests.

D. Scope and Coverage of Report

The preceding section underplays the problems and overstates the acceptance of capital account liquidation partnerships. In fact, many sophisticated tax practitioners now use tax allocations that do not drive liquidations. Many less sophisticated tax practitioners use traditional capital account allocation provisions but miss some of the nuances and fall short of the mark. And many even less sophisticated practitioners draft simple tax allocation provisions that do not even try to hit the mark. No matter how well conceived the section 704(b) economic effect regulations may have been, they are no longer carrying the day. It is time for a thoughtful reexamination.

This report is divided into the following sections: Part II provides an overview of the existing economic effect regulatory scheme. This section covers little new ground and can be skipped by partnership tax mavens. Part III serves two functions. It describes selected aspects of this regulatory scheme to explain briefly to our corporate colleagues the function of some of the tax boilerplate and convoluted provisions they always want to edit, pare down, or remove. As part of this exercise, we suggest specific steps the IRS can consider taking to eliminate some of the unnecessary traps for the unwary in the section 704(b) economic effect rules. Part IV discusses targeted allocations, Part V discusses tracking allocations, and Part VI discusses taxable income allocations.

E. Recommendations

This report proposes a partial fresh start.

First, the existing economic offset regulations should be retained because they are based on a solid economic premise. The regulations should be updated and refined.

Second, the regulations should expand the tax-oriented provisions that are deemed to be included in partnership agreements. The code and regulations mandate section 704(c) and reverse section 704(c) allocations, section 754 adjustments (in some cases), minimum gain chargebacks, and some capital account adjustments. The list can be expanded to include qualified income offsets, gross income allocations, and so on, so that the mere failure to include one of those provisions is not automatically fatal.

Third, the regulations should explicitly sanction tax allocation methods that do not drive liquidations of capital accounts but achieve similar economic symmetry between cash and tax. Two such methods are targeted allocations and tracking allocations.

Fourth, consideration should be given to developing an alternative tax allocation scheme that has as its starting point allocating taxable profits and losses (rather than book profits and losses). This would be a useful exercise, since many partnership agreements are drafted from this perspective and often do not contain much more tax plumbing.

II. Section 704(b) Economic Effect Tests

Under section 704(b), a partnership’s allocation of income, gain, loss, deduction, or credit (or item thereof) must have “substantial economic effect.” If not, the allocation is determined — taking into account all the facts and circumstances — in accordance with the “partner’s interest in the partnership.” There are two components to the substantial economic effect test: The allocation must have economic effect, and the economic effect must be substantial.⁴ Allocations are generally tested item by item, but the tests are equally applicable to the more typical allocation of bottom-line income or loss.⁵ In layman’s parlance, the tax allocation provision must be consistent with the allocation of risks and opportunities in determining each partner’s economic reward from the partnership.

The regulations provide that the tax allocation provision in a partnership agreement is valid if it satisfies one of three tests:

- the allocation has substantial economic effect;
- the allocation is in accordance with the partner’s interest in the partnership; or
- the allocation is deemed to be in accordance with the partner’s interest in the partnership.⁶

The varied versions of these tests are summarized in Appendix A.

The first two types of tests, substantial economic effect and the “partner’s interest in the partnership” test, look to who bears the economic benefit or suffers the economic burden of items of income and loss, respectively. Generally, the results should be the same under both tests.

The third type of test, “the deemed interest in the partnership” test, provides rules for allocating tax items that have no economic counterpart (for example, nonrecourse deductions).

⁴Reg. section 1.704-1(b)(2)(i).

⁵Reg. section 1.704-1(b)(1)(vii).

⁶Reg. section 1.704-1(b)(1)(i).

A. Safe Harbor Economic Effect Test

1. Mechanical test. The safe harbor economic effect test is mechanical and requires the partnership agreement to contain specific boilerplate provisions designed so that the tax allocation provisions, positive and negative, have a dollar-for-dollar effect on the aggregate amount of money each partner receives over the life of the partnership. The regulations establish three requirements for the safe harbor economic effect test:

Capital accounts: Capital accounts must be maintained as provided in the regulations.

Liquidating distributions: Liquidating distributions must be made in accordance with positive capital account balances of the partners.

Deficit restoration makeup: Partners with negative capital account balances must be obligated unconditionally to restore the amount of a deficit balance in the partner's capital account if his interest is liquidated.

2. Capital account maintenance.

a. In general. The first prong of the economic effect safe harbor is the requirement that the partnership maintain capital accounts in accordance with complex rules set forth in the regulations. These rules legitimize and indeed mandate the proverbial second and third set of books. One set must be kept on an income tax basis, a second set must be kept on a tax-book basis, and when applicable, a third set must be kept on a generally accepted accounting principles basis.

The tax regulations detail what it takes to properly maintain capital accounts. Positive adjustments are generally made for:

- contributions of money;
- contributions of property (based on fair market value net of liabilities as defined in section 752);
- tax-exempt income; and
- allocations of income and gain.

Negative adjustments are generally made for:

- distributions of money;
- property distributions to the partner (based on FMV net of liabilities as defined in section 752);
- nondeductible expenditures; and
- allocations of loss or deductions.

b. Capital account revaluation. The regulations permit capital accounts to be revalued and adjusted in the event of partner contributions and partnership distributions.⁷ This is effected by allocating the unrealized gain to the existing partners.⁸ This book

up or book down is designed so that tax results correspond with economic results.

c. Capital accounts and transfers of partnership interests. No adjustments are made to partner capital accounts in the event of a transfer of a partnership interest even if the transfer results in a technical tax termination of the partnership. Existing partners continue with their existing capital accounts. The new transferee partners inherit the capital accounts of their transferor.⁹ This is true whether or not a section 754 election is in effect. (The section 754 election effectively provides the new partner with a tax basis step-up in its share of the underlying assets.)

This no-capital-account-adjustment result for transfers is a function of the economic role played by capital accounts under the regulations. Capital accounts determine the amount of money the partner is ultimately entitled to receive from the partnership. The rights of partners in partnership liquidation proceeds cannot be altered merely because one partner takes ownership of a former partner's interest. As a corollary, this also puts great pressure on capital account computations because the new partner needs to know the amount of the capital account.

Observation: Query how many of us have been involved in partnership-sale transactions in which the transferee partner did not even ask about the amount of the capital account, much less deeply delve into the computations. And even when transferee partners ask, the capital account computations are often not maintained with great care and precision, and in any event are woefully out of date, because the tax returns for the previous year have not been filed. Does this raise any questions about the real-world economic significance of capital accounts?

3. Liquidating in accordance with capital accounts.

a. In general. The second prong of the economic offset safe harbor is the requirement that the partnership liquidate in accordance with positive capital account balances.¹⁰ Under the regulations, capital account balances are determined after taking into account all capital account adjustments for the year. The regulations require that liquidating distributions be made to the partner by the end of the tax year of that liquidation (or, if later, within 90 days after the date of the liquidation). The partnership is permitted to book up capital accounts at the time of

⁷Reg. section 1.704-1(b)(2)(iv)(f) and (g).

⁸Reg. section 1.704-1(b)(2)(iv)(f)(2).

⁹Reg. section 1.704-1(b)(2)(iv)(l).

¹⁰Reg. section 1.704-1(b)(ii)(b)(2).

liquidation, giving the retiring partner the benefit of any appreciation in partnership assets.

This requirement backstops — or more properly, gives purpose and economic substance to — the requirement that the partnership maintain proper capital accounts. If capital accounts are disregarded for purposes of determining cash distributions in liquidation or otherwise and do not affect the economics, capital account maintenance does not itself have any economic substance.

b. Purchase instead of liquidation. The regulations permit the partnership or the partners to buy out a partner (other than in a complete liquidation) under an arm's-length agreement between persons who at the time of the agreement have "materially adverse interests," provided that a principal purpose of the purchase and sale is not to avoid the principles of liquidating a partner's interest in accordance with capital accounts.¹¹

The scope of this provision is unclear. It may apply, for example, to sanction a formula price buyout of a partner when the partners want to avoid the need to determine FMV on the buyout date. Similarly, the provision may sanction a bargained-for redemption price, eliminating the risk that the IRS could argue that the purchase price did not reflect FMV and therefore the partners never intended to liquidate in accordance with capital accounts.

Observation: Query whether the provision would sanction the use of a formula price, embedded in the partnership agreement, for determining the value of various classes of partnership interests in the event the partnership was sold. Some partnership agreements provide that classes of interests with the same economic rights during the life of the partnership are to receive the same amount of sales proceeds even when capital accounts differ. The rationale is that the likelihood of liquidation is so low on a present value/actuarial basis that the two classes of interests have equivalent value. This is a sound economic judgment, but it underscores a flaw in the capital account liquidation construct.

c. Liquidation includes section 708 liquidation. The term "liquidation" includes a section 708(b)(1)(B) constructive liquidation (sale or exchange of a 50 percent or greater interest in profits and capital). The regulations indicate that partners

are not required to restore deficits in the event the partnership termination is caused by a sale or exchange.¹²

d. Liquidation: Not a state law test. The regulations eschew reliance on state law and provide a uniform rule, applicable to all partnerships, that a partnership liquidation occurs on the earlier of a technical tax termination under section 708(b)(1)(b) or the date on which the partnership ceases to be a going concern (even though it may continue for purpose of winding up its affairs, liquidating its debts, and distributing remaining amounts to creditors). While a person continues to be a partner under reg. section 1.761-1(d) as long as she is owed money by the partnership and is entitled to liquidating distributions, the regulations provide that if a liquidation is artificially delayed for a principal purpose of deferring the partner's obligation to restore a deficit, the deficit make-up provision is deemed violated.

4. Deficit makeup. The third prong of the safe harbor economic effect test requires partners with a deficit in their capital account to "unconditionally restore" the amount of the deficit before the end of the year of liquidation (or within 90 days), with the amount being paid either to creditors or to other partners with positive capital account balances. Most partners balk at signing up for unlimited liability, so the regulations have an alternative test, discussed below, which effectively permits partners to claim deductions up to the amount of their capital account balances and then some,¹³ provided the partnership agreement contains a "qualified income offset" provision.

5. Is there economic reality to the economic effect safe harbor? The economic substance of the capital account liquidation requirement is undercut by at least five features. First, there is no requirement that the partnership make nonliquidating distributions in accordance with capital accounts. The effect is that the provision at the heart of the economic effect analysis rarely comes into play.

Second, it is unclear under the regulations — and often unclear under the partnership agreement — what distributions should be treated as liquidating distributions or regular distributions. Partnership agreements often draw a different business line between operating cash flow versus cash flow from capital events (that is, sales and leveraged financings).

Third, partnerships rarely liquidate. Businesspeople might argue hard and long about how cash from a capital event should be distributed. They

¹¹Reg. section 1.704-1(b)(2)(ii)(b).

¹²Reg. section 1.704-1(b)(2)(iv)(b).

¹³Reg. section 1.704-1(b)(2)(ii)(D).

rarely get as worked up about how cash on liquidation should be distributed, other than as a subset of the business terms for distributions generally or capital events generally.

Fourth, as discussed, partners often buy and sell partnership interests without paying much attention to capital account balances.

And fifth, the economic effect tests do not take into account time value of money principles, which are really the heart of economics.

Observation: The safe harbor economic effect test takes a somewhat simplistic snapshot of partnership economics to determine whether a partnership allocation has economic effect. This rough justice was necessary for the rules to be administrable. But since the rules represent only rough justice, perhaps it is appropriate to consider whether there should be alternative approaches.

B. Alternate Test for Economic Effect

1. In general. Most partnerships do not contain a deficit restoration obligation and therefore seek to satisfy the so-called alternate test for economic effect.¹⁴ The alternate economic effect safe harbor requires the same capital account maintenance and capital liquidation as under the basic economic effect safe harbor, but it does not require deficit restoration. The trade-off for eliminating deficit restoration is that partners without a deficit restoration obligation are permitted loss allocations only up to the amount of their capital accounts. For this purpose, a partner's capital account is adjusted to include the partner's share of minimum gain (or partner minimum gain), which is treated as a deemed deficit restoration obligation. (Minimum gain is discussed in Part II.E below.) Also, capital accounts are adjusted for some anticipatory items. See II.B.2 below.

The alternate test for economic effect does not affect loss allocations of nonrecourse deductions and partner nonrecourse deductions. (Nonrecourse deductions are discussed in Part II.E below.) Those deductions have their own allocation rules independent of the substantial economic effect test.

As a technical matter, for partnerships meeting the alternate safe harbor test, the partnership allocation is deemed to have economic effect to the extent the allocation does not cause or increase a deficit balance in the partner's capital account in excess of the deemed deficit restoration obligation amount (via minimum gain and partner minimum gain chargeback) plus any actual deficit restoration obligation.

2. Anticipatory downward capital account adjustments. Under this alternate economic effect test, some downward adjustments are made to a partner's capital account that reduce the partner's ability to absorb losses under section 704(b). These adjustments provide for hypothetical reductions in the capital account of a partner for specified adjustments, allocations, or distributions that are reasonably expected to be made as of the end of the year in which the allocation is to be made. These adjustments include reasonably expected depletion allowances, reasonably expected loss and deduction allowances, and reasonably expected distributions in excess of corresponding increases in capital account.¹⁵

Depletion: The capital account must be reduced for all reasonably expected (whatever that means) depletion allowances for oil and gas properties. Although this provision seems odd, it is needed because depletion is deductible at the partner level as opposed to the partnership level.

Reasonably expected future deductions: Capital accounts must be reduced for future allocations of loss or deductions that are reasonably expected to be made under section 704(e)(2) (family partnerships), section 706(d) (changes in interests during the year), and reg. section 1.751-1(b)(2)(ii) ("hot" assets).

Distributions: The capital account must be reduced for distributions that are reasonably expected to be made after year-end to the extent those distributions exceed any reasonably expected offsetting capital account increases attributable to profits for the year.

For determining whether reasonably expected distributions will be matched by reasonably expected profit allocations, the presumed value of property is tax basis (book value), not FMV. The effect is that if the partnership has cash that it reasonably expects to distribute next year, profits from a sale it also reasonably expects to make cannot be taken into account under the "value equals basis rule" to eliminate the need for the capital account adjustment. By contrast, no adjustment is required if the cash reasonably expected to be distributed arises from the sale itself, because the value-equals-basis presumption applies to both the availability of the cash and the amount of profits reasonably projected.

3. Qualified income offset. As discussed, reg. section 1.704-1(b)(2)(ii) requires capital accounts to be

¹⁴Reg. section 1.704-1(b)(2)(ii)(D).

¹⁵Reg. section 1.704-1(b)(2)(ii)(d)(4) through (d)(6).

reduced by specified reasonably expected adjustments, allocations, or distributions. The qualified income offset requirement backstops this rule by requiring a chargeback for partners who unexpectedly receive such an adjustment, allocation, or distribution.

The qualified income offset technically allocates items of gross book income when there is a disparity between taxable income and book income. This allocation consists of a pro rata portion of each item of partnership income and gain for the year. Taxable income and gain are allocated under section 704(c) principles in cases of a book-tax disparity.

4. Practical aspects of alternate economic effect test. These rules effectively sanction allocating losses and deductions to a partner to bring its capital account to zero. As a backstop, these rules require the partnership to look forward to determine whether there are reasonably predictable future events that would bring that partner to a deficit in a subsequent year. If there are such future events, the regulations require that those amounts be taken into account in determining the amount of loss or deduction that can be allocated currently. If future events that were not reasonably expected bring the partner into a capital account deficit position, the qualified income offset provision allows special allocations of income (including gross income) to cure the partner's capital account deficit.

Observation: Query how often the anticipatory downward adjustment and the qualified income offset come into play. It is probably the rare partnership that concludes it cannot allocate deductions to a partner in year 3 that would bring her capital account to zero because a distribution to the partner is reasonably expected in the following year or two or three that will exceed the partner's share of income in the next year. In most cases tax return preparers will not even think about the next year. If they give next year so much as a fleeting thought, they will probably conclude that (1) there is enough uncertainty surrounding the cash distributions that they are not reasonably expected, or (2) even if cash distributions are reasonably expected, it is uncertain enough that there will not be offsetting income allocations to ignore the rule.

Observation: Perhaps the only circumstance in which these rules (anticipatory adjustments and qualified income offsets) may come into play as a practical matter is when the partnership has cash available at year-end to distribute. In that case, it may be inappropriate to allocate losses to the partner to take her capital account down to zero when cash out of that year's earnings will be distributed. For the

typical partnership, which does not file a tax return before the summer at earliest, these facts should be ascertainable.

C. Economic Effect Equivalence

There is a third test, the economic equivalence test, that treats some tax allocations that do not otherwise satisfy the safe harbor economic effect tests as deemed to have economic effect.¹⁶ This rule, which the IRS calls the "dumb but lucky" rule,¹⁷ can apply to partnership agreements devoid of the three provisions needed to satisfy the economic effect test (capital accounts, liquidating per capital accounts, and unlimited deficit restoration). Tax allocations are deemed to have economic effect if a liquidation of the partnership at the end of that year or any future year would produce the same results that would occur if the three requirements of the primary economic effect tests had been met.

There are two noteworthy points about this test. First, it sanctions tax allocations missing the magic words that as an economic matter would otherwise pass muster under the safe harbor economic effect test (which requires deficit restoration), but not those that would otherwise pass muster under the alternate economic effect test (which substitutes a qualified income offset for deficit restoration). While at first blush that appears to be a curious omission, it probably never occurred to the IRS regulation writers that the drafter of a dumb-but-lucky tax allocation provision would have had the foresight to include a qualified income offset provision. This becomes relevant for targeted allocations.

Second, the test requires uniformity of result "regardless of the economic performance of the partnership." The scope of this requirement is unclear. Query whether it requires the tax allocation provisions to be tested under facts that do not yet exist (for example, the partnership has nonrecourse debt; partners have deficit capital accounts, etc.).

At least one notable author has concluded that the equivalent economic effect test may have no application unless the partner has a deficit capital account restoration provision.¹⁸ That author contends that the result should be the same even when the partnership agreement prohibits loss allocations in excess of capital accounts and contains a qualified income offset provision. (This is the case with targeted allocations discussed in Part III below.) This would render the equivalent economic effect test a virtual dead letter because most partnerships

¹⁶Reg. section 1.704-1(b)(2)(ii)(i).

¹⁷See IRS, "MSSP Audit Technique Guide on Partnerships," at 6-8 (Dec. 1, 2002), *Doc* 2003-26024, 2003 TNT 241-26.

¹⁸See Terence Floyd Cuff, "Several Thoughts on Drafting Target Allocation Provisions," 87 *Taxes* 171, 188 (2009).

these days take the form of limited liability companies (because no one wants unlimited liability) and state law partnerships rarely contain deficit restoration obligation. Presumably the commentator's response would be that the provision was written in a simpler time when there were general partners and general partnerships and that its scope was intentionally limited.

This narrow reading of the regulation is inconsistent with the clear intent of the regulation to provide a safety net for unsophisticated taxpayers and their advisers when the tax allocations and economic results match through no fault of their own.¹⁹ It would serve no one's interest to limit this regulation so narrowly, forcing partners into the briar patch of "partner's interest in the partnership" described below where, unlike here, the value equals tax basis (book value) presumption is unavailable. That would not be a wise use of IRS resources.

Still, since there is contrary commentary, IRS guidance on this point would be helpful.

Recommendation 1: The IRS should issue a notice or revenue ruling (1) confirming that the equivalent economic effect test applies to a partnership with a qualified income offset, and (2) describing the circumstances in which it applies to a partnership without a deficit restoration provision when the partners do not or cannot have a capital account deficit.

D. Partner's Interest in the Partnership

1. Facts and circumstances test. Partnerships that do not satisfy the economic effect safe harbors are required to make tax allocations based on the partner's interest in the partnership.²⁰ The "partner's interest in the partnership" test is based on the economics and, in most cases, looks to the effects of the allocation on partner's capital accounts and how cash would be distributed on a hypothetical liquidation of the partnership. The test asks how income and loss items would be allocated so that, if the partnership is liquidated under the liquidation provisions of the partnership agreement, distributions would be made in accordance with capital accounts.

The regulations provide little guidance on how to determine a partner's interest in the partnership, perhaps reflecting the drafters' desire to encourage reliance on the safe harbor economic effect and alternate economic effect tests (or their conclusion that the rules were so well formulated that every-

one would comply). Perhaps too the drafters had run out of steam (and time) on the project.

The regulations state the general rule that a partner's interest in the partnership is based on "the manner in which the partners have agreed to share the economic benefit or burden (if any)" of partnership items. The regulations indicate that the partner's share should be determined item by item if the partner's economic interest in an item differs from the bottom-line sharing.

The regulations identify four facts and circumstances to be weighed, including:

- the partners' relative contribution to the partnership;
- the partners' interests in the economic profits and losses if different from those in taxable income and loss;
- the partners' interests in cash flow and other nonliquidating distributions; and
- the partners' rights to distributions in liquidation.²¹

Observation: Initially, this facts and circumstances test appears to call for a much more nuanced analysis than the economic effect safe harbor, which focuses almost exclusively on the economic results in liquidation. However, the first three factors (contributions, profits and losses, and cash flow distributions) may all be subsumed in the fourth factor (liquidating distributions). Still, the regulation does not give much guidance on how the liquidating distributions factor should be applied. The regulations do not incorporate the value-equals-tax basis (book value), which may mean the analysis should be based on FMV. Also, it is conceivable that when the sale of property triggering minimum gain or a liquidation is unlikely or distant, the partnership should match tax allocations and cash distributions on a more current basis rather than wait for the fix-up allocations.

The unavailability of the value-equals-tax basis (book value) presumption could work for or against taxpayers. For example, the effect of tax allocations on the relative economics among the partners might be very different depending on the value of the partnership's assets. This is examined further in the targeted allocation discussion below.

As a practical matter, it will usually be difficult for IRS agents and taxpayers to cope with all the permutations that would be triggered by these valuation and timing uncertainties. It would be

¹⁹For what it's worth, the IRS market segment specialization paper on partnerships, *supra* note 17, does not suggest at all that the provision should be construed so narrowly.

²⁰Reg. section 1.704-1(b)(3).

²¹Reg. section 1.704-1(b)(3)(ii).

helpful for the IRS to issue additional guidance on the partner's interest in the partnership test.

Recommendation 2: The IRS should consider whether it would be appropriate to give taxpayers the option to rely on the value-equals-tax basis (book value) rule in determining a partner's interest in the partnership. (It would be inappropriate to make the value-equals-basis rule mandatory, because the partner's interest in the partnership test turns on the economics.) The IRS should also consider additional simplifying conventions (for example, assume year-end liquidation).

2. Special rule for partnerships that maintain capital accounts but lack deficit restoration or qualified income offset. The partner's interest in the partnership regulations contain a special rule that gives the partnership allocations more certainty when the partnership maintains proper capital accounts and liquidates in accordance with positive capital accounts.²² Allocations are then made by determining how distributions and contributions would be made if the partnership were liquidated at year-end.

This special rule applies when the partnership fails the economic effect test solely because of the lack of either a deficit restoration makeup obligation or a qualified income offset. The partner's interests in the partnership are determined by comparing the hypothetical results of a current-year liquidation with a final-year liquidation. The result is adjusted for items set forth in the alternate test for economic effect (for example, reasonably expected future distributions in excess of offsetting capital account adjustments). For taxpayers maintaining proper capital accounts and liquidating in accordance with capital accounts, this rule provides some certainty, because it incorporates the simplifying and administrable value-equals-tax basis (book value) presumption.

E. Nonrecourse Deductions

The substantial economic effect rules apply principally to so-called recourse deductions — deductions funded by capital contributions or partnership liabilities when a partner has personal liability, including nonrecourse liabilities guaranteed by a partner.

There are special classes of allocations that are not subject to the substantial economic effect rules:

- nonrecourse deductions;
- partner nonrecourse deductions;
- minimum gain chargeback allocations;

- partner minimum gain chargeback allocations; and
- qualified income offset allocations.

The tax regulations²³ recognize that deductions attributable to nonrecourse debt (for example, depreciation attributable to nonrecourse purchase price financing) can never have economic effect on the partners because the lender, not the partners, suffers the economic loss associated with a corresponding value decline. When property has been acquired with equity cash and nonrecourse financing, it is only the depreciation deductions in excess of the equity cash that are treated as nonrecourse deductions, because the partners are at risk for the equity cash.

The regulations²⁴ treat allocations of nonrecourse deductions as being in accordance with the partners' interests in the partnership if they satisfy the following requirements:

Capital account maintenance: Capital accounts are properly maintained, liquidating distributions are required to be made in accordance with positive capital account balances, and partners agree to a deficit restoration obligation or to a qualified income offset.

Nonrecourse deductions: Nonrecourse deductions are allocated in a manner that is reasonably consistent with allocations that have substantial economic effect of some other significant partnership item attributable to the property securing the nonrecourse liabilities.

Minimum gain chargeback: The partnership agreement contains a minimum gain chargeback provision.

Otherwise compliant: All other material allocations and capital account adjustments are recognized under reg. section 1.704-1(b).

Minimum gain is the gain that would be realized by the partnership if the property securing the nonrecourse debt were sold in a taxable transaction for an amount equal to the nonrecourse liability. Partners are permitted to increase their capital accounts by their share of minimum gain in determining whether an allocation of losses would give rise to a deficit capital account. A partner's capital account adjusted to reflect this increase is called the "adjusted capital account."

Under the minimum gain chargeback provision, if there is a decrease in minimum gain, for example, from a sale of property or repayment of debt, the partnership allocates income or gain at that time to

²²Reg. section 1.704-1(b)(3)(iii).

²³Reg. section 1.704-2(b)(1).

²⁴Reg. section 1.704-2(e).

the partner who previously enjoyed the economic benefit of the nonrecourse deductions associated with the property.

III. What Does the Tax Boilerplate Mean?

Part II above describes in general terms the basic regulatory scheme for tax allocations that satisfy the safe harbor economic and alternate economic effect tests.

Part III is intended as a plain English roadmap explanation of the extensive tax boilerplate that implements this regulatory scheme. It describes what can go wrong if the boilerplate is not there, and it suggests specific steps the IRS can take to eliminate some of the unnecessary traps for the unwary in the section 704(b) economic effect rules. See Appendix B for a sample tax boilerplate.

A. The Boilerplate

The well-considered partnership agreement drafted by experienced tax practitioners contains tax boilerplate provisions that satisfy the safe harbor alternate economic effect test. Our corporate colleagues are often tempted to simplify the provisions for a particular deal. Sometimes this is even appropriate. But to prevent inappropriate tinkering, many firms have moved the tax boilerplate provisions to an appendix in their model partnership agreements.

The traditional partnership agreement seeking to satisfy the alternate economic effect safe harbor contains the following provisions:

- proper maintenance of capital accounts;
- liquidation in accordance with positive capital account balances;
- qualified income offset in lieu of a deficit restoration obligation;
- nonrecourse deductions allocated under one of the special allocation provisions in accordance with a permitted sharing ratio;
- minimum gain chargeback;
- gross income allocation;
- curative allocations; and
- tax distributions to cover quarterly taxes.

All but the last provision address regulation requirements. The final item (tax distributions), which is not required by the tax regulations, has been added somewhat jocularly to this list to underscore the point that the tax distribution provision can hide or soften the blow of surprises in the tax allocations.

B. What Does It Mean?

1. Why do the tax allocation provisions allocate book profits and losses, which take a full page to define, rather than taxable income? One of the more baffling aspects of partnership agreements is that the general tax allocation provisions do not

actually allocate taxable income; they allocate book income, with adjustments. The allocation provisions allocate book income rather than taxable income because the section 704(b) economic effect rules apply to allocations of book income, not taxable income.

The term “book income” in this context is a bit of a misnomer; it is a partnership tax concept that has nothing to do with GAAP or accounting income. Book income and taxable income are each determined based on income tax principles. The difference is the starting point. Taxable income uses the tax basis of an asset as the starting point. Book income uses the book value of the asset as the starting point. The initial book value of an asset is generally FMV, even if the tax basis of the asset is lower (for example, because the asset was contributed to the partnership).

In the simple case in which each partner contributes a pro rata amount of cash to the partnership at the same time and the partnership uses the cash to buy property, book income and taxable income are the same because the tax basis and book value of each asset acquired by the partnership is initially FMV.

Taxable income and book income differ, however, when:

- partners contribute appreciated or depreciated property to a partnership;
- one or more partners receive a non-pro-rata distribution of appreciated or depreciated property from the partnership;
- one or more partners receive a carried interest or a profits interest in the partnership; and
- an existing or new partner makes cash contributions to the partnership that are not pro rata to the initial cash contributions.

In each case, partnership assets and capital accounts must be revalued to FMV for book purposes to prevent an inadvertent shifting of value to or from partners. The resulting disparity between the book value and tax basis of the assets gives rise to a difference between book income and taxable income.

Example: A and B contribute \$100 each to AB Partnership for a 50 percent interest, and AB buys Blackacre for \$200. When the value of Blackacre has increased to \$300, C contributes \$100 for a 25 percent interest. The capital accounts of A and B are increased (booked up) to \$150 each.

If the partnership sells Blackacre the next day for \$300 FMV, A and B but not C should pay tax on the \$100 gain because C has not realized any economic benefit from the appreciation. This is accomplished by booking up the book value of partnership property from \$200 to \$300 when C joins the partnership.

Taking into account the \$100 cash contributed by C, the partnership now has a total \$400 book value. Future section 704(b) allocations of partnership profits or losses are based on this \$400 book value. Thus, when the partnership sells the property for \$300, it has zero book gain (\$300 sales price less \$300 book value). Then special adjustments are made under section 704(c) for A and B to account for the \$100 difference between book income and taxable income.

This book value versus tax basis dichotomy is embodied in partnership agreements in the definition of gross asset value. The initial gross asset value of an asset is its FMV on the date assets are contributed, distributed, or revalued. Assets are revalued, for example, because of capital contributions to the partnership.

The gross asset value concept manifests itself throughout the partnership tax boilerplate:

Profits and losses: Profits and losses are computed using gross asset value rather than tax basis in determining depreciation and gain or loss from the sale of an asset.

Capital accounts: Capital accounts are computed using gross asset value rather than tax basis.

Special allocation provisions: The special allocation provisions are based on gross asset value rather than tax basis.

2. How and when does the partnership agreement reconcile the difference between book income and taxable income? What's the significance of the section 704(c) allocation? As discussed above, the tax allocation provisions allocate book income and not taxable income. Book income differs from taxable income when there is a disparity between the book value of an asset and its tax basis.

Under the section 704(b) regulations, a partner's share of book items is governed by section 704(b). Once the appropriate book allocation treatment has been determined, section 704(c) governs the determination of the partner's share of the tax items (for example, depreciation or the gain or loss on sale) when tax basis differs from book basis. Section 704(c) and the companion provisions of section 704(b) are mechanical in eliminating book-tax differences over time.

The standard tax boilerplate includes a section 704(c) special allocation provision that contains the rules for allocating items to account for the difference between book income and taxable income (which, as noted above, is attributable to the difference between the tax basis and book value of an asset). The section 704(c) regulations contain several alternations for making up this difference. The tax boilerplate is modified from deal to deal to reflect

the partner's agreement to account for this difference using the traditional method, the remedial method, the curative method, or some alternative.

3. What happens if the partners have made disproportionate cash contributions? Partners often contribute capital to a partnership in a different ratio than they share profits:

Example: A contributes \$90; B contributes \$10. A and B agree to a 50/50 sharing after capital is returned ratably to A and B.

A common mistake in that situation is for the partnership agreement to allocate profits and losses consistent with cash flow. Thus, the first \$100 of profits would be allocated on a 90/10 basis. The problem is that the first \$100 of cash flow represents return of capital and therefore should effectively come back to the partners tax free. This is accomplished by allocating the first \$100 of profits using the general 50/50 sharing ratio. Partner B will be surprised to pay tax on \$50 of income even though A gets \$90 of cash and B gets \$10. Tax distribution provisions go a long way in solving this problem.

4. Why all the special definitions and special allocation provisions relating to nonrecourse deductions, nonrecourse debt, and minimum gain chargeback? The tax boilerplate typically contains several definitions and special allocation provisions regarding nonrecourse debt. Special rules are needed for nonrecourse debt because the lenders, not the partners, bear the economic risk of nonrecourse debt. For this reason, allocations of nonrecourse deductions can never have an economic effect on the partners.

The regulations need to create a legal fiction to permit nonrecourse deductions to be allocated to the partners. This legal fiction is manifested in three ways. First, nonrecourse deductions are carved out of the normal profit and loss allocation provision and are allocated under special allocation rules. Second, the allocation of nonrecourse deductions has to be substantially consistent with the allocation of another significant item relating to the property (for example, recourse deductions). Third, the tax regulations deem partners to bear the economic loss of a nonrecourse deduction if they are required to pick up the income as the debt is paid off or if the property is sold for the amount of the nonrecourse debt. This is the so-called minimum gain. The amount of nonrecourse deduction that can be allocated to a partner cannot exceed that partner's share of minimum gain.

5. What happens if the partnership agreement does not contain all the provisions relating to nonrecourse debt and minimum gain chargeback, etc.? The nonrecourse debt and minimum gain rules are mandatory and apply whether or not these

provisions are included in the partnership agreement. Nevertheless, the regulations providing the safe harbor for nonrecourse deduction allocations require the partnership agreement to include a qualified income offset and minimum gain chargeback provision.²⁵ If these provisions are not included, partners cannot determine the allocation percentages among the partners for the nonrecourse deductions. That's probably not a major concern, but it is an avoidable trap for the unwary.

Recommendation 3: The IRS should issue a notice declaring that the section 704(b) regulations will be amended to mandate a qualified income offset and to permit partners to qualify for the safe harbor for nonrecourse deductions even if the minimum gain chargeback, partner nonrecourse debt minimum gain chargeback, and qualified income offset are not included in the partnership agreement.

Partnerships without this tax boilerplate probably also run the more serious risk that if an asset subject to nonrecourse debt is sold, the mandatory minimum gain chargeback on the sale will duplicate the prior chargeback of operating income to that partner. This can occur when the partnership agreement contains the following provisions:

- allocate profits first to reverse prior loss allocations; or
- allocate income first to reverse negative capital accounts (note that it does not cause a problem to allocate income first to reverse negative adjusted capital accounts because the term "adjusted capital accounts" already reflects the hypothetical minimum gain chargeback); or
- allocate income first to partners who received prior allocations of losses in accordance with those losses.

This is probably a common problem, even for partnership agreements that contain all the requisite boilerplate. That is because tax return preparers may not maintain up-to-date minimum gain reconciliation charts. This issue arises only if partnership allocations are subject to varying sharing ratios or priorities over time. If sharing ratios are constant, no distortion will result.

The fix is easy and is reflected in standard tax boilerplate that excludes nonrecourse deductions and minimum gain from the definition of net profits and net losses. Those items are allocated under the special allocation provisions.

For partnerships without any of the nonrecourse debt plumbing, some self-help may be appropriate. It might be fair to read into the typical taxable

income chargeback provision an exception that would carve out of that chargeback a taxable income chargeback for nonrecourse deductions that will otherwise be covered by the minimum gain chargeback. It would be helpful for the IRS to issue a revenue ruling or notice to that effect.

Recommendation 4: The IRS should issue a notice declaring that the section 704(b) regulations will be amended to provide that unless the partnership agreement explicitly provides to the contrary, profits shall not be charged back to reverse nonrecourse deductions otherwise covered by the minimum gain chargeback provision.

If the partnership has charged back operating income in an earlier year that covers nonrecourse losses, as a general rule the partnership should not be required to double up with a chargeback of minimum gain to the same partners. It would be helpful if the IRS could also confirm this point through a notice or ruling. If the IRS thought it was necessary, that ruling might narrow the scope of the exception to prevent abuses.

Recommendation 5: The IRS should issue a notice declaring that the section 704(b) regulations will be amended to carve out from the mandatory minimum gain chargeback any gain that duplicates profits already allocated to the partner.

The other self-help alternative under the regulations is to obtain an IRS waiver of the minimum gain chargeback requirement.²⁶ That provision is helpful, but probably unwieldy if it requires an advance ruling. Query whether tax return preparers can simply assume that the IRS will grant the waiver in preparing the tax returns.

6. What happens if the partnership agreement does not contain a qualified income offset provision? As described above, partnership agreements include a so-called qualified income offset provision to satisfy the alternate test for economic effect. The qualified income offset covers some unexpected adjustments, distributions, and allocations to a partner. The qualified income offset occurs after allocation for minimum gain and partner minimum gain chargeback but before other allocations. The provision allocates items of gross book income.

Partnerships that liquidate in accordance with capital accounts but fail to include a qualified income offset provision in the agreement cannot qualify for the nonrecourse deduction safe harbor or the alternate economic effect test and must run

²⁵Reg. section 1.704(e)(1) and (e)(3).

²⁶Reg. section 1.704-2(f)(4).

the gamut of the special “partner’s interest in the partnership” test discussed in Part I above.

The qualified income offset provision is so obscure and so little understood or invoked that it seems inappropriate to exclude partnerships from qualifying for the nonrecourse deduction safe harbor or the alternate economic effect test merely because the partnership agreement does not contain such a provision.

Recommendation 6: The IRS should issue a notice declaring that the section 704(b) regulations will be amended to require qualified income offsets, except perhaps when the partnership agreement explicitly disclaims such a provision. At the election of the partnership, the amendment would be effective on the date of the notice (consider an even earlier effective date).

7. Is all this much ado about nothing, because the curative allocations provision conforms capital accounts to economics? Typical tax boilerplate will generally contain a curative allocations section, which would appear to hold great promise. The provision says generally that to the extent possible, the special allocations required by the tax regulations should be applied to offset other special allocations so that partners end up with the same capital account balances they would have ended up with had no special allocations been made.

To the uninitiated, this obscure language appears to be a general cure-all that brings straying capital accounts into line with the economics. No such luck!

The curative allocation provision has a much less ambitious role. The provision is needed because there is not necessarily offsetting symmetry between the allocation of nonrecourse deductions and the chargeback of minimum gain under the section 704(b) nonrecourse debt regulations.²⁷

For example, a minimum gain chargeback is triggered only if there is a net decrease in minimum gain for all partnership properties rather than on a property-by-property basis. Thus, if a partnership disposes of one of many properties subject to nonrecourse debt, the disposition does not trigger minimum gain if overall partnership minimum gain increases.²⁸ As a corollary, since minimum gain is allocated among the partners proportionately based on the allocation of all nonrecourse deductions and nonrecourse distributions, the sale of encumbered property that produces partnership minimum gain

can trigger minimum gain chargeback to a partner who has not been allocated any nonrecourse deductions from the property sold.²⁹ This is a simplifying rule, because it is easier to monitor overall partnership minimum gain rather than property-by-property minimum gain.

Similarly, a distribution of the proceeds of a nonrecourse financing can give rise to minimum gain. That minimum gain is equal to the difference between the amount of the debt and the tax basis. Under some circumstances that minimum gain can be charged back to the partners in a manner that does not track to the cash distribution.

In view of this lack of parallelism between the minimum gain chargeback and the event giving rise to the minimum gain (nonrecourse deduction or distribution of nonrecourse loan proceeds), the curative allocation provision authorizes offsetting special allocations, if possible, to bring each partner’s capital accounts in line with the economics. The curative allocation thus attempts to fix a very narrow problem. It is not a broad fix for capital account deviations.

Everyone still feel comfortable thinking that liquidating in accordance with capital accounts produces the right economic result?

8. What function does the gross income allocation serve? The tax boilerplate contains a gross income allocation, which requires items of gross income to be allocated to partners who would otherwise have had a capital account deficit in excess of the partner’s share of minimum gain. This provision rarely comes into play as an operative provision for allocating gross income. Instead, it serves to protect against capital account reductions.³⁰

This provision is the answer to the reg. section 1.704-1(b)(2)(ii)(d)(6) requirement under the alternate economic effect safe harbor that capital accounts be reduced by distributions reasonably expected to be made in subsequent years to the extent they exceed offsetting increases in capital accounts that are reasonably expected to occur. The partnership may reasonably expect to make distributions in the following year because it reasonably anticipates income. The reasonable expectation of net income does not get taken into account for purposes of determining whether a capital account reduction is necessary.

By contrast, the prophylactic gross income chargeback ensures in virtually all situations that the partnership can project capital account increases that would offset reasonably anticipated decreases from partnership distributions.

²⁷Robert L. Whitmire et al., *Structuring and Drafting Partnership Agreements*, paras. 7-35 (drafting treatise).

²⁸See reg. section 1.704-2(m), Example 2(ii).

²⁹Reg. section 1.704-2(g)(2).

³⁰Drafting treatise, *supra* note 27, at paras. 6-58.

This provision eliminates the need to adjust capital accounts in applying the alternate economic effect safe harbor for reasonably expected distributions. That leaves only the proverbial unwary who are subject to this adjustment.

Recommendation 7: The IRS should consider mandating gross income allocations, absent a specific partnership agreement disclaimer to the contrary, to eliminate this trap for the unwary.

9. What happens if the partnership agreement does not provide for capital accounts or provides a faulty definition? The section 704(b) regulations prescribe specific rules for maintaining capital accounts. When the partnership agreement is silent or provides a faulty definition, the regulations will still test the allocations based on a properly defined capital account.

For partnerships that liquidate in accordance with capital accounts, the liquidation economics should as a matter of contract law be based on the partnership definition of capital accounts, even if it departs from the tax law definition. This preserves the business deal but places the efficacy of the tax allocations at risk. This is the correct result. The IRS regulations should *not* be changed to provide a non-tax-compliant capital account definition for purposes of determining how partnership interests are to be liquidated.

IV. Targeted Allocations

A. Targeted vs. Traditional Allocations

The typical partnership has partners who put up the cash; partners who contribute appreciated property, including zero basis intangibles; and partners who contribute neither but do the work. The money partners often want their money back first; those contributing goodwill and the like want to receive back the value someday but not necessarily upfront; and those contributing services will receive a profits interest. In the typical non-tax-driven business deal, the parties will reach agreement on the economics and perhaps provide for tax distributions, but will leave the tax allocations to the drafters of the agreement.

Under the traditional tax allocation approach, the drafters will first put together the cash flow priorities and will seek to build the profit and loss allocations around the cash flows. Final distributions will be made in accordance with capital accounts. Drafters who do not want to liquidate in accordance with capital accounts but who want

more certainty than the dumb-but-lucky approach may use so-called targeted allocations.³¹

The typical partnership agreement containing targeted allocation provisions provides for detailed cash distribution provisions and says simply that profits and losses are allocated so that each partner's capital account will be equal to (or as close as possible to) the cash he is supposed to receive under the cash distribution provisions if his partnership interest were liquidated at that time. This gives economic certainty and maybe tax certainty as well if the allocations are done properly, but it makes the tax return preparer's job more difficult.

The classic situation in which a targeted allocation is used is when Partner A puts up the money and is entitled to a preferred return on the money plus a priority cash distribution of the preferred return and his capital.

Example: Partner A contributes \$1,000 to the partnership. Partner B contributes goodwill worth \$1,000. A is entitled to cash sufficient to provide A with a 10 percent preferred return plus capital; B then receives an amount equal to his \$1,000 capital contribution; and then A and B split 50/50. Assume that in year 1 the partnership has income of \$400.

The targeted allocation provision is a rather elegant way of providing A with capital back tax free. Under the targeted allocation approach, A and B's capital account will be computed taking into account contributions and distributions for the year. Then the partnership will determine how much cash each partner would receive in liquidation. Based on the facts outlined above, the liquidation value (cash plus gross asset value of assets) was \$2,400 (\$1,000 original cash plus \$1,000 goodwill plus \$400 earnings); A is entitled to a \$100 priority return after year 1 (10 percent preferred return) plus

³¹This approach has been called "forced allocations," "target allocations," and "targeted allocations." We will use the term "targeted allocations." This topic has received relatively little attention in tax writings. Terence Floyd Cuff has been the most prolific writer on this topic. See Cuff, *supra* note 18. See also Terence Floyd Cuff, "Target Allocations and the Redemption of a Member," 37 *Real Estate Tax* 60 (2010); Todd D. Golub, "Target Allocations: The Swiss Army Knife of Drafting (Good for Most Situations — But Don't Bet Your Life on It)," 87 *Taxes* 157 (2009); Thomas C. Lenz, "Using the Targeted Capital Account Approach to Allocate Income and Loss — Is It Better Than the Traditional Layered Approach?" 5 *J. Passthrough Entities* 25 (2002); Brian J. O'Connor and Steven R. Schneider, "Capital Account Based Liquidations: Gone With the Wind or Here to Stay," 102 *J. Tax.* 21 (2005); Warren P. Kean, "A Partner's Interest in the Partnership for Purposes of Section 704(b)," 807 *PLI* 825 (2008). A leading drafting treatise covers the topic tersely and treats "forced allocations" almost dismissively. Drafting treatise, *supra* note 27, at paras. 7-159 et seq.

\$1,000 return of capital or \$1,100; B is entitled to the next \$1,000; and A and B split the next \$300 50/50. That gives A a targeted capital account of \$1,250 and B a targeted capital account of \$1,150 (total \$2,400). That means that A receives an income allocation of \$250 to bring his capital account to \$1,250, and B receives an income allocation of \$150 to bring his capital account to \$1,150. In accordance with the priority distribution, all the \$400 cash is distributed to A.

The results would be the same if the partnership contained a traditional capital account liquidation provision.

B. Drafting Targeted Allocation Provisions

A somewhat simplified targeted allocation provision would be as follows:

Net Profits and Net Losses for the year shall be allocated among the partners in a manner such that, to the extent possible, the capital account balance of each partner at the end of such year shall be equal to the excess (which may be negative) of:

- (1) the amount that would be distributed to such partner if (a) the company were to sell the assets of the company for their Gross Asset Values, (b) all Company liabilities were settled in cash according to their terms (limited, with respect to each nonrecourse liability, to the book values of the assets securing such liability), and (c) the net proceeds thereof were distributed in full pursuant to the distribution provisions, over
- (2) the sum of (a) the amount, if any, without duplication, that such Partner would be obligated to contribute to the capital of the Company, (b) such Partner's Share of Partnership Minimum Gain determined pursuant to Treas. Reg. section 1.704-2(g) and (c) such Partner's Share of Partner Nonrecourse Debt Minimum Gain determined pursuant to Treas. Reg. section 1.704-2(i)(5), all computed as of the date of the hypothetical sale described in (1) above.

In practice the targeted allocation provision works as follows:

First, each partner's capital account is adjusted based on the year's activity (contributions, distributions, and capital account book-ups and book-downs), as well as special allocations that are not taken into account in net profits and net losses.

Second, the partnership computes the target amount needed in the capital account based on the amount of the hypothetical cash distribution to the

partner that would result after a cash sale of partnership property at book value.

Third, net profits and net loss items are allocated to the partners to bring each partner's capital account in line with the distributions she would receive on that year-end date.

In effect the partnership makes a year-end computation of what the partner's capital account would have to be so he would receive the correct amount of cash in liquidation of his interest and then allocates profits and losses so that the capital account reaches that total.

Tax practitioners have not settled on model language for targeted capital account allocations. The following are some of the key concepts:

Hypothetical sale at book value: The computations are based on the sale-at-book-value concept that forms the heart of the section 704(b) regulations. As with the safe harbor alternate economic effect test, this legal fiction probably distorts the true economic situation in many cases when a more realistic assumption regarding value might lead to very different tax allocations. Query whether there can be situations in which it would be appropriate to depart from this fiction and look to real values. Any such rule might be difficult to administer.

Section 704(b) plumbing: The targeted allocation provision retains the section 704(b) plumbing (definitions, capital accounts, special allocations, etc.) that is found in the traditional tax allocation provisions discussed in Part I above. Net profits and net losses are defined in terms of book income, not taxable income. It is particularly important to separately allocate nonrecourse deductions and minimum gain chargeback so that operating profits are not allocated to offset prior losses that would otherwise be covered by the minimum gain chargeback. The same holds true for partner nonrecourse deductions and partner minimum gain. This avoids a double chargeback of income (operating profits under the partnership agreement and minimum gain required by the regulations) against nonrecourse deductions and partner nonrecourse deductions. The agreement also contains the qualified income offset provision required by the safe harbor alternate economic effect and the nonrecourse deduction allocation rules.

Allocation of gross versus net income: Practitioners vary on whether partnerships should allocate items of gross income when a partner's capital would otherwise fall short of the targeted account. This will be discussed in more detail below.

C. Economic Certainty: Burden on Preparer

Partnership agreements drafted using targeted allocations provide partners certainty as to economic results; their cash flow is not tied to the vagaries of capital accounts. As is evident above, however, those agreements still require complicated and sophisticated drafting. The tax boilerplate that so many agreements lack is just as necessary for targeted tax allocation provisions as for traditional tax allocation provisions. Some of the recommendations in Part III designed to simplify tax allocation provision drafting are probably equally appropriate for targeted allocation agreements.

Targeted allocation provisions are certainly more difficult for the tax return preparer than the traditional tax allocation provisions. Targeted allocation provisions skip the step-by-step detail on how to do the allocations. Even more important, the provisions force the tax return preparer to tackle capital accounts each year with rigor and accuracy. In many cases, this task is never encountered by tax return preparers for partnerships that contain traditional allocation provisions.

This places tax return preparers in an unenviable position. At the same time, however, the partner has economic certainty in terms of the cash he would receive under various valuation scenarios.

D. Tax Certainty (or Lack Thereof)

1. Targeted allocations and economic effect tests. Partners in partnerships using targeted allocations are assured of receiving the distributions they bargained for. Query whether the tax results are as certain.

The issue is whether the partnership agreement satisfies the capital account liquidation requirement of the safe harbor economic effect and alternate economic effect tests. The capital account liquidation requirement under the regulations is that the partnership agreement “provides” that “liquidating distributions are required in all cases to be made in accordance with positive capital account balances.”³²

Those who do not believe in targeted allocations contend that even though per force the partnership’s liquidating distributions will be in accordance with capital accounts, the safe harbor economic effect tests are not satisfied because the partnership does not *explicitly* provide for liquidations in accordance with capital accounts; it *explicitly* provides for liquidation based on distribution percentages.³³ This reading of the regulations may be too narrow.

Targeted allocation provisions are designed to ensure that liquidating distributions will be made in accordance with capital accounts. A partnership agreement that contains those provisions can be said to “provide” that liquidating distributions are in accordance with capital accounts. The regulation does not require the partnership to “state” that liquidating distributions will be in accordance with capital account.³⁴ It uses the term “provides,” which has a broader meaning than the “explicitly states” reading given by some. In this context, the term “provides” has a result-oriented rather than means-oriented connotation. The “results” of targeted allocations satisfy this results-oriented test.

Under the circumstances, properly drafted targeted allocation provisions that include a qualified income offset provision ought to satisfy the section 704(b) alternate economic effect test. In view of several partnership agreements that rely on the targeted allocation approach and the mixed views reflected in writings on this issue, it would be helpful for the IRS to issue a revenue ruling or notice blessing targeted allocations under the section 704(b) alternate economic effect safe harbor.

Recommendation 8: The IRS should issue a notice or revenue ruling indicating that targeted allocation provisions can qualify under the section 704(b) safe harbor economic effect and alternate economic effect tests. If desired, the IRS can specify appropriate conditions, subject to further guidance in regulations.

2. Targeted allocations and economic equivalence tests. If targeted allocations do not satisfy the alternate economic effect safe harbor, query whether they can satisfy the dumb-but-lucky economic equivalence safe harbor.

As discussed earlier, this test validates allocations otherwise flunking the economic effect test when the hypothetical liquidation of the partnership would produce the same economic result for the partners in the current year or any future year as the economic effect test (maintain capital accounts, liquidate in accordance with capital accounts, unlimited deficit restriction) regardless of the economic performance of the partnership.

As also discussed earlier, some distinguished commentators would limit this safe harbor to partnership agreements with unlimited deficit restoration provisions. This is too narrow a reading and does not well serve the interests of the IRS or

³²Reg. section 1.704-1(b)(2)(ii)(b)(2).

³³Drafting treatise, *supra* note 27 at paras. 7-150.

³⁴Compare reg. section 1.704-2(e), which is the nonrecourse deduction safe harbor. This regulation says that the partnership agreement must “contain” a minimum gain chargeback provision. See also reg. section 1.704-1(b)(2)(ii)(d): “The partnership agreement contains a qualified income offset.”

taxpayers. Properly drafted targeted allocations ought to pass muster under this regulation.

3. Targeted allocations and partner's interests in the partnership. The section 704(b) economic effect tests are safe harbors. Failure to satisfy these tests means that the allocation will be tested under the "partner's interests in the partnership" standard. It is difficult to imagine that the IRS would consider an attack on the use of targeted allocations an efficient use of audit resources. Unfortunately, the IRS executive team's view of how audit resources should be deployed is no protection against individual agents seeking to press the point that the allocations do not stand up in a particular case.

Part II above briefly described the relevant inquiry for determining a partner's interest in the partnership. While one would generally expect targeted allocations to equal "partner's interests in the partnership," there is some softness in that conclusion because of the absence of the "tax basis equals fair market value" presumption in applying the partner's interest in the partnership method. That proves too much, however. Without that presumption, it may be difficult in many cases to determine a partner's interest in the partnership.

4. Targeted allocations and nonrecourse deductions. As described in Part II above, allocations of nonrecourse deductions can never have economic effect and must be allocated in accordance with the partner's overall economic interest in the partnership.³⁵ The regulations go on to provide a special rule that says nonrecourse deductions will be deemed to be in accordance with the partner's interests in the partnership when (1) liquidating distributions are made in accordance with capital accounts and (2) the nonrecourse deductions are allocated in a manner that is reasonably consistent with the allocation of another item that has substantial economic effect.³⁶

Some commentators argue that this rule calls into question the ability of partnerships using targeted allocations to specially allocate nonrecourse deductions because the partnership agreement does not satisfy either prong of the test.³⁷ If correct, that conclusion would leave the allocation of nonrecourse items entirely up in the air. This would not be a good result because of the whipsaw potential for either the IRS or for taxpayers.

Recommendation 9: The IRS should issue a notice or revenue ruling confirming that the

nonrecourse deduction allocation rules can be satisfied by partnerships using targeted allocations.

E. Preferred Return and Targeted Allocations

One of the disputes with targeted allocations is whether a gross income allocation may be mandatory when one partner is entitled to a preferred return that takes priority over another partner's capital return.

Example: A and B each contributes \$100 to the partnership. A is entitled to receive a compounded 12 percent return on her \$100 investment plus return of capital before B is entitled to any return of capital. The partnership earns \$10 of net profits in year 1.

In this example, net profits for the year fell short of the preferred return. This issue is not unique to targeted allocations and would also seem to be present for traditional liquidate-in-accordance-with-capital-account allocations. The question is whether the partnership should allocate \$12 of gross income to the partner who is entitled to the priority return, or treat the amount as a \$12 guaranteed payment to that partner, or simply allocate \$10 of net income and wait for the next year to catch up.

Some commentators argue that the section 704(b) partner's interest in the partnership rule may require a gross income allocation even if the targeted allocation provision in the agreement only required allocations of items of net income and loss.³⁸ Alternatively, the amount could be treated as an accrued guaranteed payment for A in year 1 or a taxable capital shift.³⁹

The difficulty with imputing phantom income each year is that it often may not correlate well with economic reality and the parties' business expectations. The parties generally expect the preferred return to come out of earnings — anticipated to be low in the early years and more significant down the road. The better view would appear to be to allocate net profit and net loss items only, particularly if the partners anticipate early-year low profits and expect that the preferred return would be funded from expected future profits.

³⁸*Id.* at 54-55. See also Lenz, *supra* note 31, at 30, who agrees that a gross income allocation is required. O'Connor and Schneider, *supra* note 31, at 24-26, conclude that the preferred return is a guaranteed payment or a taxable capital shift.

³⁹This assumes an accrual method partnership. The guaranteed payment construct gets more complicated with a cash method partnership since the deduction (and income) is postponed to the year of payment. Cuff, *supra* note 18, has argued that the apparent deemed capital shift might be a deemed guaranteed payment.

³⁵Reg. section 1.704-2(b)(1).

³⁶Reg. section 1.704-2(e).

³⁷Cuff, *supra* note 18, at 29.

Under that approach, the extraordinary adjustments (gross income allocation or guaranteed payment) would be made only if the partners' robust expectations did not materialize and the shortfall remaining at the end of the life of the partnership was made up of liquidating proceeds.⁴⁰ This avoids extraordinary year-to-year phantom income adjustments.

This result would appear to be consistent with the partner's interest in the partnership. The normal tax snapshot — tax basis equals value — does not reflect economic reality. It seems inconsistent with the partner's interest in the partnership test to require a gross income allocation or a guaranteed payment or a taxable capital shift for an earnings shortfall in a particular year when the value of the property may have increased dramatically and the future looks robust.

F. Potential Drafting Issues

The drafting treatise⁴¹ offers the following checklist of drafting issues with targeted allocations:

- 1. Circularity:** Drafters sometimes forget to remove "liquidation in accordance with capital accounts" from the distribution provisions. Leaving it in produces a circular definition.
- 2. Distribution provisions:** The targeted allocation provision puts more pressure on drafting accurate distribution provisions. Also, it may be more difficult to allocate tiers of losses to partners. This may need to be accomplished by specifying the amount the partner is entitled to receive if liquidation occurs at various times, which may be tricky.
- 3. Special allocations:** The partnership agreement still needs to provide for special allocations relating to nonrecourse deductions, qualified income offset, etc., and profits and losses based on book income. The drafting treatise adds that the curative allocation provision is not needed because targeted allocations are inherently curative.
- 4. Priority returns:** As with traditional allocation provisions, the drafter of a targeted allocation provision still needs to deal with whether priority returns of capital should be matched (if at all) with profits or items of gross income. If they are not so matched, the partner receives back his capital tax free. If they are so

matched, the partner is simply receiving a priority income allocation rather than a priority return of capital.

5. Disproportionate losses: The drafting treatise says the targeted allocation is difficult to use if the business deal calls for a disproportionate allocation of depreciation or losses and a chargeback only out of gains, not profits.

The drafting treatise is somewhat dismissive of targeted allocations, apparently based on the view that the traditional capital account liquidation provision produces the right economic result for the partners.⁴² That's theoretically true.

Theory and practice can be very different, however, as the drafting treatise admits in the next paragraph on that same page:

In all but the simplest transactions, this need to anticipate and accurately deal with a wide range of unpredictable future events *imposes a tremendous burden on the drafter and creates a very real risk that some future events will be overlooked or mishandled.* [Emphasis added.]

With such a high risk of mistake, one wonders why the drafting treatise does not more readily embrace targeted allocations. Might it be better to err on the side of tax mistake rather than economic mistake and use targeted allocations?

V. Tracking Allocations

The targeted allocation provisions discussed in the preceding section secure the partner's cash economics but provide relatively little guidance for the tax return preparer. Targeted allocation provisions also force tax practitioners to give up the hard-learned craft of drafting complex tax allocation provisions. The somewhat terse "allocate tax items to give the right capital account" is much less elegant than a well-drafted tax allocation provision. For these reasons, some drafters simply eschew reliance on capital accounts at all and draft partnership agreements with tax allocations that simply "track" the distribution provisions, that is, "tracking allocations."⁴³

The drafting process begins with the distribution provisions. Once the distribution provisions are set, the drafter develops tax allocation provisions to reflect the cash distribution priorities. This is the same process used in drafting traditional "liquidate in accordance with capital account" provisions,

⁴⁰See Lewis R. Steinberg, "Fun and Games With Guaranteed Payments," 57 *Tax Law.* 533, 567 (2004). See also Kean, *supra* note 31, at 415-417.

⁴¹Drafting treatise, *supra* note 27, at paras. 7-161 et seq.

⁴²*Id.* at paras. 7-160.

⁴³The term "tracking allocations" captures the concept, although the term may already be claimed by those who issue interests in a partnership that track specific investments.

except that here the final distributions are based on formula, not capital accounts.

If the drafter maintains the proper symmetry between the tax allocation provisions and the distribution provisions, the tax allocations during the life of the partnership should be the same as the tax allocations under the traditional capital account liquidation approach. If the tax allocations are different, the partners may suffer a tax detriment, but at least they will end up with the correct cash result.

These partnership agreements typically provide for all the tax allocation and special allocation definitions and plumbing reflected in traditional partnership agreements. Some of it may appear superfluous (for example, capital accounts). However, it is useful and helpful to include the capital account concept because capital accounts serve as the economic scorecard for judging whether a tax allocation has economic effect. In any event, IRS agents and clients will expect to see this tax boilerplate even if they do not understand it.

There may be circumstances in which this drafting technique may not work well for a particular business deal. For example, if Partner A is entitled to a preferred return that has priority over the return of B's capital, it is unclear whether A should be allocated items of gross income when taxable income for the year is less than the preferred return. As we have seen, the same issue arises under any tax allocation scheme.

In view of the emerging prevalence of this technique, it would be helpful if the IRS established rules for tracking allocations.

Recommendation 10: The IRS should issue a notice or revenue ruling indicating that tracking allocations will satisfy the economic effect or alternate economic effect safe harbors to the extent that liquidation would in fact be in accordance with capital accounts.

VI. Allocations Based on Taxable Income

We know from experience that many, perhaps most, partnership agreements do not contain the detailed boilerplate discussed in Part III and do not require liquidation in accordance with capital accounts. (We could take a survey of how many law firm partnership agreements contain these provisions, but we know the proverb about the holes in the shoes of the cobbler's children.)

The most basic tax allocation provision, which our corporate brethren and clients often urge us to adopt, is to provide simply as follows:

Taxable income and losses and distributions, including in liquidation, will be allocated in accordance with Percentage Interests.

The IRS in its audit guidelines refers to this type of provision as the dumb-but-lucky approach. In simple cases, this provision may achieve the desired business and tax results.

It is fine for the partnership to make allocations based on taxable income rather than book income when there is no difference between book income and taxable income. This would happen when (1) all partners have made pro rata cash contributions to the partnership at the same time, (2) no partner has contributed property to the partnership, (3) the partnership has not made property distributions to the partners, and (4) no partner has received a partnership interest for services. In that case, the book value of partnership assets should generally equal their tax basis so there would be no difference between book income and taxable income.

Let's say book income and taxable income are different because one of these enumerated events occurred and the book value and tax basis of an asset differs (for example, because a partner contributed an appreciated asset rather than cash). In that case section 704(c) would override the tax allocation provisions of the partnership agreement and would require, for example, an allocation of gain or loss from the sale or depreciation of the asset to be allocated among the partners to account for the difference between book value and tax basis.

The simple tax allocation provision may pass muster even in that situation, at least when filtered through the tax return preparation process, because the tax return preparer will fill in some of the gaps left open by this provision. For example, we could expect the tax return preparer to properly apply the section 704(c) rules to come up with the correct tax return reporting. In effect the popular tax boilerplate regime of using book income rather than taxable income for allocations may simply be a bookkeeping convention. In either case adjustments need to be made under section 704(c) so that tax return preparers can arrive at the correct bottom-line tax numbers for taxpayers.

Similarly, if the partnership recognized losses, the tax return preparer may well allocate the losses among the partners by applying a surrogate alternate economic effect safe harbor.

In effect the tax return preparer would probably construe the partnership agreement to contain the necessary tax plumbing to reach the right tax result from an economic perspective. As a practical matter, tax traps may not snare the unwary in the partnership tax world if one employs the right tax return preparer.

Still, because this type of allocation provision is so prevalent in the real world, it would be helpful for the IRS to develop rules.

Recommendation 11: The IRS should develop rules to accommodate allocations based on taxable income.

VII. Conclusion

The IRS and tax practitioners have spent significant time and resources of late simplifying the subchapter C rules and eliminating many long-lived traps for the unwary. This has been a productive and rewarding effort for participants and observers alike. The ground was familiar to the many of us who decided to become tax practitioners as a result of our corporate tax class. But except perhaps for spinoffs and intragroup reorganizations, the subchapter C reorganization rules pale in importance to subchapter K for most tax practitioners. Anyone can file a simple certificate and form a corporation. Tax practitioner input is needed from day one when a partnership is being put in place.

The preceding discussion makes a compelling case that subchapter K partnership allocation rules need to be refined and updated. This is one of many basic partnership tax matters that deserve concerted high-level attention. The IRS and tax practitioner groups should collaborate on this project, devoting the same level of resources to subchapter K regulation modernization that has been devoted to subchapter C. This should be a high priority project.

Appendix A:

Testing Partnership Allocations

Test 1: Economic effect safe harbor: requires capital account maintenance, liquidation in accordance with capital accounts, and unlimited deficit restoration obligation. Reg. section 1.704-1(b)(2)(ii)(b).

Test 2: Alternate economic effect safe harbor: requires capital account maintenance, liquidation in accordance with capital accounts, and qualified income offset in lieu of unlimited deficit restoration obligation; capital accounts determined taking into account anticipatory capital account adjustments using value equals tax basis (book value) presumption. Reg. section 1.704-1(b)(2)(ii)(d).

Test 3: Economic effect equivalence (dumb but lucky): tax allocations deemed to have economic effect if, at the end of each partnership year, a liquidation at year-end or any future year-end would produce the same economic results to the partners that would occur if the partnership satisfied the economic effect safe harbor (proper capital accounts, liquidation in accordance with capital accounts, unlimited deficit restoration obligation) regardless of economic performance. Reg. section 1.704-1(b)(2)(ii)(i).

Test 4: Partner's interest in the partnership — facts and circumstances: liquidating distributions

may be key, but no value equals tax basis (book value) presumption. Reg. section 1.704-1(b)(3)(i).

Test 5: Special 'partner's interest in the partnership' rule: partner's interest in partnerships that maintain capital accounts and liquidate per capital accounts determined based on book value liquidation analysis in which the partnership flunks safe harbor economic effect tests because of the lack of a deficit restoration provision or qualified income offset; capital accounts determined taking into account anticipatory capital account adjustments using value equals tax basis (book value) presumption. Reg. section 1.704-1(b)(3)(iii).

Test 6: Nonrecourse deductions: tax allocations for nonrecourse deductions based on partner's overall economic interests in the partnership; deemed to be in accordance with partner's interest if (1) capital account maintenance and liquidation is in accordance with capital accounts and deficit restoration obligation or qualified income offset; (2) allocation is reasonably consistent with allocation having substantial economic offset of another significant item related to the property; (3) minimum gain chargeback; and (4) all other material allocations recognized. Reg. section 1.704-1(b)(3)(iii).

Test 6: Partner nonrecourse deductions: tax allocations for nonrecourse deductions allocated to partner who bears economic risk of loss. Reg. section 1.704-2(i)(1).

Appendix B:

Sample Tax Boilerplate

Tax Definitions, Capital Accounts, and Special Allocations

1. Tax Definitions.

'Adjusted Capital Account Deficit' means the deficit balance (if any) in a Member's Capital Account as of the end of any taxable year of the Company, after:

- a. crediting to such Capital Account any amount which such Member is obligated to restore pursuant to this Agreement or is deemed obligated to restore pursuant to the minimum gain chargeback provisions of Treas. Reg. section 1.704-2(f) and (g), and
- b. charging to such Capital Account any adjustments, allocations or distributions described in the qualified income offset provisions of Treas. Reg. section 1.704-1(b)(2)(ii) which are required to be charged to such Capital Account pursuant to this Agreement.

'Company Minimum Gain' means the amount determined in accordance with the principles of Treas. Reg. section 1.704-2(d) and 1.704-2(g).

‘Contributed Assets’ has the meaning set forth in Section 4(a) below.

‘Depreciation’ means, for each taxable year of the Company or other period, an amount equal to the depreciation allowable with respect to an asset for such taxable year or other period; provided, however, that if the Gross Asset Value of an asset differs from its adjusted basis for federal income tax purposes at the beginning of such taxable year or other period, Depreciation shall be an amount that bears the same ratio to such beginning Gross Asset Value as the federal income tax depreciation with respect to such asset for such taxable year or other period bears to such beginning adjusted tax basis; and provided further, that if the federal income tax depreciation for such taxable year or other period is zero, Depreciation shall be determined with reference to such beginning Gross Asset Value using any reasonable method selected by the Members.

‘Gross Asset Value’ shall be determined as follows:

a. the initial Gross Asset Value of any asset contributed by a Member to the Company subsequent to the date hereof shall be the fair market value of such asset, as agreed to by the Members;

b. the Gross Asset Value of all Company assets shall be adjusted to equal their respective fair market values (taking Section 7701(g) of the Code into account) as of the following times: (i) the acquisition of additional Shares by any new or existing Member in exchange for more than a de minimis Capital Contribution or in connection with the performance of services; (ii) the distribution by the Company to a Member of more than a de minimis amount of Company assets as consideration for Shares, but only if, in the case of either (i) or (ii), the Members reasonably determine that such adjustment is necessary or appropriate to reflect the relative economic interests of the Members in the Company; (iii) the liquidation of the Company; and/or (iv) the forfeiture by a defaulting Member of its Shares;

c. the Gross Asset Value of any Company asset distributed to any Member shall be the fair market value (taking Section 7701(g) of the Code into account) of such asset on the date of distribution;

d. the Gross Asset Values of Company assets shall be increased (or decreased) to reflect any adjustments to the adjusted basis of such Company assets pursuant to Section 732(d), Section 734(b) or Section 743(b) of the Code, but only to the extent that such adjustments are taken into account in determining Capital Accounts

pursuant to Treas. Reg. section 1.704-1(b)(2)(iv)(m) and 1.704-1(b)(2)(iv)(f); provided, however, that Gross Asset Values shall not be adjusted pursuant to this subsection (d) to the extent that the Members determine that an adjustment pursuant to subsection (b) of this definition is necessary or appropriate in connection with a transaction that would otherwise result in an adjustment pursuant to this subsection (d);

e. if the Gross Asset Value of any Company asset has been determined or adjusted pursuant to subsection (a), (b), (c) or (d), such Gross Asset Value shall thereafter be adjusted by the Depreciation that would be taken into account with respect to such asset for purposes of computing gains or losses from the disposition of such asset; and

f. Gross Asset Value of any Company asset that was not contributed by a Member means the adjusted basis of such Company asset for federal income tax purposes.

‘Nonrecourse Deductions’ has the meaning set forth in Treas. Reg. section 1.704-2(b)(1).

‘Profits’ and **‘Losses’** shall mean, for each taxable year of the Company or other period, an amount equal to the Company’s taxable income or loss, as the case may be, for such taxable year or period, determined in accordance with Section 703(a) of the Code (for this purpose, all items of income, gain, loss and deduction required to be stated separately pursuant to Section 703(a)(1) of the Code shall be included in taxable income or loss), with the following adjustments:

a. any income of the Company that is exempt from federal income tax and not otherwise taken into account in computing Profits or Losses pursuant to this subparagraph shall be added to such taxable income or loss;

b. any expenditures of the Company described in Section 705(a)(2)(B) of the Code or treated as Section 705(a)(2)(B) of the Code expenditures pursuant to Treas. Reg. section 1.704-1(b)(2)(iv)(i), and not otherwise taken into account in computing Profits or Losses pursuant to this definition shall be subtracted from such taxable income or loss;

c. in the event the Gross Asset Value of any Company asset is adjusted pursuant to subparagraph (b) or (c) of the definition thereof, the amount of such adjustment shall be taken into account as gain or loss from the disposition of such asset for purposes of computing Profits or Losses;

d. gain or loss resulting from the disposition of any Company asset with respect to which gain or loss is recognized for federal income tax purposes shall be computed by reference to the Gross Asset Value of the asset disposed of, notwithstanding that the adjusted tax basis of such asset differs from its Gross Asset Value;

e. in lieu of the Depreciation taken into account in computing such taxable income or loss, there shall be taken into account Depreciation for such taxable year of the Company or other period, computed in accordance with the definition thereof;

f. to the extent an adjustment to the adjusted tax basis of any Company asset pursuant to Section 734(b) of the Code is required, pursuant to Treas. Reg. section 1.704-1(b)(2)(iv)(m)(4), to be taken into account in determining Capital Accounts as a result of a distribution other than in liquidation of a Member's Shares, the amount of such adjustment shall be treated as an item of gain (if the adjustment increases the basis of the asset) or loss (if the adjustment decreases such basis) from the disposition of such asset and shall be taken into account for purposes of computing Profits or Losses; and

g. notwithstanding any other provision of this definition, any items which are specially allocated pursuant to Section 3 below shall not be taken into account in computing Profits and Losses.

'Regulations' shall mean a regulation issued by the United States Treasury Department and relating to matters arising under the Code.

'Regulatory Allocations' has the meaning set forth in Section 3(h) below.

'Member Nonrecourse Debt' has the same meaning as the term "partner nonrecourse debt" set forth in Treas. Reg. section 1.704-2(b)(4).

'Member Nonrecourse Debt Minimum Gain' means an amount, with respect to each Member Nonrecourse Debt, equal to the Company Minimum Gain that would result if such Member Nonrecourse Debt were treated as a Nonrecourse Liability, determined in accordance with the provisions of Treas. Reg. section 1.704-2(i)(3) relating to "partner nonrecourse debt minimum gain".

'Member Nonrecourse Deductions' has the same meaning as the term "partner nonrecourse deductions" set forth in Treas. Reg. section 1.704-2(i)(1) and 1.704-2(i)(2).

2. Capital Accounts.

Each Member's initial Capital Account shall reflect the Gross Asset Value of such Member's initial Capital Contribution. Except as provided in this

Section 2, the Capital Account of each Member shall be (i) increased by (A) the amount of cash and the Gross Asset Value of any property contributed to the Company by such Member (net of liabilities secured by the property or to which the property is subject that the Company is considered to assume or take subject to pursuant to Section 752 of the Code), and (B) Profits and any other items of income and gain allocated to such Member; (ii) decreased by (A) the amount of cash and the Gross Asset Value of any property distributed to such Member (net of liabilities secured by the property or to which the property is subject that such Member is considered to assume or take subject to pursuant to Section 752 of the Code) and (B) the Losses and any other items of deduction and loss allocated to such Member; and (iii) otherwise maintained in accordance with Treas. Reg. section 1.704-1(b)(2)(iv) in order for the allocation of Profits and Losses to have "substantial economic effect" in accordance with Treas. Reg. section 1.704-1(b)(2).

For purposes of this Section 2, (i) an assumption of a Member's unsecured liability by the Company shall be treated as a distribution of money to that Member, and (ii) an assumption of the Company's unsecured liability by a Member shall be treated as a cash contribution to the Company by that Member.

In the event of a contribution of money or other property to the Company (other than a contribution made ratably by all existing Members), an issuance of Shares in connection with the performance of services, or the forfeiture by a Member of its Shares, the Capital Accounts for the Members shall be adjusted in respect of the hypothetical "book" gain or loss that would have been realized by the Company if all Company assets had been sold for their Gross Asset Values in a cash sale.

In the event that Company assets other than money are distributed to a Member in liquidation of the Company, or in the event that assets of the Company other than money are distributed to a Member in kind, in order to reflect unrealized gain or loss, Capital Accounts for the Members shall be adjusted in respect of the hypothetical "book" gain or loss that would have been realized by the Company if the distributed assets had been sold for their Gross Asset Values in a cash sale. In the event of the liquidation of a Member's Shares, in order to reflect unrealized gain or loss, Capital Accounts for the Members shall be adjusted in respect of the hypothetical "book" gain or loss that would have been realized by the Company if all Company assets had been sold for their Gross Asset Values in a cash sale.

If Company property is reflected on the books of the Company at a book value that differs from the adjusted tax basis of such property, the Members'

Capital Accounts shall be adjusted in accordance with Treas. Reg. section 1.704-1(b)(2)(iv)(g) for allocations of depreciation, depletion, amortization, and gain or loss, as computed for book purposes, with respect to such property.

Upon any transfer of all or part of an interest in the Company, as permitted by this Agreement, the Capital Account (or portion thereof) of the transferor that is attributable to the transferred interest (or portion thereof) shall carry over to the transferee.

The foregoing provisions of this Section 2 and the other provisions of this Agreement relating to the maintenance of Capital Accounts are intended to comply with Treas. Reg. section 1.704-1 and 1.704-2 and shall be interpreted and applied in a manner consistent with such Regulations and any amendment or successor provision thereto. The Members shall cause appropriate modifications to be made if unanticipated events might otherwise cause this Agreement not to comply with such Regulations, so long as such modifications do not cause a material change in the relative economic benefit of the Members under this Agreement.

3. Special Tax Allocations. The following special allocations shall be made in the following order:

a. Minimum Gain Chargeback. Subject to the exceptions set forth in Treas. Reg. section 1.704-2(f), if there is a net decrease in Company Minimum Gain during a taxable year of the Company, each Member shall be specially allocated items of income and gain for such taxable year (and, if necessary, for subsequent years) in an amount equal to such Member's share of the net decrease in Company Minimum Gain during such taxable year (which share of such net decrease shall be determined under Treas. Reg. section 1.704-2(g)(2)). It is intended that this Section 3(a) shall constitute a "minimum gain chargeback" as provided by Treas. Reg. section 1.704-2(f) and shall be interpreted consistently therewith.

b. Member Nonrecourse Debt Minimum Gain Chargeback. Subject to the exceptions contained in Treas. Reg. section 1.704-2(i)(4), if there is a net decrease in Member Nonrecourse Debt Minimum Gain during a taxable year of the Company, any Member with a share of such Member Nonrecourse Debt Minimum Gain (determined in accordance with Treas. Reg. section 1.704-2(i)(5)) as of the beginning of such taxable year shall be specially allocated items of income and gain for such taxable year (and, if necessary, for subsequent years) in an amount equal to such Member's share of the net decrease in Member Nonrecourse Debt Minimum Gain (which share of such net decrease shall be determined under Treas. Reg.

section 1.704-2(i)(4) and 1.704-2(j)(2)). It is intended that this Section 3(b) shall constitute a "partner nonrecourse debt minimum gain chargeback" as provided by Treas. Reg. section 1.704-2(i)(4) and shall be interpreted consistently therewith.

c. Qualified Income Offset. In the event any Member unexpectedly receives any adjustments, allocations, or distributions described in Treas. Reg. section 1.704-1(b)(2)(ii)(d)(4), 1.704-1(b)(2)(ii)(d)(5), or 1.704-1(b)(2)(ii)(d)(6) (modified as appropriate, by Treas. Reg. section 1.704-2(g)(1) and 1.704-2(i)(5)), items of Company income and gain for such taxable year shall be specially allocated to the Member in an amount and manner sufficient to eliminate, to the extent required by the Regulations, any Adjusted Capital Account Deficit of the Member as quickly as possible, provided that an allocation pursuant to this Section 3(c) shall be made if and only to the extent that the Member would have an Adjusted Capital Account Deficit after all other allocations have been tentatively made as if this Section 3(c) were not in this Schedule 3.01.

d. Gross Income Allocations. To the extent required by the Regulations, in the event a Member has a deficit balance in its Capital Account at the end of any taxable year of the Company in excess of the sum of (A) the amount such Member is required to restore pursuant to the provisions of this Agreement, if any, and (B) the amount such Member is deemed obligated to restore pursuant to Treas. Reg. section 1.704-2(g) and 1.704-2(i)(5), such Member shall be specially allocated items of Company income and gain in the amount of such excess as quickly as possible, provided that an allocation pursuant to this Section 3(d) shall be made if and only to the extent that such Member would have an Adjusted Capital Account Deficit after all other allocations have been tentatively made as if this Section 3(d) were not in this Schedule 3.01.

e. Nonrecourse Deductions. Any Nonrecourse Deductions shall be allocated to the Members in the same manner as Losses are allocated pursuant to Section 4.01 of this Agreement.

f. Member Nonrecourse Deductions. Any Member Nonrecourse Deductions shall be allocated to the Member that bears the economic risk of loss for the Member Nonrecourse Debt to which such deductions relate as provided in Treas. Reg. section 1.704-2(i)(1). If more than one Member bears the economic risk of loss, such deduction shall be allocated between or

among such Members in accordance with the ratios in which such Members share such economic risk of loss.

g. Certain Section 754 Adjustments. To the extent any adjustment to the adjusted tax basis of any Company asset pursuant to Section 732(d), Section 734(b) or Section 743(b) of the Code is required, pursuant to Treas. Reg. section 1.704-1(b)(2)(iv)(m), to be taken into account in determining Capital Accounts as the result of a distribution to a Member in complete liquidation of its interest in the Company, the amount of such adjustment to Capital Accounts shall be treated as an item of gain (if the adjustment increases such basis) and an item of loss (if the adjustment decreases such basis) and such gain or loss shall be specially allocated to the Members in accordance with their interests in the Company as determined under Treas. Reg. section 1.704-1(b)(3) in the event Treas. Reg. section 1.704-1(b)(2)(iv)(m)(2) applies, or to the Member to whom such distribution was made in the event Treas. Reg. section 1.704-1(b)(2)(iv)(m)(4) applies.

h. Limit on Loss Allocations. Notwithstanding the provisions of Section 4.01 of this Agreement or any other provision of this Agreement to the contrary, Losses (or items thereof) shall not be allocated to a Member if such allocation would cause or increase a Member's Adjusted Capital Account Deficit and shall be reallocated to the other Members in proportion to their [respective Capital Account balances], subject to the limitations of this Section 3(h).

i. Curative Allocations. The allocations under Sections 3(a) through (h) above (such allocations, the "Regulatory Allocations") are intended to comply with certain requirements of the Regulations. It is the intent of the Members and the Company that, to the extent possible, all Regulatory Allocations shall be offset either with other Regulatory Allocations or with special allocations of other items of income, gain, loss or deduction pursuant to this Agreement. Therefore, notwithstanding any other provision of this Agreement to the contrary (other than the Regulatory Allocations), the Company shall make such offsetting special allocations of income, gain, loss or deduction in whatever manner the Company determines appropriate so that, after such offsetting allocations are made, each Member's Capital Account balance is, to the extent possible, equal to the Capital Account balance such Member would have had if the Regulatory Allocations were not part of the Agreement and all items were allocated pursuant to Section 4.01 of the

Agreement. For purposes of this Section 3(i), future Regulatory Allocations under Sections 3(a) through (h) that are likely to offset other Regulatory Allocations previously made shall be taken into account.

4. Tax Allocations: Section 704(c).

a. For federal, state and local income tax purposes only, with respect to any assets contributed by a Member to the Company ("Contributed Assets") which have a Gross Asset Value on the date of their contribution which differs from the Member's adjusted basis therefore as of the date of contribution, the allocation of Depreciation and gain or loss with respect to such Contributed Assets shall be determined in accordance with the provisions of Section 704(c) of the Code and the Regulations promulgated thereunder using the method described under Treas. Reg. section 1.704-3(b). [This needs to be conformed to the specific deal]. For purposes of this Agreement, an asset shall be deemed a Contributed Asset if it has a basis determined, in whole or in part, by reference to the basis of a Contributed Asset (including an asset previously deemed to be a Contributed Asset pursuant to this sentence).

b. In the event the Gross Asset Value of any Company asset is adjusted pursuant to subparagraph (b) of the definition thereof, subsequent allocations of income, gain, loss and deduction with respect to such asset shall take account of any variation between the adjusted basis of such asset for federal income tax purposes and its Gross Asset Value in the same manner as under Section 704(c) of the Code and Treas. Reg. section 1.704-3(b).

c. Allocations pursuant to this Section 4 are solely for purposes of federal, state, and local taxes and shall not affect, or in any way be taken into account in computing any Member's Capital Account or share of Profits, Losses, other items, or distributions pursuant to any provision of this Agreement.

5. Allocations in the Event of Transfer. If all or any portion of any Shares are transferred to a substitute Member during any taxable year of the Company, Profits, Losses, each item thereof and all other items attributable to such Shares for such period shall be divided and allocated between the transferor and transferee by applying an interim closing of the Company's books method.

6. Profits Interest Safe Harbor. The Tax Matters Member is authorized to amend this Agreement, without the consent of the other Members, to comply with any safe harbor finalized by the United States Department of the Treasury or the Internal

Revenue Service relating to the tax treatment of a transfer of an interest in the Company for services. For example, this Section 6 shall apply to any safe harbor finalized by Internal Revenue Service notice or Regulations as successor to the proposed safe harbor described in Internal Revenue Service Notice 2005-43, 2005-1 C.B. 1221. In the event any such safe harbor is finalized and elected by the Company, all Members agree to comply with all the requirements of such safe harbor and any amendments to this Agreement that the Tax Matters Member effects pursuant to this Section 6.

Appendix C: Sample Targeted Allocation Provision

A somewhat simplified targeted allocation provision would be as follows:

Net Profits and Net Losses for the year shall be allocated among the partners in a manner such that, to the extent possible, the capital account balance of each partner at the end of such year shall be equal to the excess (which may be negative) of:

(1) the amount that would be distributed to such partner if (a) the company were to sell the assets of the company for their Gross Asset Values, (b) all Company liabilities were settled in cash according to their terms (limited, with respect to each nonrecourse liability, to the book values of the assets securing such liability), and (c) the net proceeds thereof were distributed in full pursuant to the distribution provisions, over

(2) the sum of (a) the amount, if any, without duplication, that such Partner would be obligated to contribute to the capital of the Company, (b) such Partner's Share of Partnership Minimum Gain determined pursuant to Treas. Reg. section 1.704-2(g) and (c) such Partner's Share of Partner Nonrecourse Debt Minimum Gain determined pursuant to Treas. Reg. section 1.704-2(i)(5), all computed as of the date of the hypothetical sale described in (1) above.