Alert

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Drafting Partnership Agreements: Ensuring You Get the Returns You Bargained For

PIP (partners' interests in the partnership) allocations are very commonly used in partnership agreements.[1] For this reason, Investors and managers should understand the basics of PIP allocations and whether and when they should be used before entering into a partnership agreement.

In this Alert, we cover the following topics:

- What are PIP allocations?
- How do PIP allocations work?
- Choices in applying PIP allocations
- When they are useful?
- When they are less useful?
- When they are at odds with other allocations?
- Whether PIP allocations obviate the need for special allocations like nonrecourse deductions, minimum gain, qualified income offset, and curative allocations

Background

First, some background on partnership allocations in general.

A partnership is taxed under partnership tax rules. Those rules require the partnership to create and maintain a capital account for each partner. The capital account maintenance rules are accounting rules. Those rules can be complex and unyielding. A mistake, or failing to anticipate and address an economic cost or reduced earnings, can cause capital accounts to fall out of line with the business deal. That is unless the partnership properly employs PIP allocations. Properly employed PIP allocations force the capital account balances to align as closely as possible with the business deal. The following discusses factors to consider in properly drafting and employing PIP allocations.

PIP Allocations

After taking into account Special Allocations (see below), a partnership using PIP allocations employs a five-step process:

- **Step 1:** Determine cash available for a liquidating distribution if assets were sold for book values and all debts/liabilities were discharged[2]
- **Step 2:** Determine how net cash would be distributed to the partners
- **Step 3:** Determine each partner's pre-allocation capital account balance[3]
- **Step 4:** Adjust each partner's capital account balance for shares of minimum gain (as described below)
- **Step 5:** Allocate income items so each partner's post-allocation adjusted capital account equals the cash that the partner would receive in Step 2

As noted in Step 4, the capital accounts need to be adjusted for shares of minimum gain. The

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adjustment for minimum gain shares accounts for gain that will eventually be allocated to the partners under the minimum gain chargeback rules. If this adjustment were not made, PIP allocations would cause capital accounts to be out of line with the partners' shares of liquidation proceeds under Step 2.

As a technical matter, PIP allocations are not authorized by partnership tax rules except in limited situations. Most practitioners are comfortable, though, that PIP allocations align with the policy of partnership tax rules and should be respected, if properly implemented, in most situations. The Treasury Department and the IRS seem to agree, to some degree anyway. They know that PIP allocations are widely used. They have also asked tax practitioners for input on rules that would govern PIP allocations. Still, you should know that there is no expressed authority for using PIP allocations in the way they are most commonly employed.

Items to Allocate Under PIP

PIP allocations are often drafted to allocate net profits or net losses, (aka, profits and losses) which are net amounts. To determine net profits (and net losses) the partnership nets all income and deduction items (after taking account of special allocations). This approach can cause capital accounts to differ from shares of liquidation proceeds. Such an imbalance can occur when, for example, one partner's capital account is greater than that partner's share of proceeds, but the partnership is allocating net profits. For this reason, when allocating net profits and net losses under PIP, it is necessary at some point to correct imbalances in capital accounts with allocations of individual income items in lieu of net profits or net losses. Often, this correction occurs when the partnership is liquidated.

PIP allocations are sometimes drafted to allocate individual items of income, deduction, gain, and loss (Income Items). This approach allows the partnership more flexibility in achieving correct capital account balances annually. So, in contrast to allocating net profits or net losses, allocating Income Items usually does not require special allocations of individual items on liquidation. However, when allocating Income Items, it is important to direct the partnership to allocate pro rata shares of each income item as much as possible. So, for example, this approach would prevent one partner from receiving ordinary income while another partner receives an equal amount of long-term capital gain.

While you can allocate under PIP using net profits or losses, or Income Items, for several reasons due mainly to timing, the choice between these two methods can have a significant impact on after-tax returns for partners. The partners should determine which approach works best for each deal.

When PIP Allocations Are Useful

PIP allocations are most useful for complex waterfalls. PIP allocations work well if the waterfall contains hurdles or thresholds. PIP allocations are also useful when the partners' ownership interests are divided between/among classes, especially if one class has a preference[4] over others.

When PIP Allocations Are Not So Useful

PIP allocations are not nearly as useful when partners contribute capital and share cash according to unit ownership or percentage interests. In these simple straight up partnerships, it makes sense to consider using other safe harbor allocations.

When PIP Allocations Are at Odds with Other Tax Rules

Some partnerships should generally not use PIP allocations:

- Any partnership that generates low-income housing tax credits, historic rehabilitation tax credits, or renewable energy tax credits allocates those credits under special rules. Those rules, though, will not apply if the partnership uses PIP allocations. For this reason, these partnerships generally use safe harbor allocations.
- Any partnership that applies the fractions rule cannot use PIP allocations. The fractions rule is an allocation method that can apply to certain tax-exempt entity partners. If the rule is

correctly applied, tax-exempt partners should not realize unrelated business taxable income on account of debt-financed income.

- Any partnership that issues non-compensatory partnership options, including interests of one class that are convertible into another class of interest (e.g., preferred to common). The regulations addressing these options only apply if safe harbor allocations are used. Drafters should carefully consider how to account for the conversion feature if the partnership uses PIP allocations.
- Tax regulations provide a safe harbor rule for allocating nonrecourse deductions. That safe harbor is not available if the partnership uses PIP allocations. In practice, though, partnerships using PIP allocations also allocate nonrecourse deductions under that safe harbor. Practitioners generally take comfort in the fact that the safe harbor is designed to cause the nonrecourse deduction to be allocated according to the partners' interests in the partnership.

Special Allocation Provisions

Most partnership agreements include special allocations for qualified income offset rules, nonrecourse deductions, and minimum gain chargebacks. There are two reasons to keep these allocations, though they are arguably unnecessary (especially the qualified income offset). First, the nonrecourse deductions and minimum gain chargeback rules instruct the partnership managers on allocating these items under accepted rules, and those allocations most likely will be according to the partners' interests in the partnership. Second, many (opposing counsel) practitioners will want those provisions included in the partnership agreement.

Curative Allocations

Curative allocations are intended to reverse the effect of the other special allocations to the extent those other allocations cause capital accounts to be at odds with the business deal. In other words, they have the same goal as PIP allocations. Yet, they can also interfere with the goal of PIP allocations to cause every partner's capital account to be as close as possible to that partner's share of liquidation proceeds. For this reason, you should consider whether curative allocations should be included if PIP allocations are used.

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[1] The term *partnership* herein means a partnership for U.S. federal income tax purposes, including a limited liability company (LLC) with two or more members that have not elected to be taxed as a corporation. A *partnership agreement* includes an LLC's operating agreement or limited liability company agreement.

[2] Also, adjust for unfulfilled partner obligations to contribute capital, if applicable.

[3] Adjust the balance for contributions and distributions made during the given tax year.

[4] If a preferred interest has a conversion feature, consider whether and (if so) how PIP allocations can work with that conversion feature.