Drafting Allocation and Distribution Language for LLCS and Partnerships

The New Trend

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The Section 704(b) Regs. In 1985, the IRS issued final regulations under Section 704(b) of the Internal Revenue Code. The new Regs set out intricate rules under which the allocations of gain and loss from a partnership to its partners had to be reflected in the partners' capital accounts. The Regs provided that allocations carried out in accordance with the new rules would generally be respected for tax purposes so long as the partners' ultimate rights to distributions were tied directly to their positive capital account balances.

Efforts To Comply – Income Allocations Drive Distributions. The initial reaction of practitioners was confusion and a bit of paranoia. There followed a long period during which advisors drafting allocation provisions in partnership agreements (and in operating agreements for LLCs treated as partnerships for tax purposes) would go to excruciating lengths to comply. With simple allocation schemes based merely on a fixed-percentage sharing ratio among the partners, compliance remained fairly easy. But when there was a system of preferences in the intended distributions, a so-called "waterfall" in which some partners would be paid up to certain targets prior to distributions to the other partners, the complexity quickly compounded. Drafters struggled to craft allocations of gain and loss that would set up the partners' capital accounts so that the partners would, some years into the future, be entitled to receive the distributions the parties had intended in their original agreement.

The Backlash – Deliberately Directing That Distributions Drive Income Allocations. In recent years, there has been a shift in the attitude of many attorneys preparing allocation language. The trend now is to set out the intended distribution scheme for the partners and to simultaneously instruct the entity's managers simply to allocate gain and loss in a manner that will result in capital accounts allowing the intended distributions to occur. This approach achieves several positive goals. It permits the economic distributions to drive the tax allocations, instead of the tax allocations determining the economic distributions. It also eliminates a lot of dense allocation language that was difficult to draft and difficult to interpret and that tended to be a source of frustration and confusion for clients. The main disadvantage to this approach is that it creates some ambiguity and uncertainty as to the exact allocations of taxable gain and loss that will occur. Many clients, however, will perceive this as an acceptable trade-off, especially if tax benefits are not a material aspect of an investment in the client's partnership or LLC.

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Keep this in mind as you prepare new partnership agreements and operating agreements for your clients. And be aware of this as you review agreements drafted by others – the new approach is often a deliberate choice of flexibility, expediency and efficiency over precision.