Part I

Targeted Partnership Allocations

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Partnerships afford the greatest flexibility to business owners to craft an entity that tracks any complex economic deal they can conceive. Along with this flexibility, however, comes complexity. Partnership tax law is charged with taxing these complex business arrangements conceived by business owners.

Partnership taxation has been referred to as the most complex area of the tax law.[1] At the heart of this complexity is the requirement that the tax consequences of a partnership's operations inure to the benefit or detriment of those partners who are economically at risk—a union of tax consequences and economic consequences.[2] Historically, drafters of partnership agreements guaranteed this union by requiring that (1) the partnership maintain a separate capital account for each partner that tracked each partner's economic rights in the partnership and (2) the partnership liquidate in accordance with those capital accounts.[3]

For partnerships liquidating in accordance with the partners' capital accounts, partnership allocations were, and still are, drafted to attempt to cause the partners' ending capital accounts to achieve the desired economic deal (so-called safe-harbor, or layer cake, allocations[4]).

A partnership "allocation" is simply a division of each item of income, gain, loss, deduction, and credit of the partnership between and among the partners. An allocation is not to be confused with a distribution of cash; and allocations and distributions do not necessarily go hand-in-hand. Also, the income or loss that is allocated in a partnership agreement is Sec. 704(b) book income or loss—not taxable income or loss. Most partnership agreements, however, require that taxable income or loss be allocated in the same manner as Sec. 704(b) book income or loss. For purposes of this article,

1 See, e.g., *Foxman*, 41 T.C. 535, 551 n. 9 (1964), aff'd, 352 F.2d 466 (3d Cir. 1965) ("The distressingly complex and confusing nature of the provisions of subchapter K present a formidable obstacle to the comprehension of these provisions without the expenditure of a disproportionate amount of time and effort even by one who is sophisticated in tax matters with many years of experience in the tax field . . . ").

2 See, e.g., McKee, Nelson & Whitmire, *Federal Taxation of Partnerships and Partners* ¶10.02[1] (Warren Gorham & Lamont 3d ed. 1996) (McKee) ("If a partner will benefit economically from an item of partnership income or gain, that item must be allocated to him so that he bears the correlative tax burden. Conversely, if a partner will suffer the economic burden of an item of partnership loss or deduction, he must be allocated the associated tax benefit. In other words, tax must follow economics.").

3 In this regard, partners' capital accounts have been described as, "in a certain sense a fiction that exists solely to assist in the allocation of taxable income or loss" (Sloan, "Opening Pandora's Box: Who Is (or Should Be) a Partner?" in Practising Law Institute, *Planning for Domestic and Foreign Partnerships, LLCs, Joint Ventures & Other Strategic Alliances*, Ch. 48-1, n. 162 (2011)).

4 Although both terms are used interchangeably in practice, this article refers to these kinds of partnership allocations as safe-harbor allocations.

unless indicated otherwise, the terms "partnership allocation" or "partnership allocations" mean allocations of partnership Sec. 704(b) book income or loss, but with the assumption that the partnership agreement requires that partnership taxable income or loss be allocated in the same manner as partnership Sec. 704(b) book income or loss.

Starting in the early 1990s, however, a new method of wedding the partnership's tax and economic consequences arose (so-called targeted, or forced, allocations[5]). Under this new method, a partnership liquidates not in accordance with partner capital accounts but, instead, in accordance with a negotiated distribution waterfall that reflects exactly the partners' economic deal. A "distribution waterfall" is just what the name implies. It is the order in which any cash available to distribute is distributed. For example, a distribution waterfall might read as follows:

> Cash available for distribution shall be distributed as follows: first, to Partner *A* equal to the amount Partner *A* has contributed to the partnership; second, to Partner *B* equal to the amount Partner *B* has contributed to the partnership; and, thereafter, equally to Partner *A* and Partner *B*.

A partnership's distribution waterfall embodies the partners' economic deal because it dictates how the partners will share all cash distributed by the partnership.

Once the economic deal (i.e., the distribution waterfall) is drafted, the partnership's allocations are then drafted to force the income or loss over the life of the partnership to be allocated so that each partner's ending capital account balance equals what it must be to allow the partnership to liquidate in accordance with the distribution waterfall, while simultaneously ensuring that each partner's ending capital account balance is reduced to zero as a result of the final partnership liquidating distribution (i.e., force partnership allocations to follow the economic deal).

Today, nearly all partnership agreements contain targeted allocations, and very few contain safe-harbor allocations. While this distinction may seem like an exercise in semantics, the consequences of drafting partnership allocations in one manner or the other can be significant to both the drafter and the tax return preparer.

This two-part article first discusses the rules governing safe-harbor allocations. Next, it discusses the rules governing targeted allocations and reasons for the use of targeted allocations. In next month's issue, part II discusses some issues targeted allocations raise and recommends guidance the IRS should issue.

Safe-Harbor Allocations

As stated above, when drafting safe-harbor allocations, the goal is to draft a set of allocations that will cause the partners' ending capital account balances to achieve a given economic deal and then to liquidate the partnership in accordance with those balances. Because allocations of partnership profit or loss increase or decrease, respectively, the partners' capital accounts, and because the partnership will ultimately be liquidated in accordance with the partners' ending capital accounts, in all but the simplest of partnership arrangements, it is difficult to correctly draft safe-harbor allocations so that the partners' ending capital accounts achieve the partners' desired economic deal.

Under Secs. 704(a) and (b), allocations of partnership income, gain, loss, deduction, or credit between or among the partners[6] are generally respected so long as the allocations to each partner (1) are set forth in the partnership agreement and (2) have substantial economic effect. Practitioners often refer to partnership allocations that satisfy these conditions as being "safe-harbor" allocations, because the allocations are drafted to satisfy the safe harbor in the regulations.

A primary advantage of safe-harbor allocations (as opposed to targeted allocations) is that, if properly drafted, they will generally be respected by the IRS and the courts.[7] So, what does it take for the allocation to have substantial economic

EXECUTIVE SUMMARY

- Partnership allocations are the division of the partnership's items of income, gain, loss, deduction, and credit between and among the partners. For allocations to be respected, they must have substantial economic effect.
- Safe-harbor partnership allocations are allocations that meet one of three requirements under Regs. Sec. 1.704-1(b) to be respected as having substantial economic effect.
- Targeted allocations, which generally do not meet any of the safe-harbor requirements, allocate partnership items so that the partners' ending capital accounts equal the amount the partners should receive under the partnership agreement's specific order of distribution in liquidation, commonly called the distribution waterfall. They will be respected if they are in accordance with the partners' interests in the partnership.
- Reasons that targeted allocations are used include that in general they are more easily understood by partners and are much easier to properly draft than safe-harbor allocations.

5 Although both terms are used interchangeably in practice, this article refers to these kinds of partnership allocations as targeted allocations. In the author's experience, nearly all partnership agreements drafted today contain targeted, as opposed to safe-harbor, allocations.

6 That is, each partner's distributive share of such items.

7 Stated differently, safe-harbor allocations comply with the safe harbor provided in the Treasury regulations.

effect (i.e., to satisfy the safe harbor in the regulations)? The test for whether an allocation has substantial economic effect is really a two-part test.[8] First, the allocation must have economic effect. Second, the allocation must be substantial. This article next discusses each part of the test in order.

Economic Effect: Three Ways to Win

If a partnership agreement provides for allocating an item of income, gain, loss, deduction, or credit to a partner, there are three ways in which the allocation can have economic effect under the Code and regulations.[9] First, an allocation will have economic effect if the allocation satisfies three strict requirements discussed below under the basic test for economic effect. Second, an allocation will have economic effect if it satisfies the alternate test for economic effect. Third, an allocation will have economic effect if, taking into account all the facts and circumstances, the allocation reaches the same result as if the three strict requirements were contained in the partnership agreement. These three tests for economic effect are explained in the next three sections.

Basic test for economic effect: A partnership allocation generally satisfies the basic test for economic effect "*if, and only if, throughout the full term of the partnership, the partnership agreement*"[10] satisfies three strict requirements. First, capital accounts must be maintained in accordance with the regulatory requirements. Second, partnership liquidating distributions are required to be made "in all cases" in accordance with the partners' positive capital account balances (after taking into account all adjustments, if any, for the partnership tax year during which the liquidation occurs). Third, any partner having a deficit in his or her capital account after taking into account all adjustments for the tax year of liquidation must be unconditionally obligated to restore the deficit no later than the end of the tax year, or, if later, within 90 days after the liquidation date (a "deficit restoration obligation").

Collectively, these three requirements are the "big three." If any one of the big three is not satisfied, then no allocation of the partnership can ever satisfy the basic test for economic effect. Thus, if a partnership is formed on day 1, but no agreement (oral or written) satisfying the requirements set forth in the previous sentence is entered into until day 2, then the allocations will never satisfy the basic test for economic effect.

Practice tip: This issue arises frequently in practice. Through oversight, an entity is formed but no agreement (oral or written) is entered into until sometime after the formation. Often, upon inquiry, it turns out that the parties orally entered into a partnership agreement to be memorialized in writing at a future time. If so, it is crucial that the drafter make clear that an oral partnership agreement has been entered into effective as of formation and that the agreement previously entered into is now being memorialized in writing.[11]

Alternate test for economic effect: Many state law entities taxed as partnerships for U.S. federal tax purposes afford their owners limited liability. For example, a limited partner in a limited partnership is not generally liable for the limited partnership's obligations.[12] The same can generally be said for members of limited liability companies (LLCs) and partners in limited liability partnerships (LLPs).[13] Recognizing that members of limited liability entities taxed as partnerships for U.S. federal tax purposes might not want to obligate themselves to contribute additional funds to the entity, the IRS adopted an alternate test for economic effect to accommodate members of those entities.[14]

Under the alternate test for economic effect, the partnership agreement must first satisfy the first two requirements of the big three (i.e., the partnership agreement must provide for maintaining capital accounts, and the partnership must liquidate in accordance with the partner's positive capital accounts). If so, then an allocation to a partner will have economic effect even if the partnership agreement does not contain a deficit restoration obligation (or even if the deficit restoration obligation is limited) so long as two additional requirements are satisfied.

First, the partnership agreement must contain a "qualified income offset" provision.[15] Second, the allocation must not cause or increase a deficit balance in the capital account of the partner receiving the allocation.[16] For purposes of testing whether an allocation causes or increases

8 Regs. Sec. 1.704-1(b)(2)(i).

9 Regs. Sec. 1.704-1(b)(1)(i).

10 Regs. Sec. 1.704-1(b) (emphasis added).

11 See Regs. Sec. 1.704-1(b)(2)(ii)(h) (defining "partnership agreement" for purposes of Sec. 704 to include "all agreements among the partners, or between one or more partners and the partnership, concerning affairs of the partnership and responsibilities of the partners, *whether oral or written*, and whether or not embodied in a document referred to by the partners as the partnership agreement") (emphasis added).

12 See, e.g., Uniform Limited Partnership Act §303 (2001). There are situations in which a limited partner could be held liable for the limited partnership's obligations. For example, in some states, a limited partner may be found responsible if the limited partner knowingly allows his or her name to be used in the limited partnership's name, also serves as a general partner, or participates in the management and control of the limited partnership's business (Callison and Sullivan, *Partnership Law and Practice* §23:1 (Clark Boardman Callaghan 2011)).

13 For a discussion of piercing the veil of noncorporate limited liability entities, however, see, e.g., Schwindt, "Limited Liability Companies: Issues in Member Liability," 44 *UCLA L. Rev*. 1541 (June 1997); Rapp, "Preserving LLC Veil Piercing: A Response to Bainbridge," 31 *J. Corp. L*. 1063 (Summer 2006); Klein, "Piercing the Veil of the Limited Liability Company, From Sure Bet to Long Shot: *Gallinger v. North Star Hospital Mutual Assurance, Ltd*.," 22 *J. Corp. L*. 131 (Fall 1996); Michael, "To Know a Veil," 26 *J. Corp. L*. 41 (Fall 2000); Callison, "Rationalizing Limited Liability and Veil Piercing," 58 *Bus. Law*. 1063 (May 2003); Miller, "Are There Limits on Limited Liability? Owner Liability Protection and Piercing the Veil of Texas Business Entities," 43 *Tex. J. Bus. L*. (Fall 2009); and Morrissey, "Piercing All the Veils: Applying an Established Doctrine to a New Business," 32 *J. Corp. L*. 529 (Spring 2007).

14 Regs. Sec. 1.704-1(b)(2)(ii)(d).

15 Regs. Sec. 1.704-1(b)(2)(ii)(d)(3).

16 Regs. Sec. 1.704-1(b)(2)(ii)(d)(3) (flush language). Because an allocation will not be respected if it causes or increases a deficit in a partner's capital account, it is advisable to include a provision in the agreement that notwithstanding any other provision in the agreement, no allocation or distribution shall be made to a partner if such allocation or distribution causes or increases a deficit in any partner's capital account.

a deficit balance in a partner's capital account, the partner's capital account is reduced for (1) certain depletion allowances,[17] (2) certain loss and deduction allocations,[18] and (3) distributions that, as of the end of the year, are reasonably expected to be made to the partner.[19] A partnership agreement contains a "qualified income offset" provision "if, and only if, it provides that a partner who *unexpectedly* receives an adjustment, allocation, or distribution described in [the previous sentence] will be allocated items of income and gain . . . in an amount and manner sufficient to eliminate such deficit balance as quickly as possible."[20]

Economic effect equivalence test: Even if an allocation fails both the basic and alternate tests for economic effect discussed above, it may still be deemed to have economic effect if, as of the end of each partnership tax year, a liquidation of the partnership would produce the same economic results to the partners as if each requirement of the big three were satisfied regardless of the partnership's economic performance.[21] Stated differently, even if the partnership agreement fails in every way, but liquidating the partnership at the end of the tax year would end with the same results as if the partnership agreement satisfied the big three at the end of each tax year and regardless of the performance of the partnership, then the allocation rules deem the partnership's allocations to have economic effect.[22]

Practice tip: This test is often referred to as the "dumb, but lucky, rule" for obvious reasons. Although it exists as a fallback, taxpayers relying on the safe harbor generally should never plan a transaction based on satisfying this test. Instead, taxpayers seeking the protection of the safe harbor should carefully craft partnership allocations to satisfy either the basic or the alternate test for economic effect.[23]

Substantial

Even if an allocation has economic effect under the basic test, the alternate test, or the economic effect equivalence test, it will not be respected unless the economic effect of the allocation is "substantial." The economic effect of an allocation generally is substantial if there is a reasonable possibility that the allocation will affect substantially the dollar amounts the partners will receive from the partnership, independent of tax consequences.[24] However, the economic effect of an allocation is not substantial if, at the time the allocation becomes part of the partnership agreement, (1) the after-tax economic consequences of at least one partner may, in present-value terms, be enhanced compared to the consequences if the allocation were not in the partnership agreement and (2) there is a strong likelihood that the after-tax economic consequences of no partner will, in present-value terms, be substantially diminished compared to the consequences if the allocation were not in the partnership agreement.[25] Thus, the substantiality rules mandate an examination of each partner's personal tax situation.

A detailed discussion of the substantiality requirement is beyond the scope of this article.[26] Any tax-motivated partnership allocation should be carefully tested under the substantiality requirement.

Targeted Allocations

Safe-harbor partnership allocations (i.e., those complying with the substantial economic effect requirements discussed above) prevailed until sometime in the early 1990s when certain drafters of partnership agreements made a conscious decision to draft partnership allocations in a completely different manner. Drafters of targeted allocations do not draft allocations to try to cause the partners' ending capital accounts to achieve an economic deal. Instead, drafters of targeted allocations first draft a distribution waterfall (i.e., the partners' economic deal) and then draft a simple allocation provision that mandates that partnership profit or loss be allocated to cause the partners' ending capital account balances to equal what they must be in order to liquidate the partnership in accordance with the distribution waterfall (thus causing each partner's ending capital account balance to be reduced to exactly zero by the partnership liquidating distribution).

A typical distribution waterfall might be as follows:

> Cash Available for Distribution (defined here to mean cash flow from any source, including a sale of all the partnership's property) shall be distributed as follows:[27]
>
> - First, to the Preferred Interest Partners in proportion to and to the extent of their Contributed Capital;
> - Second, to the Common Interest Partners to the extent of and in proportion to the Common Interest Partners' Contributed Capital;

17 Regs. Sec. 1.704-1(b)(2)(ii)(d)(4).

18 Regs. Sec. 1.704-1(b)(2)(ii)(d)(5).

19 But only to the extent such distributions exceed offsetting increases to such partner's capital account that reasonably are expected to occur during the partnership tax years in which such distributions are expected to be made (Regs. Sec. 1.704-1(b)(2)(ii)(d)(6)).

20 Regs. Sec. 1.704-1(b)(2)(ii)(d) (flush language) (emphasis added). The emphasized language makes clear that *expected* adjustments, allocations, or distributions are not protected by this rule. For a more in-depth analysis, see, e.g., Cuff, "The Alternate Test for Economic Effect and the Qualified Income Offset," in Practising Law Institute, *Planning for Domestic and Foreign Partnerships, LLCs, Joint Ventures & Other Strategic Alliances*, Ch. 78-1 (2011).

21 Regs. Sec. 1.704-1(b)(2)(ii)(i).

22 Id.

23 But see the discussion *infra* regarding targeted allocations and substantial economic effect.

24 Regs. Sec. 1.704-1(b)(2)(iii)(a).

25 Id.

26 For more in-depth discussion of the substantiality requirement, see, e.g., Buchholz, "Section 704(b)—Substantiality," in Practising Law Institute, *Planning for Domestic and Foreign Partnerships, LLCs, Joint Ventures & Other Strategic Alliances*, Ch. 82-1 (2011); and Scharfstein and Falevich, "Ruminations on Substantiality Under the Section 704(b) Regulations," in Practising Law Institute, *Planning for Domestic and Foreign Partnerships, LLCs, Joint Ventures & Other Strategic Alliances*, Ch. 83-1 (2011). One unresolved issue not discussed by these commentators is whether drafting a partnership allocation constitutes a "transaction" subject to Sec. 7701(o).

27 On liquidation, Cash Available for Distribution is first used to pay any outstanding liabilities of the partnership and to set up any necessary reserves before any distribution is made to the partners.

- Third, to the Preferred Interest Partners to the extent of and in proportion to the Preferred Interest Partners' Unpaid Preferred Return;
- Thereafter, to the Common Interest Partners in proportion to the Common Interest Partners' Percentage Interests.

Once the distribution waterfall is drafted, the drafter next drafts an allocation provision that allocates items of partnership income, gain, loss, deduction, and credit to force the partners' ending capital accounts to equal the amount each partner would receive if the partnership sold all of its assets for book value and liquidated the partnership in accordance with the distribution waterfall. For this purpose, book value does not mean adjusted tax basis or GAAP book value. Instead, book value means the Sec. 704(b) book value of the assets inside the partnership, i.e., the book value computed in accordance with the Sec. 704(b) regulations.[28] In all but the simplest of partnerships, complying with the partnership tax rules and following the partners' desired economic arrangement requires maintaining at least two sets of partnership books tracking at least two different sets of partner capital accounts from inception: (1) tax and (2) Sec. 704(b). In all but the simplest of partnerships, any attempt to prepare a partnership tax return, including the allocation of income or loss between or among the partners, or to divide proceeds on liquidation between or among the partners, without maintaining separate (1) tax and (2) 704(b) partner capital accounts from inception is akin to driving a car in the dark with the headlights turned off—you might get lucky and end up in the right place, but you do not know whether you will, and even if you do end up in the right place, you will not know that the place you ended up is the right place.

A typical targeted partnership allocation provision might read as follows:

> Partnership Profit or Loss shall be allocated in a manner to cause the Partners' ending Capital Accounts to equal the amount they would receive if the Partnership were to sell all of its assets for Book Value and liquidate pursuant to the liquidation waterfall set forth in Section [xx] of this Agreement.

Thus, instead of liquidating the partnership in accordance with the partners' ending capital accounts and trying to draft partnership allocations that "hit" the mark (i.e., trying to draft partnership allocations that cause the partners' ending capital accounts to equal the amount the partners should receive under the partners' economic deal), a targeted allocation uses partnership allocations of income, gain, loss, deduction, and credit to force the partners' ending capital accounts to equal the amount the partners would receive if the partnership were to liquidate in accordance with the distribution waterfall (i.e., the partners' economic deal). The targeted allocations of partnership items of income, gain, loss, deduction, and credit force partners' capital accounts to follow the economic deal.

Because targeted allocations do not comply with the safe-harbor rules, though, they will be respected under the partnership tax rules only if they are deemed to be in accordance with the "partners' interest in the partnership."[29] Very generally, the partners' interest in the partnership signifies the manner in which the partners have agreed to share the economic benefit or burden (if any) corresponding to the income, gain, loss, deduction, or credit (or item thereof) that is allocated.[30]

Factors considered in determining each partner's interest in the partnership include each partner's (1) contributions to the partnership, (2) interest in the economic profits and losses (if different from that in taxable income or loss), (3) interest in partnership cash flow and other nonliquidating distributions, and (4) rights to distributions of capital upon liquidation.[31] Under this test, so long as partnership allocations are proportionate to partner capital, then targeted allocations generally work fine. If one or more partnership allocations are not in proportion to partner capital ("special allocations"[32]), however, then targeted allocations may not always achieve the desired result.

Why the Shift?

The most common reason cited for the shift from safe-harbor to targeted allocations by drafters of partnership agreements is that clients have difficulty understanding safe-harbor allocations and capital accounts, but clients do understand their economic deal (i.e., the distribution waterfall). Another reason given for using targeted allocations versus safe-harbor allocations is fear that mistakes in the allocations will distort the desired economic deal.

Whatever the original reason for the shift, there is another more important reason that caused drafters to almost completely abandon safe-harbor allocations in favor of targeted allocations. To understand this reason, one has to look at the partnership allocation scheme through two different sets of eyes: (1) those of the drafter of the partnership agreement and (2) those of the person preparing the partnership tax return.

The drafter of the partnership agreement prefers to draft targeted allocations in partnership agreements because it reduces malpractice risk. When drafting safe-harbor allocations, drafters must cause the detailed allocations they have drafted to result in ending capital account balances that achieve the partners' economic deal because each partner will receive a liquidating distribution of his or her ending capital account balance and because the allocations will impact the amount of each

28 See Regs. Sec. 1.704-1(b)(2)(iv)(b) (basic capital account maintenance rules).

29 Sec. 704(b) and Regs. Sec. 1.704-1(b)(3).

30 Regs. Sec. 1.704-1(b)(3)(i).

31 Regs. Sec. 1.704-1(b)(3)(ii). An in-depth consideration of "partners' interest in the partnership" is beyond the scope of this article. For a more detailed analysis of the topic, see, e.g., Whitmire et al., *Structuring and Drafting Partnership Agreements: Including LLC Agreements*, ¶¶4.02 and 4.03 (Thomson/RIA 2012); McKee at ¶11.03; Willis et al., *Partnership Taxation*, ¶¶10.01–10.05 and 22.03-22.04 (Thomson/RIA 2012) (Willis).

32 The term "special allocation" does not appear in the Code or Treasury regulations. The term is part of partnership law, however. See Willis at ¶¶10.01[2] n. 16 and 10.01[3][c]. The term generally refers to an allocation of partnership income, gain, loss, deduction, or credit in a manner that is not in proportion to the partners' respective interests in the partnership (usually referring to partners' capital contributions).

partner's ending capital account balance. Any mistake in drafting the partnership allocations can distort the economic deal.

To assist in the drafting process, careful drafters engage the help of accountants or other professionals who are skilled at modeling partnership allocations, including allocations of debt among the partners and the dreaded Sec. 704(c) allocations, to prepare partnership allocation models (or "what-ifs"). Often, the models are run in several different ways—assuming there are losses in early years followed by profits throughout the life of the partnership; assuming there are losses throughout the life of the partnership; assuming there are losses in early years, followed by years of profits, followed by more years of losses, etc. Sometimes, one or more of these models is attached to, and becomes a part of, the partnership agreement as an example of how the parties understand the economic deal should work under different scenarios.

Engaging accountants or other professionals to carefully model the partnership's allocations over the expected life of the partnership greatly mitigates the risk to the drafter of a partnership agreement. However, despite the added value and lessened risk, accountants or other professionals are rarely engaged to model partnership allocations before a partnership agreement is executed, even in complicated economic arrangements. One can question whether this is because drafters do not advise clients to have partnership allocations modeled or whether clients simply refuse the advice because they do not want to pay the added cost.

By drafting the economic deal (i.e., the distribution waterfall) and then forcing the allocations to be carried out to achieve that economic deal, by contrast, drafters achieve two goals. First, they guarantee the client's economic deal will be preserved. Second, they transfer the burden of making sure the allocations are proper onto the person preparing the partnership tax return. Stated differently, a targeted allocation is not an allocation at all, but simply a directive to draft an allocation. By not drafting the allocation, the drafter may have avoided the risk of being the "preparer" with respect to the partnership's allocations.

Thus, by drafting targeted allocations the drafter has mitigated the risk of the drafted allocations' not achieving the client's economic deal and that the drafted allocations will not be respected for tax purposes. Instead, with targeted allocations, the risk of getting the partnership's allocations correct is entirely on the person preparing the partnership tax return—not on the drafter of the partnership agreement. In all but the simplest of partnership arrangements, tax return preparers should ask the drafter of a partnership agreement containing targeted allocations to provide a set of partnership allocations for use in preparing the partnership tax return (including the allocations of partnership items of income, gain, loss, deduction, and credit contained therein). Obtaining a set of partnership allocations from the drafter shifts the risk back to the drafter of the partnership agreement to draft a set of allocations that will properly achieve the partners' desired economic deal.

If the drafter of a partnership agreement does not draft partnership allocations designed to cause the partner's ending capital account to equal what it must to achieve the partners' economic deal, then the drafter has avoided the risk that those allocations are wrong. The drafter may have also avoided being the "preparer" with respect to the allocation of partnership items of income, gain, loss, deduction, and credit set forth in the partnership agreement that is reported on either (1) the Form 1065 filed by the partnership or (2) the tax return filed by each partner, whether an individual (Form 1040) or entity (e.g., Form 1065, Form 1120, Form 1120S, or Form 1041) tax return.[33]

If the drafter of a partnership agreement is a "preparer" with respect to the allocations of partnership income or loss set forth in the partnership agreement, then he or she must take care to comply with the due-diligence requirements of Circular 230, which might include, at a minimum, advising clients who are partners of all but the simplest of partnerships to engage accountants or other professionals to model the partnership's allocations before executing the partnership agreement.[34] A leading commentator strongly suggests involving accountants in the drafting process to ensure they understand the language of the provisions in the partnership agreements.[35]

Part II of this article, in next month's issue, will discuss a number of unresolved issues regarding targeted allocations.

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EditorNotes

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33 See, e.g., Sec. 7701(a)(36); Regs. Secs. 301.7701-15(a), 301.7701-15(b)(2), 301.7701-15(b)(3)(i), 301.7701-15(b)(3)(ii), and 301.7701-15(b)(3)(iii). See also *Adler & Drobny, Ltd.*, 9 F.3d 627 (7th Cir. 1993), rev'g 792 F. Supp. 579 (N.D. Ill. 1992) (suggesting that accountants who prepared a partnership return may be "preparers" of each partner's return if the income or loss reported to each partner constitutes a "substantial portion" of a partner's tax return); *Adler*, No. 88 C 10051 (N.D. Ill. 1995), on remand from 9 F.3d 627 (7th Cir. 1993) (holding that accountants who prepared a partnership tax return were "preparers" of a substantial portion of the partners' tax returns and, therefore, presumably were "preparers" of the individual partners' tax returns); *Goulding*, 717 F. Supp. 545 (1989) (holding generally that an attorney who prepared a partnership tax return is the "preparer" of each partner's return); and *Pugh*, 717 F. Supp. 2d 271 (E.D.N.Y. 2010) (holding as a preparer someone who did not actually sign the tax return, but rendered advice on a position that appeared in the tax return).

34 See Circular 230, *Regulations Governing Practice Before the Internal Revenue Service* (31 C.F.R. Part 10), §10.22.

35 Cuff, "Drafting Tax Distribution Provisions," 38 *Real Estate Tax'n* 10 (Fourth Quarter 2010).