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In this article, Spence illustrates how treating tax distributions as advances of regular distributions may produce unintended results when the ownership of a partnership changes after tax distributions are made.

Many partnership and limited liability company agreements provide that tax distributions are advances of regular distributions. That can produce unintended results when the ownership of a partnership changes after tax distributions are made.

Approaches to Tax Distributions

Most LLC and partnership agreements provide for tax distributions. Tax distributions are usually based on allocations of actual taxable income. Sometimes, however, section 704(c) and reverse section 704(c) allocations and section 743 basis adjustments are disregarded.

Often the right to tax distributions is separate from regular distributions. In some cases, tax distributions are required only to the extent regular distributions are not sufficient for the payment of taxes. Tax distributions are usually authorized only to the extent of available cash and permitted by loan agreements and applicable law.

Disproportionate Allocations of Taxable Income

Even if a partnership has only one class of interest so that all units have identical distribution rights (other than tax distributions), allocations of taxable income among the partners may not be pro rata. Section 704(c) allocations are required if a partner contributes appreciated property. If a partner acquires an interest from another partner when the partnership has a section 754 election, there is a section 743 basis adjustment that affects taxable income allocated to the purchaser. If a partner inherits an interest upon the death of a relative when the partnership has a section 754 election, there is a section 743 basis adjustment. If a partner makes a capital contribution for a new interest after the partnership's assets appreciate, there may be a restatement of book basis and capital accounts that requires reverse section 704(c) allocations.

Allocations of income will not be pro rata with units if a partnership has more than one class of units that have different distribution rights. If a partner has a preferred interest with an annual preferred return, income will generally be allocated first to match the preferred return. If a partner has a catch-up profits interest, income will generally be allocated first to cause the partner's capital account to catch up. If a manager has a carried interest, all income may be allocated to the manager after a specified target is achieved until the manager has received a pro rata share of income on a cumulative basis. If there are both preferred and common interests, losses are generally first allocated to the common interest. The first income is then allocated to the common interest to reverse the prior loss allocations or to the preferred interest to match the preferred return.

Business Intent

Most business people believe partners should receive distributions at least sufficient to pay taxes on the partnership income allocated to them. Business people also usually believe tax distributions should not change the business deal on a cumulative basis. Under that approach, if there are disproportionate tax distributions, adjustments are made to later regular distributions so that on a cumulative basis the disproportionate tax distributions do not alter the partners' economic rights. Most agreements address that by stating tax distributions are advances of regular interim and liquidating distributions. Those are, of course, business issues. Some agreements do not provide for tax distributions. Some provide for tax distributions but do not treat them as advances of regular distributions.

Treating tax distributions as advances of regular distributions may produce unintended results when the ownership of a partnership changes after tax distributions are made. That is illustrated in the examples below. In most cases, business people intend partners who acquire interests after a tax distribution has occurred not to receive additional distributions resulting from treating prior tax distributions as advances or loans. It is helpful for the tax distribution provision to state, for the avoidance of doubt, (1) tax distributions are treated as advances only in determining the distribution rights of interests outstanding when the tax distribution was made, and (2) the distribution rights of interests issued after a tax distribution are unaffected by the previous tax distributions.

Examples

Example 1. A and B form a simple 50-50 partnership. The agreement provides tax distributions based on actual taxable income allocations. A is allocated more taxable income than B because A contributed appreciated assets. In the first year, there are no regular distributions. In that year A receives tax distributions of $100,000. B receives tax distributions of $50,000. In the second year, the partnership makes a regular distribution of $450,000. Because the tax distributions in the prior year are treated as an advance of regular distributions, in year 2 the distributions are $200,000 to A and $250,000 to B. After that, each has received cumulative distributions of $300,000, which is consistent with the 50-50 deal.

Example 2. Assume the same facts as above, except at the end of year 1, B sells its interest to C. C should step into the shoes of B. Thus, the distribution during year 2 should be $200,000 to A and $250,000 to C. Conversely, if C acquired A's interest, the distribution during the second year should be $200,000 to C and $250,000 to B. It is helpful for a tax distribution provision to state that, for the avoidance of doubt, assignees step into the shoes of assignors in treating tax distributions as advances of regular distributions.

Example 3. Assume the same facts as in Example 1, except at the end of the first year, the partnership redeems half of B's interest. Thereafter, regular distributions are generally two-thirds to A and one-third to B. When the partnership distributes $450,000 in year 2, the parties probably intend the previous tax distributions to be handled as if B's units had been held by two persons, one whose interest was redeemed and another who retained its interest. Thus, B should probably receive an additional $25,000 rather than $50,000. The $450,000 should probably be distributed $283,333 to A and $166,666 to B. Issues of that type should be discussed with the parties in negotiating and drafting redemption and similar agreements.

Example 4. Assume the same facts as in Example 1, except at the end of year 1, C makes a capital contribution to acquire a one-third interest. The parties do not consider the effect of previous tax distributions and their treatment as advances of regular distributions. If the tax distribution in year 1 is treated as a true advance, the distribution in year 2 might be $100,000 to A, $150,000 to B, and $200,000 to C. That is probably inconsistent with the parties' intent. They probably view C as acquiring a true one-third interest without any benefit from treating prior tax distributions as advances. If the parties fully consider the issue, they probably intend the distribution to be $125,000 to A, $175,000 to B, and $150,000 to C.

Example 5. Assume for 10 years A and B receive only tax distributions. Each receives $10 million of tax distributions over that period. After year 10, C makes a capital contribution for a one-third interest. The parties do not consider the effect of previous tax distributions. In year 11 the LLC makes a $10 million regular distribution. If the previous tax distributions are treated as true advances, the entire $10 million is distributed to C. That is almost certainly not the parties' intent. The parties probably intend for C to receive one-third of the distribution regardless of prior tax distributions. If A and B had received different amounts of cumulative tax distributions, the distributions between them should be adjusted to reflect that, with no effect on C.

Example 6. Assume the same facts as in Example 1, except after year 2, C makes a capital contribution for a one-third interest. Even if tax distributions are generally treated as true advances, the tax distribution in year 1 should probably be disregarded in year 3 and subsequent years because in year 2 regular distributions were adjusted to reflect tax distributions in year 1.

Example 7. Assume A and B each receive a $100,000 tax distribution in year 1. Assume in year 2 each receives a $100,000 regular distribution. C makes a capital contribution for a one-third interest at the end of year 2. Even if tax distributions are generally treated as true advances, should the tax distributions in year 1 be disregarded because they should be treated as reversed in year 2, notwithstanding that all distributions were pro rata? Should the result be affected by whether the distribution in year 2 is (1) a tax distribution or (2) a regular distribution because the agreement states tax distributions are not made to the extent regular distributions are sufficient to pay taxes? In each case, the parties probably intend for C to be unaffected by tax distributions in prior years and instead receive one-third of all distributions (other than potentially disproportionate tax distributions).

Example 8. Assume A and B each receive a $100,000 tax distribution in year 1. At the end of year 1, the partnership grants a profits interest to C entitling it to one-third of distributions after cumulative distributions to A and B equal $1 million. At the end of year 2, the partnership makes a regular distribution of $1.45 million. The first $1 million is distributed to A and B because of C's hurdle. If the tax distributions in year 1 are treated as true advances, the remaining $450,000 will be distributed about $118,000 to A, $118,000 to B, and $218,000 to C. That is almost certainly not the parties' intent.

Conclusion

It is surprising that partnership and LLC agreements routinely state that tax distributions are advances of regular distributions without addressing potential later changes in ownership. Not doing so risks uncertainty and disputes and may result in distributions that are inconsistent with the partners' intent. ■